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Labour Standards, Flexibility, and Economic Performance

Abstract

Labour market regulations belonging to an earlier world in which markets were more sheltered and the organization of work more stable now often require reform. This paper argues that labour market regulation does affect economic performance, but in ways that are often non-obvious, and otherwise difficult to measure. There are many different routes to flexibility, and in no general way is labour market regulation an obstacle. It can surely be acknowledged that labour market regulation has a cost side, it also has benefits. The latter, for several reasons, has been under-researched. Understanding the benefits of labour market regulation, however, both broadens the definition of flexibility and deepens our insights into how labour markets work.

Introduction

The topic really needs no introduction. The economic effects of labour market rules and regulations have occupied the heart of a debate over labour market flexibility for almost two decades now. As it turns out, however, this is not a simple story, a fact to which the debate's longevity readily attests. One reason for the matter having become something of a hardy perennial is the yawning gap between theory and evidence and, often, the dominance of the former over the latter. Another reason is that, quite obviously, in an increasingly interdependent world economy and the competition it has engendered, and with the new microelectronics-based technologies that have so profoundly changed how work and production are organized, the need for adjustment is now more widespread and more urgent than at any time in the postwar era. It seems clear to most of us that the need for adjustment can imply the need for change, and the need for change, flexibility. On this everyone agrees.

Such consensus resolves little, however, and for two reasons. First, theory does not help us very much in understanding how real-world labor markets really work. Indeed, there are as many good theoretical reasons for thinking that labor standards improve outcomes as there are appealing arguments on how markets work best without intervention from standards. Theory alone therefore would seem to offer little guidance in choosing the right policies for engendering the right labor market behaviours. Second, the concept of flexibility turns out to be rather complicated in itself and prone to a lot of definitions – and how flexibility relates to labour market rules and behaviours is far from being clearcut.

The present paper is in four parts. The first dives immediately into the flexibility/ rigidity debate and queries whether labour market regulation has much or little to do with the current OECD employment problem. The second arranges an awkward meeting between theory and reality by introducing the orthodox view of flexibility to a few realities of the labour market. The third moves to the developing world and asks the empirical question of whether labour standards are harmful to economic performance. The fourth revisits the earlier notion of flexibility and suggests why we might wish to revise the theory rather than the world.

The OECD Origins of the Debate

The story in its popular version is a familiar one concerning the American 'job machine' versus the stagnation of employment in Europe. In particular, Europe's high unemployment, poor record of employment creation, and highly regulated labour markets contrast with America's low unemployment, high rate of job creation, and – comparatively speaking – relatively unregulated labor market. The key theme, of course, is the causal association of different regulatory patterns with different employment outcomes. Labour market rigidities are invoked to shoulder the blame for Europe's problems – 'Eurosclerosis' (Giersch, 1985) – while their relative absence in America is accorded major explanatory weight in that country's record of employment creation.

Now the plausibility of this view is quite dependent on whether there are no more important factors determining employment creation, for those who cast labour market regulation in negative light tend also to assume, whether implicitly or not, that labour market regulation is the most important among factors that could determine job creation. It is here then where doubts first arise, for there are contending explanations for the employment problem in the OECD area. The International Labour Office's research[1] into the matter assigns pride of place to a rather different source of the problem: slow growth and inadequate demand sustained over two decades in the OECD irrespective of differences in labour market regulation. Trade, technology, and other trappings of globalization contribute to the employment problem, but by no means in the magnitude that some dire commentators have suggested. All these factors seem to speak of fundamental changes in the nature of labor demand. The bottom line of all this is that something is biasing OECD labour markets against the demand for unskilled labor, and this indeed is a problem for high-wage countries.

When the blame for the OECD's employment problem is shifted to other factors, labour market regulation not only does not emerge as the cause of the problem – it is the cause of the problem (slow growth and inadequate demand) that turns out to have

[1] These pages summarize conclusions of the ILO's *World Employment 1995* and *World Employment 1996/1997*.

a profound effect on labour market regulation. In short, it matters fundamentally whether labour market rigidities are behind Europe's unemployment problem – or, on the contrary, whether high unemployment is undermining features of labour market regulation, as, for example, unemployment benefit systems. Why is this of fundamental concern? The point is that, if labour market rules turn out not to be the cause of the problem, removing them might not be a good solution. There are two reasons why we should be skeptical of solutions to the employment problem based wholly or mainly on dismantling labour market rules.

