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Labor Policy in the Great Recession

ROBERT J. FLANAGAN*

All political administrations confront two great labor market concerns—the general level of employment and the distribution of wages, employment, and other labor market outcomes. Although both of these concerns faced the Obama administration, which inherited both a serious recession and an upward trend in earnings inequality, the country's severe employment losses clearly presented the more urgent problem. This Article considers the policy responses and the scope for labor market regulation in addressing these challenges.

All political administrations also confront two constraints in the pursuit of their labor market goals. Responsible labor market policy design must recognize tradeoffs—inherent conflicts with other policy objectives. Efforts to raise employment eventually encounter very real risks of inflation, expansionary fiscal policies increase federal budget deficits, and efforts to reduce inequalities may mute incentives. The art of policymaking involves judging how far key objectives can be pursued before the tradeoffs become salient.

The political system imposes the second constraint. Raising the level of employment is largely an issue for macroeconomic policy on which there are distinct limits on a president's power. Employment losses during a recession may be reversed by appropriate monetary and fiscal policies, but U.S. presidents do not get to design and implement monetary policy. The Federal Reserve Board (FRB), which formulates and implements U.S. monetary policy, remains formally independent of the executive branch of government. Its members serve long, staggered terms that are independent of national political cycles. The FRB may choose monetary policies that complement the nation's fiscal policies, but it is not required to do so and has not always chosen to do so. (The European Central Bank enjoys similar independence as do central banks in a growing number of countries.) A president can initiate fiscal policies by proposing changes in expenditures and/or the tax code, but all such proposals may be altered significantly before they acquire congressional approval. The same may be said of policies and regulations aimed at altering the pay distribution. Under the extensive sharing of powers in U.S. political system, no president has the unilateral power to “bail out” workers or to alter the pay distribution.

Part I of this Article addresses efforts to attain full employment by countering the decline in aggregate demand for the nation's production. This is mainly macroeconomic terrain with little useful role for traditional labor market regulation. In fact, there is evidence (discussed in Part II of this Article) that extensively regulated labor markets produce inferior macroeconomic outcomes. There is a modest complementary role for some varieties of active labor market policy, however. The second Part also addresses the distribution of labor market outcomes. In a fully employed economy, this topic raises mainly microeconomic issues. In

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one way or another, labor market regulations seek to alter the distribution of outcomes, but they are frequently undermined by unintended consequences. Since the United States has less labor market regulation than most other countries,¹ the experience of foreign countries provides much of the available evidence on the impact of labor market regulations. The fact that the Obama administration has not pursued an active program of labor market regulation is consistent with both the priority of restoring full employment and the fact that labor regulations may not be the best policy approach to altering the income distribution.

I. ATTAINING FULL EMPLOYMENT

By any objective standard of international evidence, the working conditions and labor rights of U.S. workers are among the best in the world. American workers enjoy comparatively high pay levels and low industrial accident rates, although relatively high annual hours of work. The United States also offers superior labor rights—stronger civil liberties, less child and forced labor, and less discrimination than most other nations.² All of these working conditions and labor rights are strongly correlated with economic growth: A significant proportion of intercountry differences in labor conditions reflect different stages of economic development and, more importantly for the United States and other industrialized countries, labor conditions vary over time with variations in national output (gross domestic product or GDP).³ Even superior labor conditions are threatened by cyclical variations in demand, and few threats have been as strong as the “Great Recession” that began in 2007.

That recession dominated all other labor market issues for the first years of the Obama administration as the overall national unemployment rate more than doubled, increasing by 4.7 percentage points between 2007 and 2009.⁴ In contrast, the average increase in the unemployment rate among Organization for Economic Co-Operation and Development (OECD) countries was 2.5 percentage points.⁵ During this period, the most industrialized countries experienced unemployment rate increases that were less than half the U.S. increase.⁶ One must look to Iceland,

1. Danielle Venn, *Legislation, Collective Bargaining and Enforcement: Updating the OECD Employment Protection Indicators* 8 (OECD Soc., Emp’t & Migration Working Papers, Paper No. 89, 2009), available at <http://www.oecd-ilibrary.org/docserver/download/fulltext/5ksf7m6glc40.pdf?expires=1317397354&id=id&accname=guest&checksum=E9FFDB0453A6B53849FA6F9FC9F61280>; see also Juan C. Botero, Simeon Djankov, Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Regulation of Labor*, 119 Q. J. ECON. 1339, 1363 tbl.3 (2004).

2. See ROBERT J. FLANAGAN, *GLOBALIZATION AND LABOR CONDITIONS* 9–34 (2006) (discussing labor conditions around the world).

3. *Id.* at 35–54.

4. ORG. FOR ECON. CO-OPERATION & DEV., *OECD EMPLOYMENT OUTLOOK: MOVING BEYOND THE JOBS CRISIS* 270 tbl.A (2010) [hereinafter 2010 OECD EMPLOYMENT OUTLOOK], available at http://www.tuac.org/en/public/e-docs/00/00/07/4E/document_doc.phtml.

