COMENTARIO

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The role of institutions and shocks to economic structure in explaining the different performance of labour markets in different countries has attracted much attention in the recent literature on labour markets. In this paper Giuseppe Bertola reviews some of this recent literature which includes much of his own work. The emphasis of the paper is on two points. First that reform is a choice variable and, second, that there is an observable trade-off between unemployment and wage inequality.

The point on the theoretical side is to stress that reforms in labour market institutions are endogenous. The argument is that labour market institutions have beneficial effects for some individuals and damaging effects for others. When the economic environment or the balance of power changes, the balance between gainers and losers also changes and pressure mounts towards reform. A clear example is the early reform in the Netherlands at the beginning of the 1980s.

In the empirical part the author presents some estimated equations of unemployment (or employment) on measures of wage inequality using a panel of OECD countries and concludes that the data support the existence of a trade-off between wage inequality and unemployment.

My comments are on these two points. First, on the process and factors leading to institutional reform:

(i) Political institutions, such as the electoral and party systems, may play an important role in the process leading to labour market reforms. There are substantial differences in political institutions across countries, which may explain why some countries did undertake reforms while others under similar economic conditions did not. The author has to invoke policy maker personalities (an output of political institutions) to explain why the UK reformed its labour market while other worst performing countries did not. For example, the UK parliamentary and party systems may be both more receptive to new political ideas and more effective in building up decisive majorities. Median voter arguments that abstract from the mechanisms by which

majorities are formed are likely to leave too much unexplained variation in the timing and scope of reforms across countries.

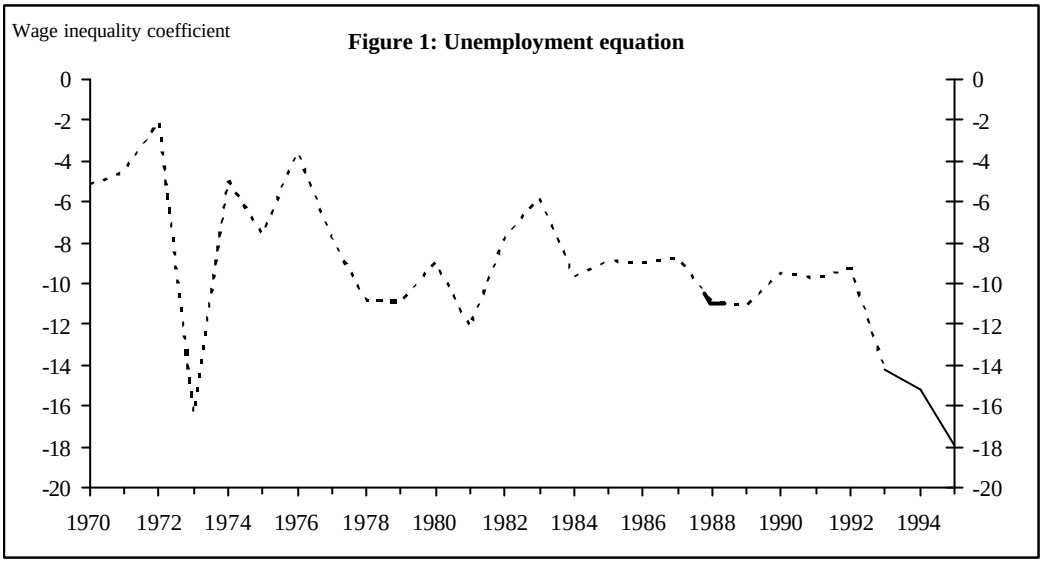
(ii) The institutional indicators that have been assembled in the literature are imperfect measures that are nevertheless useful for comparisons in *levels*. However, using *changes* over time in these indicators as measures of institutional reform is probably too much to ask from them, in the sense that a substantial amount of variation in the changes will be due to measurement error. If the emphasis is on the endogeneity of the labour market *reforms* one has to look at determinants of such reforms (past outcomes, political institutions, etc…), which in turn require a different data collection agenda. Direct indicators of reforms should be constructed because the indices that are used to compare cross country levels are not necessarily useful in changes.