Consider first by process of elimination that it is really inadequate demand with which we should be concerned. To begin with, if labour market rules are the primary problem, then the steady rise in European unemployment since the mid-1970s ought to go hand in hand with increasing labor market rigidities. But Europe did change its rules: wage and employment flexibility increased in every European country throughout the 1980s and 1990s. Wage indexation was abandoned or weakened. Dismissal rules were weakened. Wage bargaining was decentralized. Unemployment benefits and their duration were shortened. All this, and unemployment remained high.

Throughout Europe wage shares in national income – which were indeed high in the late 70s and early 80s – returned in the 1980s to their 1972 levels and have stayed there; that is, wages have grown less than productivity and corporate profits are as high in Europe now as they were at the end of the golden years of postwar growth, and still few jobs have been created.

Employment security rules are the frequent target of those who consider that labour market rules are the enemy of employment. But consider the following: Spain liberalized the use of fixed-term contracts back in the 1980s as a means of getting around those rules. So did France. The overwhelming majority of new jobs in Spain are fixed-term, yet Spain still has the highest unemployment in Western Europe, while France has over 12% unemployed. Moreover, Portugal has rather similar labour rules as Spain, but it has quite low unemployment. Why can it be argued that the rules negatively affect one setting and not another? How can it be argued that their removal generates employment when it apparently has not?

Have over-generous unemployment benefits made the unemployed prefer no work to having a job? This would appear highly unlikely. Survey after survey show that the unemployed always prefer a job if there were one to no job at all. There is, moreover, widespread empirical agreement that the level of unemployment benefits is a factor in increasing the duration of unemployment, but the effect is in every case small: neither therefore can the level of unemployment benefits be thought of as a big factor in increasing European unemployment, nor would a reduction in the level of benefits paid greatly reduce unemployment. But can unemployment benefits last too long? Here, the evidence is more affirmative: skills can erode; employers can be reluctant to hire. Hysteresis does seem to describe Europe's labour market problem, and there is consequently wide agreement that a more active component must be introduced into unemployment insurance systems where duration of benefits is long. But does the duration of benefits mean the unemployed are too choosy? Perhaps it depends more on the choices available. What if the job being offered is a part-time or temporary one paying less than the benefit? What is then the rational choice of the unemployed? Perhaps a solution could be to make 'atypical' jobs more attractive by providing the unemployed with in-work benefits so that the job they take does not reduce their income without work. This could be one way to address disincentive effects.

Have rigid wage floors have priced people out of work? Again, as a general rule, this does not seem plausible. There is no evidence that minimum wages are too high in Europe. Moreover, if rigid wage floors matter then it should be low-wage workers who should be unemployed in rigid systems, whereas, in flexible wage systems, unemployment should be more evenly distributed across skill levels. This does not conform to the empirical record, however. Unemployment is highly concentrated among the low-skilled everywhere in the presence or absence of wage floors.

If doubts can be cast on the salience of labour market explanations of poor employment performance, can evidence be mustered that inadequate demand is to blame? First, where demand is present, labour market regulation concerns do tend to recede in importance: In the recovery that Europe enjoyed between 1987 and 1990, Europe added 17 million new jobs – more than America added during this period. Labour market rigidities largely disappeared from the front page news in these years. Second, is there an aggregate demand problem in Europe that is somehow different than the one in the US? It would certainly appear so. Deflationary monetary policy has governed Europe for fifteen years. Not so in the US. In the 1990s, moreover, European governments are pushing toward a single currency. One of the rules is that governments have to reduce their spending to 3 percent of GDP. One should therefore not look for any fiscal stimulus to growth in Europe, and look, instead, for continued pressure on the welfare state to shrink. Since these macroeconomic constraints were rather lighter in the US, could this be part of the reason for the contrasting pattern of job creation there and in Europe? The proposition seems plausible.