5. *Id.*

6. *Id.*

Ireland, and Spain to find countries where unemployment rates increased notably more than in the United States.⁷

The rise in the U.S. unemployment rate also exceeded historical experience. For decades, a relationship known as Okun's Law provided reliable predictions of how unemployment varies with GDP. If the traditional relationship had held throughout the Great Recession, the rise in the unemployment rate would have been half what the nation experienced. Unusually rapid productivity gains in 2009 appear to explain the breakdown in the historical relationship.⁸ The productivity surge enabled employers to reduce employment levels even after GDP began to recover. The Business Cycle Dating Committee of the National Bureau of Economic Research (NBER)—a committee of macroeconomists that dates the peaks and troughs of U.S. business cycles—has noted that the decline in national output that began in December 2007 (over a year before the Obama administration took office) reached its low point in June 2009.⁹ Yet, payroll employment continued to decline until December 2009.¹⁰ The persistence of employment declines after output begins to recover is not unusual. The NBER committee noted that “in 2001-03, the trough in payroll employment occurred 21 months after the NBER trough date.”¹¹ Without the productivity surge, the U.S. unemployment growth would have been much closer to the European experience. It is not yet clear why the productivity surge experienced in the United States did not emerge in other countries.

On the surface, the appropriate policy response was well defined. Recessions occur when actual GDP falls short of potential GDP—the output that could be produced in a fully employed economy. To reduce unemployment and restore full employment, aggregate demand must be increased sufficiently to eliminate the gap between actual and potential GDP. The textbook policy responses are for central banks to reduce interest rates to encourage spending on investment and consumption items that must be financed and for the executive and legislative branches to approve increased government spending and/or reduced taxes to encourage more private spending. Dollar for dollar, direct government spending will provide the more powerful fiscal stimulus, because some of the increased disposable income provided by tax cuts will be saved.¹²

The current recession was met with an appropriate mix of monetary and fiscal policies. The Federal Reserve reduced short-term interest rates to approximately zero and adopted several innovative strategies to increase the money supply. With the central bank unable to reduce interest rates below zero, further stimulus had to come from fiscal policy. Eventually, a divided Congress approved a package of federal spending projects known as the American Recovery and Reinvestment Act

7. *Id.*

8. MARY DALY & BART HOBIJN, FED. RES. BANK OF S.F., FRBSF ECONOMIC LETTER: OKUN'S LAW AND THE UNEMPLOYMENT SURPRISE OF 2009 (2010), available at <http://www.frbsf.org/publications/economics/letter/2010/el2010-07.html>.

9. NBER Business Cycle Dating Committee Announces Trough Date, NAT'L BUREAU OF ECON. RES. (Sept. 20, 2010), <http://www.nber.org/cycles/sept2010.html>.

10. *Id.*

11. *Id.*

12. ANDREW B. ABEL, BEN S. BERNANKE & DEAN CROUSHORE, MACROECONOMICS 416-19 (6th ed. 2008).

(ARRA).¹³ Although debates continue about both the size and composition of the package, the nonpartisan Congressional Budget Office concluded that expenditures provided by the ARRA raised employment between 1.3 and 3.3 million people and reduced the national unemployment rate in 2010 by between 0.7 and 1.8 percentage points.¹⁴ The economic recovery that began in July 2009 slowed dramatically by mid-2010, however. Yet, two concerns inhibited efforts to provide more fiscal stimulus—the impact of further economic expansion on inflation and on government deficits and debt.

II. UNEMPLOYMENT AND INFLATION

Historically, concerns about increasing inflationary pressures dominated thinking about how far employment could be expanded. As output increases and new hiring diminishes the pool of the unemployed, employers eventually raise pay to attract workers, and the increased costs are transmitted into prices. As prices increase, expectations of future price increases are built into pay demands and the costs of other inputs. Ideally, a country reduces unemployment to the rate where those pressures just begin to build. That is, the full employment goal is effectively defined in terms of inflation. The full-employment unemployment rate—known by the technically accurate but verbally awkward term “nonaccelerating inflation rate of unemployment” (NAIRU)—is not zero. Even in a fully employed economy, the expansion and contraction of individual firms along with job search by those entering the labor force produces frictional unemployment. It takes time to match workers with appropriate jobs. While the NAIRU is not necessarily constant over time, estimates of the current U.S. NAIRU fall in the range of 4.5–5%—too far below the actual unemployment rates of 9.6–9.8% in the second half of 2010 to accept inflation risk as a credible objection to further monetary and fiscal stimulus.¹⁵

Nevertheless, if the target unemployment rate ultimately constrains an employment expansion, what policies might lower the target rate? Almost sixty years ago, economists in the Swedish labor unions proposed, and their government ultimately accepted, a variety of “active labor market policies” intended to move workers from sectors of weak demand to sectors with vacant jobs.¹⁶ The proposal was part of an effort to implement a “solidaristic wage policy” that would provide equal pay for equal work.¹⁷ Faced with concerns that the policy would suppress market incentives for workers to move from areas of low labor demand to areas of

13. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009), available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ005.pdf.