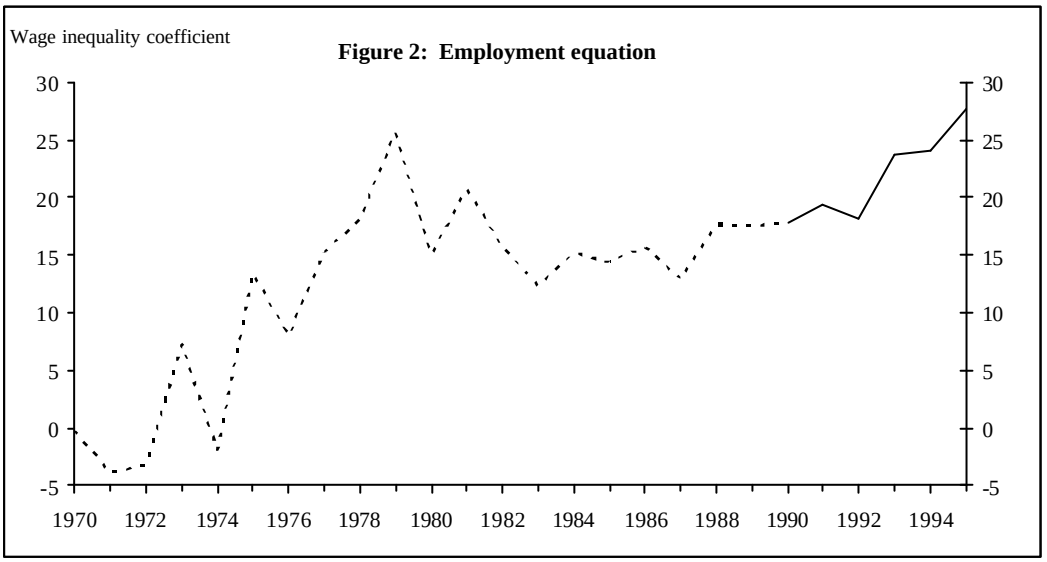
A paper that relates to these issues is Besley and Case (2000) which highlights the relevance of (a) (state and country level) political and economic characteristics for policy choices, and (b) studying what drives policy as a way of finding instrumental variables.

On the empirical side I have few comments on the estimated trade-off between unemployment and wage inequality.

(i) To interpret the differences across countries in wage dispersion as due to institutions it would be better to try and use a wage inequality measure clear of differences in labour force characteristics. Indeed, greater heterogeneity may generate greater inequality. Part of this heterogeneity may be endogenous but not all. For example, in Blau and Kahn (1996) it is found that holding the distribution of measured characteristics constant, the average difference between the U.S. 50-10 wage gap and that for other countries would decline, as is to be expected. On the contrary, the figure for the 90-50 gap would increase.

(ii) One would not expect a stable trade-off between unemployment (or employment) and wage inequality during the last 30 years. I have allowed for the coefficient of the wage inequality to vary over time and those coefficients are plotted in Figures 1 and 2, for the unemployment and the employment estimated equations, respectively. The size of the coefficient changes importantly during the last three years of the sample period and is indeed only then that these coefficients are significantly different from zero. So that trade-off is in fact only present after the first years of the 1990s.





——— significant at 95%

Source: Nickell and Nunziata Database, OECD Labour Market Statistics: Percentile distribution of gross earnings.

(iii) In the spirit of Blanchard and Wolfers (2000) I have estimated the following equations that allow for different effects of institutions over time:

$$y_{it} = l_t + d_t h_i + v_{it} \qquad (1)$$

where t=1970,…,1995, i=country indicator, y=unemployment rate, employment to population ratio. In Table 1 we can see that by doing that the reduction in the standard error of the basic equation ($y_{it} = l_t + h_i + v_{it}$) is 20% for the unemployment equation and 10% for the employment equation, both larger than the ones achieved by adding the wage inequality term, 4.5% and 6.3% respectively.

Table 1[1]

Regressors:	Constant	Time dummies	Country dummies	Time and country dummies	Time dummies and $d_t h_i$
		Unemployment equation			
Standard error of the equation	4.2007	3.6414	3.0954	2.1461	1.7160
		Employment equation			
Standard error of the equation	7.9533	8.1034	3.0602	2.9983	2.7059

1. Note: Sample period 1970-1995, 515 observations.
Source: Nickell and Nunziata database.

Suppose that we regard both unemployment (u_{it}) and wage inequality (w_{it}^d) as outcomes of equations like (1). Then the coefficients on wage inequality in the regressions reported in the paper are difficult to interpret as measures of trade-off because the wage inequality is an endogenous variable:

$$\begin{aligned} u_{it} &= l_t + d_t h_i + n_{it} \\ w_{it}^d &= g_t + r_t h_i + e_{it} \end{aligned} \qquad (2)$$

$$\Rightarrow u_{it} = b_t w_{it}^d + a_t + V_{it}$$

where $V_{it} = n_{it} - b_t e_{it}$ and $b_t = d_t / r_t$. Clearly $Cov(w_{it}^d, V_{it}) \neq 0$.

A better description of the 'trade-off' could be obtained from the evolution of the coefficients d_t and r_t in (2).

REFERENCES

Besley, T. and A. Case, "Unnatural Experiments? Estimating the Incidence of Endogenous Policies", *The Economic Journal*, November 2000.