There is a second reason why simply dismantling labour market rules is unlikely to offer a costless solution to the OECD's employment problem. America gives us a good insight into this matter, and here are the broad outlines of the employment situation in that country. Its labour market is relatively unregulated and the country has created an enormous number of jobs – 36 million over the past 20 years, enough for several Belgiums or Swedens. The majority of the new jobs pay above the median wage – that is, one cannot contend that employment creation was possible only because people willingly work for 'peanuts' or – to invoke the more usual food metaphor – because they flip hamburgers. All this is true, and unambiguously positive.

But a fair look at the States cannot ignore some problems. The real earnings of a large minority of the workforce – millions of Americans – in *existing jobs* is lower now than it was twenty years ago. The working poor, estimated at 25% of the workforce,[2] are a substantial and increasing minority of the workforce. Poverty remains stubbornly high. More of the working age population is actually working in America than elsewhere, but a relevant question is whether more households are working

[2] According to the OECD's *Employment Outlook* for 1996.

longer hours to maintain an eroding standard of living. Fewer workers have access to healthcare benefits now than they did 15 years ago. Inequality has greatly risen, and so have the number of those working involuntarily in part-time jobs.

The United Kingdom is another country in which the fall in unemployment is often attributed to the benefits of fewer labour market rigidities following an extensive programme of labour market deregulation. There, however, a recent report of the Bank of England casts doubt on this thesis: 'the proportion of people neither employed nor actively seeking work – the inactive – rose sharply in the 1990s.' The rise in non-employment or inactivity 'accounted for *almost the entire net improvement*' in the unemployment figures. Moreover, the Bank found that nearly all the new jobs created 'fell under the heading of part-time posts', ('Workforce dropouts help statistics', *International Herald Tribune*, 2 September 1996).

Now much is going right in these countries and reference to their experiences is surely not offered as an indictment of their distinctive national styles of regulation of which there are no doubt benefits not considered here. Rather, the point is a simple one: If labour market regulation were the principal cause of poor labour market performance, then the less regulated settings should show forth a more thoroughly positive rather than checkered performance. Since checkered it is, we should be suspicious that the problems facing the advanced or high-standard labour markets are just the standards themselves, and we might be right in thinking that the absence or weakness of standards may not solve the problem, but exchange one problem for another. In sum, *all OECD countries appear to be experiencing problems in labour market performance as measured in terms of both the quantity and the quality of employment.* If regimes of labour market regulation are distinctively different across countries in the OECD, while all countries are experiencing some form of inadequate labour market performance, this strongly suggests that the problem lies elsewhere than in the labour market.

One could nevertheless argue that differences in labour market regulation will determine whether what shows up as unemployment in one setting will show up as widening inequality in another. Furthermore, on the convincing ground that any job is better than no job at all, some would no doubt argue a normative preference for less regulated environments. Recent evidence casts doubt even on this proposition, however. The OECD's *Employment Outlook* for 1996 evaluates the trend toward rising earnings inequality in OECD countries and *no evidence of a trade-off was found between greater inequality and greater employment creation.* In short, a high degree of wage flexibility does not appear to generate more jobs than in the more rule-bound European economies. The sources of employment creation, therefore, appear *in the main* to lie elsewhere than in differences in labour market regulation.

Summing Up

When a broad construct of labour market performance embracing notions of the quantity as well as quality of jobs is considered, there would seem to be ample evidence of inadequacy throughout *all* OECD countries. Differences in labour market regulation may matter, but matter only in so far as rules distinctively channel how that inadequacy manifests itself. The lack of evidence of a tradeoff between inequality and employment creation suggests two things. First, it suggests that the *source* of employment problems may lie elsewhere than in the labour market alone. Despite the absence of evidence, we might still retain the idea that at least some tradeoff could exist between *jobs* and some countries' labour market rules. After all, the inability to marshall evidence on this point is not quite the same thing as disproving the point. But since the evidence is hard to come by, this also does suggest that were we somehow able to sweep away all labour market rules, *fewer jobs would be created than one might suspect.*

Our suspicion should be aroused that the presence or absence of labour market rules has much to do with job creation. Second, and to the contrary, there would seem to be more convincing evidence that absent labour market rules inequality would deepen, affecting the most vulnerable. A safe and cautious conclusion to draw thus far is that while there might be a *minor negative* tradeoff between some wealthy countries' labour market rules and *employment,* there could also be a *major positive* linkage between labour market rules and overall labour market *performance*, as measured by such things as job quality and decent wages.