14. CONG. BUDGET OFFICE, ESTIMATED IMPACT OF THE AMERICAN RECOVERY AND REINVESTMENT ACT ON EMPLOYMENT AND ECONOMIC OUTPUT FROM APRIL 2010 THROUGH JUNE 2010, at 3 tbl.1 (2010), available at <http://www.cbo.gov/ftpdocs/117xx/doc11706/08-24-ARRA.pdf>.

15. ABEL ET AL., *supra* note 12, at 459.

16. Robert J. Flanagan, *Efficiency and Equality in Swedish Labor Markets*, in THE SWEDISH ECONOMY 125, 154 (Barry P. Bosworth & Alice M. Rivlin eds., 1987).

17. *Id.* at 131.

high demand, the union economists argued that such reallocations of labor could be achieved far more effectively by government policies to train workers and subsidize their mobility between regions.¹⁸ By shortening the duration of time between jobs, it was argued, the target unemployment rate—the lowest rate that could be achieved with insignificant inflation—could be reduced.¹⁹

In short, active labor market programs (ALMPs) could complement monetary and fiscal expansions. After all, there must be sufficient demand in the first place to provide employment opportunities for retrained workers. Retraining could qualify workers for better opportunities but by itself could not create those opportunities. Within a few years these programs became quite the policy rage as country after country was attracted to the possibility of lowering the NAIRU.²⁰ The United States introduced its first programs in the early 1960s, albeit on a much smaller scale than Sweden, and many other industrialized nations followed Sweden's lead over the next decade.²¹ Gradually, the variety of programs increased from classroom and on-the-job training to public service employment programs, wage subsidies for hiring low-skill workers, and job search assistance programs. By 2007, expenditures on such programs²² represented 1.12% of GDP in Sweden, but only 0.131% in the United States. (The average for OECD nations was 0.57%.)²³

Over the decades, such active labor market programs have produced mixed results. A recent “meta-study” synthesized the findings of some ninety-seven ALMP evaluations providing 199 separate estimates of ALMP impacts in twenty-six mainly European and North American countries.²⁴ The synthesis was able to provide assessments of program impacts one year, two years, and three years after program completion. Job search assistance programs were most likely to generate positive outcomes for program participants, presumably by reducing the length of their unemployment and possibly by identifying jobs offering superior earning opportunities. Training programs were unlikely to produce gains immediately after program completion, but significant positive outcomes often emerged after two to three years.²⁵ Public service employment programs were least likely to produce positive outcomes for participants.²⁶

18. *Id.* at 133.

19. See Rudolf Meidner, *The Goals of Labour Market Policy*, in ON INCOMES POLICY: PAPERS AND PROCEEDINGS FROM A CONFERENCE IN HONOUR OF ERIK LUNDBERG 189, 189 (Industrial Council for Social and Economic Studies ed., 1969) (“[I]t would be possible to close an inflationary gap with the help of recruitment of new labour.”).

20. See ORG. FOR ECON. CO-OPERATION AND DEV., EMPLOYMENT OUTLOOK 73–85 (1992), available at <http://www.oecd.org/dataoecd/59/23/2485416.pdf>.

21. *Id.* at 73.

22. Expenditures for training, employment incentives such as wage subsidies, supported employment, direct job creation, and startup incentives, and the public employment service.

23. 2010 OECD EMPLOYMENT OUTLOOK, *supra* note 4, 305 tbl.K.

24. David Card, Jochen Kluge & Andrea Weber, *Active Labor Market Policy Evaluations: A Meta-Analysis* 1–3 (Nat'l Bureau of Econ. Research, Working Paper No. 16173, 2010).

25. *Id.*

26. *Id.*

The effectiveness of ALMPs has not changed much over time. Looking back at the past twenty years, Card, Kluge, and Weber conclude that “there is no tendency for the most recent programs to exhibit better or worse outcomes than programs from the late 1980s.”²⁷ A separate analysis of unemployment in OECD countries concludes that public investments in ALMP reduce a country’s NAIRU but provides no information on which types of programs are relatively effective.²⁸ The Obama administration has announced no ALMP initiatives to date. Even if there were strong evidence that such policies shifted the NAIRU, they have no practical role to play until macroeconomic policies reduce unemployment to a level that raises the demand for workers and the threat of inflation.

III. GOVERNMENT DEFICITS

Political resistance to further fiscal stimulus also reflects concerns about the impact of fiscal policies on the federal government budget balance. Countercyclical fiscal policy requires deficit financing in recessions as a national government seeks to stimulate demand by spending more money itself or providing taxpayers with more spendable income by reducing their taxes. (Conversely, when demand is strong, a government budget surplus can restrain inflationary pressures.) Without deficit financing, there is no fiscal stimulus. Objecting to deficit spending in a period in which monetary policy has been carried as far as it can go is effectively a recipe for inaction in the face of the highest unemployment rates incurred in the United States since the Great Depression.

But do policies that provide more employment for today’s workers burden future generations of worker-taxpayers who must repay the government’s debts? The answer to this question depends on how the money is used—whether government stimulus spending is mainly for investment or consumption. Public (and private) investment may provide the means for future repayment by increasing future national output and income sufficiently to leave future generations better off even after repaying the debt. In contrast, spending for current consumption purposes does not provide the means for future repayment, since it does not contribute to the growth of future output. Over the past thirty years, U.S. government deficits have financed rather more consumption than investment spending.²⁹ Prospectively, the proposals by the Obama administration for additional stimulus in the form of investment in public infrastructure are more likely to contribute to economic growth.

Before the current era of globalization, economics textbooks often noted that to a large extent the government debt was “owed to ourselves.”³⁰ That is, the future

27. *Id.* at 16.

28. ORG. FOR ECON. CO-OPERATION AND DEV., OECD EMPLOYMENT OUTLOOK: BOOSTING JOBS AND INCOMES 208–09, 216–17 (2006) [hereinafter 2006 OECD EMPLOYMENT OUTLOOK], available at http://www.oecd.org/document/0/0,3746,en_2649_33927_40774656_1_1_1_1,00.html.

29. CHARLES L. SCHULTZE, MEMOS TO THE PRESIDENT: A GUIDE THROUGH MACROECONOMICS FOR THE BUSY POLICYMAKER 247–48 (1992).

30. See GEORGE LELAND BACH, ROBERT FLANAGAN, JAMES HOWELL, FERDINAND LEVY & ANTHONY LIMA, ECONOMICS: ANALYSIS, DECISION MAKING, AND POLICY 236 (11th ed.

taxes paid by Americans to retire the government debt were received by other Americans who held that debt. Retiring the debt involved an internal redistribution of income, but not a burden on the country as a whole. Nowadays, foreign countries hold vast amounts of government debt.³¹ Indeed, with the country's notoriously low private savings rate and regular government deficits (negative government savings), U.S. private investment would have been much lower over the past quarter century if foreign countries had been less willing to lend to us.³² To a significant extent, we no longer "owe it to ourselves." Whether the eventual need to repay foreigners to retire some government debt constitutes a burden once again depends on what the debt finances. Sufficiently productive investments can in principle yield returns large enough to provide domestic gains after repaying foreign investors, but there is no guarantee that the political process will produce such public investments.

Concerns with government deficits and the accumulated public debt periodically produce proposals to amend the U.S. Constitution to require that federal government budgets balance projected revenues and expenditures annually, except in times of war or other national emergency (as determined by vote of a congressional supermajority).³³ Such proposals lie outside the realm of labor market regulation, but if enacted could have a huge impact on the employment of the nation's workers. A balanced budget requirement would eliminate the use of fiscal policy to stabilize the economy unless a congressional supermajority defined a recession as a national emergency. In the current recession, with the tools of monetary policy more or less exhausted, taking a fiscal policy response off the table would be a recipe for a much longer and deeper recession. Nor is it necessary to abandon fiscal policy tools. There are other approaches to limiting the growth of government debt that would preserve fiscal policy as a countercyclical weapon.³⁴

IV. TAKING STOCK

The goal of attaining full employment in the current recession is dominantly a task for macroeconomic policy. The current administration has initiated appropriate fiscal policies, although there is room for debate about whether they should have been stronger or composed differently. Both of these qualifications have more to do with congressional than executive branch behavior. There are active labor-market policies that might eventually lower a nation's NAIRU, but these involve subsidies for acquiring and deploying human capital rather than new regulations. Indeed, evidence presented in the next Part indicates that certain varieties of *deregulation* in labor markets could lower the NAIRU further. Finally, proposals to require federal budget balance irrespective of macroeconomic conditions threaten much greater sacrifices of output, employment, and income during recessions.

1987).

31. See Martin S. Feldstein, *Preventing a National Debt Explosion* (Nat'l Bureau of Econ. Research, Working Paper No. 16451, 2010).

32. See SCHULTZE, *supra* note 29, at 247–54.

33. For a political history of balanced budget proposals, see Kathy Gill, *Balanced Budget Amendment: Timeline*, ABOUT.COM http://uspolitics.about.com/od/thefederalbudget/a/balanced_budget.htm.

34. See NAT'L COMM'N ON FISCAL RESPONSIBILITY & REFORM, *THE MOMENT OF TRUTH* (2010); Feldstein, *supra* note 31.

In the future, legal regulation of other markets may reduce the odds of a repeat experience. In the wake of the Great Recession, for example, there has been widespread agreement that regulation of some aspects of financial markets would lower the risk of following a similar path to recession in the future. In July 2010, Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act,³⁵ establishing new regulations for the financial sector. But administrations rarely receive credit for heading off future problems. As this Article is written, voters seem far more concerned with the sluggish pace of recovery from the recession than the reduced odds of a repeat occurrence.