In the end, distinctive national patterns of labour market regulation cannot be exonerated from having some explanatory role to play in the current difficulties facing OECD labour markets. However, the *weight* that we should assign to labour market explanations appears to be far less than is commonly thought: it is a *downstream* factor, whereas the more significant source of inadequate labour market performance lies *upstream* in the factors that can explain inadequate growth.

The reform of labour market regulation is no doubt called for in many settings, but *less* for what such reform might portend for job creation, since it appears to portend little, and *more* for adjusting to a radically changed competitive environment. There can be little doubt that our institutions are exposed to market forces far more now than in the past: it is becoming harder to find shelter and stability in product markets in an era of rising economic interdependence and fast-paced technological change. What course the *reform* of labour market regulation could take would seem to be the good stuff of the debate; the job-creation variant would seem less promising.

Are Labour Standards and Flexibility Substitutes or Complements?

If labour market flexibility is controversial, it probably comes from the notion that flexibility and labour market regulation are in some views awkward to combine. These views arise from orthodox economic theory – to be taken seriously for many reasons, but perhaps most of all because it is orthodox theory that has shaped the policy debate on labour market reform over the past two decades. Indeed, caricature is easy here, for it almost seems at times that theory looked at the real world and found it wanting! When applied to the labour market, the orthodox view of flexibility is most often defined as the *short-term* speed of adjustment of prices and quantities – that is, labour costs and employment – to changes in the economic environment.[3]

[3] A clear and concise distinction between 'orthodox' and 'institutional' views of the labour market is made by Freeman, 1992.

Furthermore, orthodox theory spends a lot of time looking at the *individual* – whether the individual person or the individual firm – and often assumes that the adjustment the individual makes is favorable to *overall* economic efficiency, and, second, that labour market interventions largely interfere with efficient adjustment. For believers in the view that there is only *one* path to flexibility, the standard theory does seem to offer a one-best-way model in which rules and interventions are clearly a problem (or, in the language of the debate, rigidities). For in the standard view of how competitive markets work, labour standards should impede adjustment, and thus impede the efficient allocation or reallocation of resources. All these rules, in short, should work to the detriment of economic growth and of job creation.

Of course, this view leaves us to contend with some alarming contradictions. (How, for example, did highly regulated Germany and Japan somehow muddle through to become the economic powerhouses that they became 'despite' rather than because of the way their labour markets are regulated?) But nowadays the case cannot rest on past performance when adjustment was much less of an issue. At the extreme, what the theory really seems to imply is that the future belongs to the short-term adjusters, the quickest to change will be the quickest to benefit, and the quickest to change will be those not encumbered by distortionary rules.

Labour as a Market unlike Others

One major problem with standard theory – and standard theorists are quite aware of this problem – is that it assumes a world of perfect competition. Yet nowhere in the world does the labour market behave like the market for foreign exchange or the spot market for oil. Everywhere in the world, labour markets depart from the textbook ideal of rapid, short-term adjustment of prices and quantities. The labour market is rule-bound – prices and quantities ultimately do adjust, but not that quickly. What is more, the rules that govern behavior in the labour market have many sources: they are formal and informal in origin. The formal ones include all those in the contemporary debate – wage floors, employment protection, unemployment benefits, social security charges, and so forth. These rules do two things in the main: they *standardize* behaviors among all actors within a relevant sphere of application; second, they *constrain* behaviors, foreclosing certain paths through which adjustment can occur.

Again, these rules need not always be the ones that legislatures pass or trade unions bargain for, but can also be quite informal in origin. One of the most important empirical works in labor economics in recent years[4] looked at the relationship between unemployment and wages in twelve countries. If one is a believer in the textbook equilibrium between prices and quantities, then one should be able to guess how wages and unemployment should fit together: local economies with high unemployment should have wages that are too high; areas with low unemployment should have a low level of wages. But the study in question finds across all locations that high levels of local unemployment coexist with low levels – not falling levels – of wages, and, conversely, that low levels of unemployment are found in locations with

[4] Blanchflower and Oswald, 1992.

high wage levels. This is exactly the opposite of how a competitive labour market should work. Trade unions or distorting regulations are to blame, one might think. But the astonishing thing is that these relationships are found to be the same, irrespective of the location in question, irrespective therefore of the different laws in play, and irrespective of whether trade unions are present or absent. Finally, how much wages do adjust when unemployment increases is just about identical across all these twelve countries – again, irrespective of differences in labour market institutions which textbooks would assume to result in different degrees of wage rigidity.

All this is to say that the labour market does not appear to behave – as Robert Solow (1992) once quipped – like the market for dead fish. It seems to have its own rules – those we apply to it when we formalize labour market regulation, as well as the informal social norms or codes of behavior that arise quite independently of the legislative process. Why, then, does the real world frustrate standard theory? Here, we would seem to have two options: either the world is wrong or the theory has its limitations. We return now to what little is known about labour standards and economic performance and, this time, with reference to the developing countries.

More Facts: A Return to the Empirical Debate

If adjustment is occuring efficiently, it ought to be reflected in a broad number of economic indicators – such as the rate of economic growth and growth of per capita GDP, employment creation, and the growth of trade. All of these indicators can be taken as proxy measures for whether labour markets are functioning efficiently and flexibly.

Consider first the OECD's (1996b) recent two-year examination of the relationship between trade and labor standards in developing countries. The study looked at whether certain minimum labour standards harmed or improved the growth of trade. For example, does a country's trade performance improve when the core labour standards of freedom of association and collective bargaining are repressed? The evidence did not confirm this. First, countries with low labour standards are not necessarily countries with low labour costs – that is, suppressing unions is no guarantee of low labour costs: indeed, real wages have grown faster than productivity in several countries such as Kuwait, Malaysia, and Singapore, which are hardly known for the strength or militancy of their trade unions. And the reverse? Did highly regulated public-sector and urban formal wages stubbornly resist adjusting to the poor economic climate of the 1980s? Again, the evidence was unavailing. Throughout the developing and developed world, downward real wage flexibility was the norm.

Second, import prices on world markets tend to be about the same for developing country exporters, irrespective of the level of their labour standards. So the notion that countries can gain market share by undercutting labour standards does not seem borne out by any evidence. Of course, this is not the same as saying that some governments *might think* they can preserve their comparative advantage or show themselves as more attractive to foreign investors by suppressing freedom of association rights. But there is no evidence that such suppression improves trade performance. In fact, the OECD speculates that such a strategy carries great risks. It could end up by *misallocating* resources – that is, of locking in countries to low-skilled, low-margin niches in international competition. Labour market flexibility through this route can create incentives that worsen economic performance.

In short, not only do better core labour standards seem not to negatively affect economic performance or developing countries' competitive positions in world markets. On the contrary, the observance of core standards seems to strengthen the long-term economic performance of all countries. Freedom of association and collective bargaining could increase labour costs, but such standards do not always increase labour costs because they also tend to improve productivity. If labour costs are increased, does this harm trade performance? Again, no evidence could be found for this. Finally, democratic societies in which freedom of association rights exist would appear to have growth advantages over dictatorships in which freedom of association and other liberties are repressed.

Excessive flexibility through the absence of standards can lead to excessive inequality. Is inequality then good for growth? Evidence does not suggest this, as the example of East Asia clearly shows: the most unequal societies are those where the rate of growth is lowest. This is largely because inequality does not mean that are all wealthy but some are remarkably wealthy. Inequality shows up among society's least protected. These have neither the incentive nor the means to contribute to domestic savings and investment. The wealthy, meanwhile, spend disproportionately on imports. As a World Bank studies also show, the poor in unequal societies underinvest in health and education which ultimately curbs economic growth.

There is a strong positive correlation between the growth of trade and the growth of GDP. Trade *liberalization* would therefore seem to be an important policy objective for increasing economic growth. A relevant question is whether the promotion of freedom of association and bargaining rights impede trade liberalization. Here, too, the answer is negative. Not only do the two seem to go hand-in-hand, in a large number of cases, improving core labour standards came first and seemed to help trade reform. How could this be so? Perhaps because a minimum level of worker protection helps to overcome resistance to trade liberalization. Unprotected workers perceive their interests narrowly. The fact that trade liberalization improves economic performance in some abstract way is of little concern to workers who are narrowly defending their own interests. Labour standards can remove narrow concerns and increase the acceptance of a trade reform agenda. Finally, the OECD report argues that the market alone is unlikely to generate such minimum standards: this is the role of the state, and state intervention in this area would seem necessary for trade reform and thus growth.