V. LABOR MARKET REGULATION AND ECONOMIC OUTCOMES

No country has been willing to permit market forces to be the sole arbiter of national employment conditions. Yet, the extent and substance of labor regulation vary widely. By all available measures, the United States has less labor market regulation than most other countries. The most comprehensive study of comparative labor regulation assesses the legal protection of a standard worker or employer in eighty-five countries as of 1997.³⁶ The project recorded the extent of legal protection for different aspects of the employment relationship and assessed the costs of certain personnel actions, such as increasing work hours or dismissing workers. For each country, the study produced an overall index of the degree of labor protection, and sub-indices of four specific areas of protection—employment laws (wage and hour regulation, dismissal procedures, etc.), collective relations laws (union formation, collective bargaining, and labor disputes), social security laws (eligibility and benefits for various types of social insurance), and civil rights laws.

Based on these indices, the United States ranks seventy-sixth out of the eighty-five nations in the strength of its employment and collective relations regulations.³⁷

35. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010), *available at* http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=111_cong_public_laws&docid=f:publ203.pdf.

36. Botero et al., *supra* note 1. Quoting from the study:

The standardized male worker has the following characteristics: (i) he is a nonexecutive full-time employee who has been working in the same firm for twenty years; (ii) his salary plus benefits equal the country's GNP per worker during the entire period of employment; (iii) he has a nonworking wife and two children, and the family has always resided in the country's most populous city; (iv) he is a lawful citizen who belongs to the same race and religion as the majority of the country's population; (v) he is not a member of the labor union (unless membership is mandatory); and (vi) he retires at the age defined by the country's laws. We also assume a "standardized" employer with the following characteristics: (i) it is a manufacturing company wholly owned by nationals; (ii) its legal domicile and its main place of business is the country's most populous city; (iii) it has 250 workers; and (iv) it abides by every law and regulation, but does not grant workers more prerogatives than are legally mandated.

Id. at 1353 n.6.

37. *See id.* at 1362–63.

It ranks eighty-first in the level of its dismissal costs, although it is not clear how effectively the study evaluated the exceptions to at-will employment fashioned by U.S. state courts in recent decades.³⁸ In comparative perspective, the United States ranked highest in the areas of civil rights and social insurance (forty-first and fifty-first out of eighty-five, respectively).³⁹ (These were the only areas of employment regulation in which the United States ranked above the mean for the international sample.)

VI. SOURCES OF INTERNATIONAL REGULATORY DIVERSITY

What accounts for this diverse regulatory experience, and what difference does it make for economic policy? A country's legal traditions may influence the extent of its employment regulation. Common law systems, associated with England and its former colonies, take a comparatively skeptical stance toward the role of the state and rely more on judicial discretion than civil codes. Civil law systems that emerged in France, Germany, and Scandinavia rely heavily on substantive and procedural codes and limit judicial discretion. On average, countries with a civil law tradition produce more extensive labor (and other) regulation.⁴⁰ Yet, the common law tradition in the United States does not fully explain its modest level of labor regulation. Even among industrialized, common law countries the U.S. ranking is comparatively low.

The varied rationales for labor regulation account for additional international diversity in labor regulation. Much U.S. labor legislation proceeds from a rarely examined assertion that employers always bring superior bargaining power to the employment relationship. The assertion is not a convincing basis for regulatory policy. Employers may announce employment conditions on a take-it-or-leave-it basis, but if workers leave it, choosing instead to work for another employer, the announcement amounts to little practical economic power. Bargaining power in fact rests on the degree of choice available to employers and workers respectively. The working conditions offered by any employer are constrained by the ability of employees or job applicants to take other jobs offering superior conditions. Similarly, the conditions demanded by any worker are constrained by the employment conditions that other workers are willing to accept. Unequal bargaining power emerges only when choice is circumscribed on either side of the market.

A September 2010 antitrust settlement between the Department of Justice and six high-tech firms in Silicon Valley illustrates how worker choice (bargaining power) that has been circumscribed can be reestablished by appropriate legal action.⁴¹ Beginning in 2005, six large Silicon Valley firms established a series of bilateral agreements in which each firm agreed not to "cold call" (initiate recruiting

38. Data accessed at <http://iicg.som.yale.edu/>.

39. See Botero et al., *supra* note 1, at 1362–63.

40. Rafael La Porta, Florencio Lopez-de-Silanes & Andrei Shleifer, *The Economic Consequences of Legal Origins*, 46 J. ECON. LITERATURE 285 (2008).

41. Competitive Impact Statement, United States v. Adobe Sys., Inc., No. 1:10-cv-01629 (D.D.C. Sept. 24, 2010).

contacts with) employees of other companies.⁴² By reducing the effective choice of employers available to workers, such agreements converted a competitive labor market into a monopsonistic market, suppressing pay and other conditions of work. In the settlement, the offending firms agreed to eliminate this practice.⁴³ The attractive approach of the Obama Department of Justice was to eliminate the source of unequal bargaining power rather than to conjecture about how the regulation of employment conditions might counter it.

Other regulations seek to provide workplace public goods, like job safety.⁴⁴ A safe workplace benefits all employees simultaneously, but individual workers, who each receive only a fraction of the benefits from greater safety, are unlikely to bargain hard for it. Many will free ride on the efforts of others. Job safety regulation may solve this collective choice problem. Still other regulations, such as unemployment insurance, workers compensation, and retirement benefits, insure workers against employment risks. Variations in labor regulation among countries reflect different national assessments of the importance of these factors.

VII. LABOR REGULATION AND MACROECONOMIC OUTCOMES

Two major international studies of the relationship between labor market regulations and macroeconomic outcomes indicate that the United States may benefit from its comparatively modest regulation. A cross-country regression analysis of the 1997 data from eighty-five countries indicates that stronger employment regulations are associated with higher unemployment rates (particularly among younger workers), lower male labor force participation rates, and relatively high employment in unofficial (unregulated) sectors of the economy.⁴⁵

In a separate study, the OECD also finds that most of its member countries go further than the United States with labor market regulation.⁴⁶ For example, their statutory minimum wages are a higher fraction of the median wage, their unemployment benefit payments replace a larger fraction of past wages, and their employment protection laws (restrictions on separations) are more stringent.⁴⁷ A regression analysis of data from member countries for 1982 through 2003 found that greater labor and product market regulation tends to raise the noncyclical unemployment rate (that is, the NAIRU). In fact, the OECD study concluded that “changes in policies and institutions appear to explain almost two-thirds of non-cyclical unemployment changes over the past two decades.”⁴⁸

How can regulation worsen a country’s unemployment experience? Consider the OECD’s finding that a relatively high unemployment insurance replacement rate is associated with higher unemployment. A long line of labor market research

42. *Id.*

43. *Id.*

44. *See, e.g.*, Occupational Safety and Health Act, 29 U.S.C. §§ 651–78 (2006).

45. Botero et al., *supra* note 1, at 1375–78.

46. ORG. FOR ECON. CO-OPERATION AND DEVEL., ECONOMIC POLICY REFORMS: GOING FOR GROWTH 118–26 (2009).

47. *Id.* at 118 fig.4.1, 119 fig.4.2, 125–26 fig.4.8.

48. 2006 OECD EMPLOYMENT OUTLOOK, *supra* note 28, at 208.

recognized by the 2010 Nobel Prize in economics has explored links between job search incentives and unemployment. A fundamental prediction of this research is that lowering the cost of job search will lengthen the search (unemployment).⁴⁹ The comparatively generous European approach to supporting the unemployed also reduces the cost of job search and hence reduces the pressure to find and accept a job until unemployment benefits are near exhaustion. The higher level of unemployment that results from more generous benefits, while modest in comparison to the effects of the collapse of national output, prompted many Republican members of Congress to oppose the Obama administration's ultimately successful efforts to extend unemployment benefits during the depths of the Great Recession. The tension between supporting the unemployed and reducing incentives to accept work reflects a failure to recognize that each economic policy instrument can target only one objective. Higher replacement rates target the need to support the unemployed. Combining higher replacement rates with a program rewarding job acceptance would mitigate the incentive problem. In fact, the OECD study finds evidence that packages of complementary labor market programs can lower unemployment.⁵⁰

Employment protection laws provide a second example of unintended consequences. The laws are intended to reduce unemployment by raising the costs of dismissals. However, the OECD analysis finds that the strength of dismissal regulation is not significantly related to the unemployment rate. By reducing dismissals, the regulations do reduce flows of workers from employment to unemployment (as intended), but they also reduce flows out of unemployment into employment once employers realize that new hiring binds them to long-lasting employment commitments. As a consequence, those who lose a job or enter the labor force to seek work find it difficult to escape unemployment, and unemployment durations lengthen. Despite the fact that the length of U.S. unemployment spells recently reached their highest levels since the Great Depression, the duration of U.S. unemployment remains well below the durations reported in major European countries.⁵¹ In 2009, for example, the share of the unemployed who had been out of work for over twenty-six weeks exceeded 50% in France, Germany, and Italy, but was 31.5% in the United States.⁵² Given the skill depreciation and discouragement that accompany long spells of unemployment, this unintended outcome of regulation can have serious long-term consequences. Furthermore a recent review of the literature on the impact of dismissal regulations concludes that increased employment protection law tends to reduce the employment for individuals with less attachment to the labor market.⁵³

49. Peter A. Diamond, *Mobility Costs, Frictional Unemployment, and Efficiency*, 89 J. POL. ECON. 798 (1981); Dale T. Mortensen, *Job Search, the Duration of Unemployment, and the Phillips Curve*, 60 AM. ECON. REV. 847 (1970); Christopher A. Pissarides, *Search Unemployment with On-the-Job Search*, 61 REV. ECON. STUD. 457 (1994).

50. Giuseppe Nicoletti & Stefano Scarpetta, *Product Market Reforms and Employment in OECD Countries* 30–31 ¶ 56 (OECD Econ. Dep't Working Papers, Paper No. 472, 2005), available at <http://dx.doi.org/10.1787/463767160680>.