Labour standards can increase labour costs, as noted above. Many mandated benefits, for example, increase the nonwage labour costs of employers. The World Bank (Rama, 1996) has begun to compile a large bank of data on labor market institutions and their effect on economic performance. One recent study looked at 30 Latin American countries and tried to determine whether mandated benefits in these countries depressed economic growth rates and job creation. Now, in the standard treatment of the matter, mandated benefits should harm economic performance because they increase labour costs and thus reduce employment. But the empirical record appears rather different: 'neither annual leave entitlements, nor maternity leave, nor social security contributions, nor minimum wages, nor severance pay have a noticeable effect on the growth rate of output' – Nor did the study find that any of these benefits appear to affect the growth rate of employment.

Higher social security contributions were found to be associated with higher labour costs, but there is a surprise here: the higher the social security contributions, the greater the growth of employment in Latin America. One explanation for this textbook anomoly might be that these nonwage cost elements contribute to government revenues, which better allows governments to avoid destabilizing fiscal crises. Finally, and equally surprising from the viewpoint of standard theory, across this 30-country sample *higher* minimum wages were found to be associated with an *increase* in total employment, not a decrease.

Now this same study did find that trade unionism correlated negatively to economic growth. Here, finally, one suspects one is getting closer to the world of standard theory. The reasons for this correlation, however, turn out to be not because trade unions slowed adjustment in the private sector, bargained unreasonable wages, or were associated with lower productivity. Quite simply, trade union membership was highest where the public sector was largest in these 30 countries. Public sector companies tend to be the most protected and the most sluggish to adjust to competition. It may certainly be assumed that trade unions do not necessarily always obstruct efficiency in the public sector, but may indeed do so when they are good incentives for such behaviour, (such as a protected market and a soft budget constraint). The operative point, of course, is that such incentives can be changed. Nor can it be assumed that the public sector is always a drag on growth. Public sector employment has greatly expanded in Malaysia, for example, with no obvious ill effects on that economy's growth. There is no economic law that public sector employees are non-productive or that the public sector itself is inherently inefficient. Indeed, to argue along slightly different lines, there is now strong empirical evidence that the size of government is positively correlated to economic openness in countries throughout the world, irrespective of their different levels of economic development (Rodrik, 1996).

The ILO's (ILO, 1996) own look at mandated benefits and their link to economic growth follows a slightly different path, but largely confirms the World Bank findings. Mandatory benefits, it turns out, tend to be roughly the same across developing countries, whereas the performance of these countries' economies varies greatly. The provision of benefits, therefore, cannot be a factor that influences the relative international competitiveness of developing countries. There is no clearcut empirical support for the claim that high nonwage labour costs hamper economic performance: Singapore does not seem to be doing badly, yet it has nonwage labor costs of European proportions. In developing countries, meanwhile, the level of these benefits is in any case rather modest. Also, throughout the developing world, the level of minimum wages as a percentage of the average wage is relatively low. By and large, it is also true that the level of the real minimum wage in developing countries has plummeted since the 1970s – an indicator of substantial real wage flexibility. Empirically, it would seem that countries rarely set minimum wages at levels that seriously cut into employment.

Rethinking Flexibility

Such evidence as is available raises doubts that labour standards necessarily impede flexibility. Where then does this leave us on the relationship of labour standards to flexibility? The short answer is that it leaves us with a rather poor *initial* definition of flexibility. There are perhaps five ways – or lessons – in which refinements can be usefully introduced to the standard definition (Sengenberger and Campbell, 1994). *First lesson*: *labor standards do not necessarily prevent short-term adjustment.* America is a place where there are few constraints on hiring and firing. Germany is one where employment security laws and agreements are fairly stringent. But over the business cycle, Germany and America show an almost identical variation in the volume of labor input. As Abraham and Houseman (1994) show, in America, it is the number of people employed who vary with the cycle. In Germany, it's the number of hours that people work that vary. German labor standards as they relate to strong employment security cannot be held to prevent short-term adjustment.