51. 2010 OECD EMPLOYMENT OUTLOOK, *supra* note 4, 292 tbl.H.

52. *See id.*

53. W. Bentley MacLeod, *Great Expectations: Law, Employment Contracts, and Labor*

Like earlier academic studies, the OECD study also finds that higher payroll taxes raise the target unemployment rate (NAIRU).⁵⁴ Turning to the effect of labor market institutions, the study finds that while there is no statistically significant relationship between unemployment and the fraction of the workforce that is unionized, countries with highly centralized and coordinated collective bargaining arrangements—the opposite of the bargaining arrangements found in the United States—have lower unemployment.⁵⁵

VIII. LABOR REGULATION AND THE DISTRIBUTION OF OUTCOMES

The Obama administration took office in a country in which the dispersion of pay was larger than in other industrialized nations. Table 1 provides three measures of pay dispersion for several industrialized countries. The ratio of the wage received by workers at the ninetieth percentile of the wage distribution to the median wage (the ninety:fifty wage ratio) measures inequality in the upper half of the wage distribution. (In 2008, a worker at the ninetieth percentile received 2.34 times the median wage in the United States, for example.) The ratio of the median wage to the wage received by workers at the tenth percentile measures inequality in the bottom half of the distribution. For most countries, pay is more compressed at the bottom of the distribution. Whether one looks at the upper or lower reaches of the pay distribution, however, pay dispersion in the United States exceeds that of other countries. The last measure in Table 1 shows that the ratio of female to male wages in the United States increased considerably during the last decades of the twentieth century and the beginning of the twenty-first century and now stands at about the international average.

Market Performance 54 (Nat'l Bureau of Econ. Research, Working Paper No. 16048, 2010).

54. 2006 OECD EMPLOYMENT OUTLOOK, *supra* note 28, at 230 tbl.7.A1.1.

55. *Id.*

Table 1: Measures of Wage Inequality, 2008

	90:50 Wage Ratio			50:10 Wage Ratio			Female/Male Pay Ratio		
	1995	2008	Change	1995	2008	Change	1995	2008	Change
Denmark	1.69	1.74	+0.05	1.46	1.57	+0.12	.86	.88	+0.02
Finland	1.66	1.76	+0.10	1.41	1.46	+0.05	.78	.79	+0.01
Norway	1.40	1.46	+0.06	1.35	1.56	+0.21	n.a.	.91	n.a.
Sweden	1.59	1.66	+0.07	1.39	1.37	-0.02	.81	.85	+0.04
France	1.93	1.98 ^a	+0.05	1.59	1.47 ^a	-0.12	.90	.88 ^a	-0.02
Germany	1.79	1.72	-0.07	1.56	1.93	+0.37	.77	.75	-0.02
Spain	2.10	1.98	-0.12	2.01	1.66	-0.35	.71	.88	+0.17
U.K.	1.88	1.98	+0.10	1.85	1.83	-0.02	.73	.79	+0.06
Japan	1.85	1.85	0	1.63	1.63	0	.63	.69	-0.06
Canada	1.74	1.88	+0.14	2.01	2.00	-0.01	.74	.80	+0.06
USA	2.17	2.34	+0.17	2.11	2.09	-0.02	.75	.80	+0.05
Average	1.80	1.85	+0.05	1.67	1.69	+0.02	.77	.81 ^b	+0.04

Wages = gross earnings of full-time wage and salary workers.

^a 2007 data.

^b Data from Norway not included.

Sources: OECD (2007) p. 268; OECD (2010) p.295.

Table 1 also reveals that pay dispersions in industrialized countries increased on average since the early 1990s. Although pay dispersion actually narrowed slightly in the lower half of the U.S. wage distribution, the United States experienced a comparatively large growth in the dispersion of pre-tax wages in the upper half of the wage distribution between 1995 and 2008, as did a number of other OECD countries. Tabulations such as Table 1 describe but do not explain wage dispersion and by themselves provide no basis for judgments about the “fairness” or “equity” of measured pay inequality.

The level and change of these national wage distributions reflect the interplay of market and institutional forces—often in unknown combination. The fact that the lower half of most wage distributions is usually less dispersed than the upper half may reflect in part the influence of minimum wage laws and collective bargaining, for example. Likewise, laws that prohibit different labor market treatment based on personal characteristics (for example, race, gender, religion, national origin, age, etc.) may have facilitated the rise in the female relative wage (as well as the increasing relative wages of racial minorities in the United States).

Yet, tax policies provide the most powerful and potentially even-handed approach to altering the after-tax distributions. Reversing tax policies that contributed to increased inequality is a more reliable approach to reducing overall inequality than specific regulations for at least two reasons. First, much pay inequality reflects skill dispersion rather than the arbitrary exercise of market power. For over sixty years, statistical analyses of U.S. labor markets have recorded the strong correlations between pay and schooling, employment

experience, IQ, and other factors that influence the on-the-job productivity of workers.⁵⁶ These pay differentials not only reward individuals for the investments that they have made in acquiring skill, but provide incentives for others to make similar investments. Indeed, as workers respond to the incentives by acquiring more skill, skill differentials should diminish. If there are barriers that limit this market response to pay differentials, the first-best policy is to reduce or eliminate the barriers rather than tinkering with the pay structure directly. (Even the use of tax policies to reduce inequality must remain sensitive to these issues.)

Nonetheless, even after controlling for the influence of skill, many analyses of the wage distribution continue to find pay differences associated with race, gender, and national origin.⁵⁷ There is a clear role for regulations that defeat the behavior underlying such differentials, and nondiscrimination laws represent one of the success stories of U.S. labor market regulation over the past fifty years.

But is labor market regulation likely to counter the *growing* pay dispersion of the past two decades? Research shows that increased demand for high-skill workers drove much increased pay inequality over this period. Declining union representation and less frequent adjustments in the federal minimum wage cannot explain developments in the upper half of the pay distribution. Reversing these trends will not counter the growing inequality there.

Globalization also plays a small role in increasing pay dispersion.⁵⁸ As we see in Table 1, increasing dispersion has mainly been in the upper half of the pay distribution—a region more accessible to tax policy than labor market regulation.

The unintended consequences of some labor market regulations provide a second reason for preferring tax policy. Direct labor market regulations often divide workers into groups of “insiders,” who enjoy the benefits of the regulations, and “outsiders,” who do not—an outcome that does not reliably reduce the inequality of labor market outcomes.⁵⁹ Such unintended consequences flow from efforts to escape regulatory costs, much like the adjustments that individuals and organizations make to avoid taxes. Regulations that raise employment costs create incentives to reduce employment. Payroll taxes and minimum wages effectively benefit covered workers over uncovered workers—who either must work in unofficial (unregulated) employment, incur unemployment, or leave the labor force. Each of these alternatives yields inferior income. Membership in these two groups is not randomly determined. As Nobel laureate James Heckman and his coauthor Carmen Pagés observed in summarizing a comprehensive study of labor market regulation in South America, “Regulation acts unevenly across different groups in society. Young, uneducated, and rural workers are much less likely to enjoy coverage than older, skilled and urban workers.”⁶⁰ More broadly, there is no significant statistical relationship between the strength of national labor market

56. RONALD G. EHRENBERG & ROBERT S. SMITH, *MODERN LABOR ECONOMICS: THEORY AND PUBLIC POLICY* 300–06 (6th ed. 1997).

57. *Id.* at 413–32.

58. WILLIAM R. CLINE, *TRADE AND INCOME DISTRIBUTION* 253–72 (1997).

59. Recall the example of European dismissal regulations, which benefit the employed insiders but reduce the prospect of finding a job for the unemployed outsiders.

60. LAW AND EMPLOYMENT: LESSONS FROM LATIN AMERICA AND THE CARIBBEAN 85 (James J. Heckman & Carmen Pagés eds., 2004).

regulations and several measures of working conditions and labor rights.⁶¹ In contrast, tax policies can be applied more evenly across social groups.

CONCLUSION

I was asked to address the question of whether additional labor market regulation could effectively address the needs of (all) workers at the halfway point in President Obama's first term of office. The immediate need of American workers is clearly full employment, a decidedly macroeconomic issue. Increased labor market regulation provides no mechanism for achieving full employment, and as foreign experience demonstrates, some regulations alter the level, character, and distribution of unemployment in unattractive ways. Even the development of a more ambitious noninflationary, full-employment target is not a matter for further labor regulation. On the contrary, there is growing evidence that labor market *deregulation* would better serve that goal. Given evidence that some labor regulations can produce adverse macroeconomic consequences, the low weight placed on new regulatory initiatives by the Obama administration is consistent with the objective of reestablishing full employment.

As the economy approaches full employment, policy objectives may shift, focusing more attention on the distribution of labor market outcomes in a fully employed economy. That focus may elevate discussions of labor market regulation, but the potential contribution of such regulation depends on what factors drive current pay dispersion. Regulations can help counter the more whimsical aspects of a wage distribution—differences associated with discriminatory prejudices, for example. But pay dispersion that reflects the distribution of employee qualifications should be left untouched, since pay compression risks diminishing the incentives to acquire better qualifications.

Proposals for more extensive labor market regulation will encounter the headwinds of international experience. We have already seen that industrialized foreign countries have carried labor market regulations much further than the United States. Their experience with regulation provides evidence on regulatory consequences. Based on that evidence, the OECD—the main international organization concerned with the economic growth of advanced countries—has increasingly encouraged an agenda of deregulated labor markets. This stance is supported by substantial analysis of their member countries' experience. The World Bank has increasingly provided similar advice to developing countries, based on studies of their experience. This advice has the virtue of recognizing that it is difficult to improve general labor compensation without first raising labor's productivity.

61. FLANAGAN, *supra* note 2, at 158.