There is more to be learned from this one example as to how labour standards relate to flexibility. The *second lesson* is that, contrary to the implication of a one-best-way, *there is more than one path to short-term adjustment.* The reason is that by foreclosing adjustment through one path, a labour standard can create an incentive for flexible adjustment elsewhere. If there are limits on hours of work, the incentive is to organize those hours more efficiently – conversely, if hours of work are too long, there may be little incentive to use labour efficiently. If trade unions are repressed, accident rates might shoot up. If there are limits on unilateral dismissal, the incentive is to hire the best people and, further, to improve the education and training systems so that more best people are produced. If there are lower limits on what people can be paid, then other ways need to be found for controlling labour costs, such as improving productivity.

The above links closely to a *third lesson*: *the impact of a single rule can just not be known in isolation*, yet most of the 'damage estimates' of standards that economists have produced have studied standards in just this 'partial equilibrium' way. Labour standards work as a package or a system – how a particular rule works depends on how it interacts with others. As Boyer (1994: 60) observes: 'the same isolated labour institution – for example, a minimum wage, job security regulations, etc. – may have opposite effects when inserted into different national settings.' There is a simple message here: dysfunctional rigidities can be designed into systems of labour market regulations by not allowing firms to lay off workers, or to vary their hours, or to adjust their wages, or to move them across jobs. On the other hand, if employment security becomes a behavioural constraint, firms may choose to vary a component of real wages with the business cycle or firm performance through profit sharing or performance pay; they also have an incentive to hire wisely and to train employees in a broad number of areas. This is, of course, the stylized version of Japan, a system constructed on what Ronald Dore (1986) calls 'flexible rigidities.' The essence of this thought is that some rigidities can work to improve flexibility.

The point is not that labour standards are not a problem for flexibility because ways can be found to get around the constraints they impose. Imagine if the labour market were like a spot market, and workers alone bore the brunt of short term adjustment either through their pay or their jobs. This would be a world of total flexibility, and it would be suboptimal. There is, for example, a lot of evidence that the provision of employment security is an inducement for firms' – their investment protected – to invest in training, and for workers – their employment secure – to accept such training. Employment insecurity weakens that inducement on both sides and can show up in the non-regeneration of skills in the external labor market. As the *Economist* observed: 'A vicious circle develops as higher labour turnover produces a less trained and hence less loyal workforce. And the macroeconomic moral from all this? If a country's companies switch to more flexible types of employment contracts, individual firms may well prosper. But if workers get less training as a consequence, the country's economy might become less competitive' (quoted in Sengenberger and Campbell, 1994: 156).

Suppose for argument's sake that the much-discussed thesis that employment security with the same firm is a thing of the past is true, a casualty of the decline of more stable and sheltered systems of production. If true, then the question becomes how to provide efficient retraining and redeployment in the outside labor market. Training institutions are important for this. But so are regional or local organizations of employers and trade unions. The point is that, in the absence of new agents of external labour market intermediation, one firm's flexibility can create negative externalities, or efficiency losses outside the firm. To paraphrase Dore's description of Japan, the presence of negative externalities could be one of 'rigid flexibilities', the absence of constraints on individual flexibility creating its own rigidities in the broader economy.

This point underscores another major lesson about standards – *lesson four*, to be exact – which is that *a sole focus on just the individual does not necessarily improve everyone else's efficiency*. The benefits a firm gets from externalizing its problems can show up as costs elsewhere in the economy. Here, the logical parallel is that systems of labour standards shared by actors within a relevant sphere is akin to the regulatory architecture of environmental protection. The goal is to increase the benefits of all by creating incentives for the internalization of the costs of some behaviours. Labour standards can be one means of this by socializing market risks, i.e. they spread the risks and thus improve overall outcomes. In the German example, the risks of recession are spread more evenly on the population as a whole, rather than more severely concentrated on a minority. Nor does this appear to harm flexible adjustment: the overall pattern of job creation and job destruction is much the same in Germany as in the United States.

Fifth, and finally, *flexibility is wrongly conceptualized as just a short-term matter. We should be concerned with long-term dynamic efficiency* – high skills, high productivity, high adaptability, and high cooperation. Here the role of common standards is to channel incentives toward the long term. As Storper (1994, p. 155) argues: 'the impact of industrial relations on economic efficiency has been associated, whether implicitly or explicitly, with those who criticize unions in particular and worker protections in general as fetters on the optimal level of ongoing adjustment in the economy. Yet in recent years there has been a growing awareness that certain forms of institutionalized worker protections and unionism are associated with superior competitiveness...There is a sense that in certain countries the existence of highly institutionalized labor markets has something to do with a dynamic of self-selection into high-value-added, highly competitive economic activities, and that industrial relations are a central element of the institutional structure.'

If labour standards can improve long-term competitive prospects, one problem is that we appear to know a lot about short-term costs of standards and much less about long-term benefits. We know, for example, that family allowances or maternity leave costs money, but relatively little on the benefit side of this investment in future, more productive employees. We know that unemployment benefits increase the duration of unemployment – the cost side – but why are unemployment benefits paid? The economic rationale is that they allow job seekers to find the most productive match for their skills, rather than to settle for any job to put food on the table, and because they ought to encourage labour mobility. The most productive match is an overall good for the economy and should reduce future spells of unemployment. There is virtually no empirical research devoted to this very reasonable hypothesis. Nevertheless, the World Bank (1996) has recently argued – on grounds of theory – that the underdevelopment of unemployment insurance in the transition economies of Central and Eastern Europe may result in worker resistance to change and the immobility of labour from declining to growing firms, sectors, and regions. The message here would appear to be that social funds to mitigate the cost borne by labour of restructuring can speed up and improve the economic outcomes of restructuring.

Of course, another problem is that if standards are not shared by all competitors, firms may face incentives to undercut each other in the short term, leading all to become preoccupied with short-term costs rather than innovation, which takes more time. A preoccupation with the short term can interfere with long-term economic adjustment, and such adjustment is unlikely to occur in the absence of standards, because short-term competitive pressures would be too great. Locke, Kochan, and Piore (1995: 154), for example, report on a multi-country empirical study of firms' responses to the now global sources of competitive pressures: 'the low-cost response to market pressures and changes appears to occur most frequently in countries with weak institutions, low levels of unionization, decentralized bargaining structures, and a limited government role in the labor market... Cost-based strategies may give firms a comparative advantage over value-added firms in the short run. However, they exert a perverse externality on the society by making it more risky for competing firms to make the long-term investments needed to upgrade skills and change their organizational practices in order to reap the benefits of these investments. Thus to the extent that cost-based strategies predominate in a country, the nation risks getting caught in a low-wage/low-skill equilibrium. Nations that lack strong institutions constraining the choice of the low-wage option are particularly vulnerable to this problem.'

Slow growth in an increasingly interdependent world economy is indeed putting standards under great strain. Market forces are shaping labour market outcomes much more now than in the past, and, with globalization, 'national' labour market outcomes may be increasingly contingent or dependent upon *other countries'* competitive advantages which, in turn, are related to their own labour market arrangements and institutions. Much more needs to be said than is said here on whether rising economic interdependence also implies labour market interdependence and the new constraints and opportunities this may pose in the design of national labour market regulations. It seems clear that the new standards we design will have to work with market forces rather than against them and that the responsibility of national governments and the private labour market actors is not merely engaged by the process but *rendered substantially more important*. The nation, in short, continues to be the relevant level of action in the global economy.

At the very least, the evidence presented here suggests that the reform of labour market regulations will continue and appropriately so to top the agenda of policymakers and practitioners who, facing a rising rate of change, may often have to rethink how its costs and benefits can be most efficiently distributed in society. But here, the operative word is reform, not removal, since in the empirical world, we should doubt whether the mere dismantling of existing labour market rules and letting relative wages widen can be a major source of employment creation. And we should suspect that such a course runs the strong risk of creating precisely the wrong incentives for sustaining competitive advantage and healthy economies. Not every labour market regulation can be defended, of course. They can over-shoot; they can obsolesce. But that is a rather different matter than the empirical conclusion that labour standards and good economic performance are complements rather than substitutes.

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