Testimony of
Tim Kane
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Chairman Schumer, Representative Maloney, Senator Bennett, and other distinguished members of the Committee, I appreciate the opportunity to testify before the Joint Economic Committee today on the subject of Importing Success: Why Work-Family Policies from Abroad Make Economic Sense for the U.S. As a former staff economist for the JEC, this homecoming is a special honor.

In my testimony, I would like to: (1) describe the nature of the challenge facing Congress in the context of the booming U.S. economy in recent years; (2) offer a set of principles for both enhancing our economy generally and labor economy specifically under the framework of economic freedom and (3) suggest that Congress should not use the conventional European approach to labor markets unless it also wishes to invite European levels of unemployment which occur at roughly twice the rate as in the United States.

The Nature of American Prosperity in this Decade

As obvious is this may seem, every analysis of economic policy at the federal level in the United States must begin with recognition of the comprehensive, record-setting strength of the national economy. By almost every indicator, the American economy is prosperous, but especially so in comparison to other advanced economies.

- **There are More Working Americans than Ever Before**. In the latest Employment Situation report from the Labor Department, it is reported that there are 152.8 million Americans in the labor force, and 145.9 million employed. These are just shy off all-time records set in the last few months.
- **8 million payroll jobs in 4 years**. I try to remind myself given all the gloom in the media that during a four year span, job growth in America has averaged 167,000 every month. That's 5559 jobs added to U.S. payrolls every day, or 232 jobs per hour, or a new job every 16 seconds for four straight years.
- **Extraordinarily Low Unemployment.** The rate of unemployment is just 4.5 percent nationally. In most introductory economics courses, this is considered a rate that is below the natural rate of unemployment, and a sign of possible overheating. By any measure, it is a low rate, far below the average of the 1990s, which itself was a healthy decade economically.
- **Growth in Output and Productivity.** The positive growth rates in GDP every quarter since the attacks of 9/11 are a very powerful symbol of the resilience of the American economy. Despite the recent slowdown in Q1's preliminary growth estimate, the critical fact is that the economy is still expanding in a positive direction with many signals that this growth will continue and even accelerate. But a more important measure, as you know, is the high GDP per capita

Americans enjoy. By comparison, U.S. GDP per capita is 20 percent higher than income levels in nearly every other country in the world, particularly the advanced industrial economies of Europe, as well as Japan.

Economic Freedom and the Institutions of Growth

I find that the most useful framework for approaching fiscal economic policy is not is traditionally known as macroeconomics, but instead growth economics, particularly the renewed consensus among economists that institutions are the key to overall performance. This idea is captured well by Stephen Parente and Ed Prescott's line of research "Barriers to Riches" which is also the title of their book. It is also the approach we use in the Heritage Foundation/Wall Street Journal *Index of Economic Freedom* – a systematic, empirical measurement of economic freedom in countries throughout the world. As the director of the team that assembles the Index, I should mention that we make all the material, country scores, and even raw data available for free on the Internet at www.heritage.org/Index.

Economic theory dating back to the publication of Adam Smith's *The Wealth of Nations* in 1776 emphasizes the lesson that basic institutions that protect the liberty of individuals to pursue their own economic interests result in greater prosperity for the larger society. Modern scholars of political economy are rediscovering the centrality of "free institutions" as fundamental ingredients for rapid long-term growth. The objective of the *Index* is to catalog those economic institutions in a quantitative and rigorous manner.

The *2007 Index of Economic Freedom* measures 157 countries across 10 specific factors of economic freedom, which include:

- Business Freedom
- Trade Freedom
- Fiscal Freedom
- Freedom from Government
- Monetary Freedom
- Investment Freedom
- Financial Freedom
- Property Rights
- Freedom from Corruption
- Labor Freedom

The methodology for measuring economic freedom is significantly upgraded. The new methodology uses a scale of 0-100 rather than the 1-5 brackets of previous years when assessing the 10 component economic freedoms, which means that the new overall scores are more refined and therefore more accurate. Second, a new labor freedom factor has been added, and entrepreneurship is being emphasized in the business freedom factor.

Both of these new categories are based on data that became available from the World Bank only after 2004.

The methodology has been vetted and endorsed by a new academic advisory board and should better reflect the details of each country's economic policies. In order to compare country performances from past years accurately, scores and rankings for all previous years dating back to 1995 have been adjusted to reflect the new methodology.

Economic freedom is strongly related to good economic performance. The world's freest countries have twice the average income of the second quintile of countries and over five times the average income of the fifth quintile of countries. The freest economies also have lower rates of unemployment and lower inflation. These relationships hold across each quintile, meaning that every quintile of less free economies has worse average rates of inflation and unemployment than the preceding quintile has.

Of the 157 countries graded numerically in the 2007 *Index*, only seven have very high freedom scores of 80 percent or more, making them what we categorize as "free" economies. Another 23 are in the 70 percent range, placing them in the "mostly free" category. This means that less than one-fifth of all countries have economic freedom scores higher than 70 percent. The bulk of countries—107 economies—have freedom scores of 50 percent–70 percent. Half are "somewhat free" (scores of 60 percent–70 percent), and half are "mostly unfree" (scores of 50 percent–60 percent). Only 20 countries have "repressed economies" with scores below 50 percent.

The typical country has an economy that is 60.6 percent free, down slightly from 60.9 percent in 2006. These are the highest scores ever recorded in the *Index*, so the overall trend continues to be positive. Among specific economies during the past year, the scores of 65 countries are now higher, and the scores of 92 countries are worse.

The variation in freedom among all of these countries declined again for the sixth year in a row, and the standard deviation among scores now stands at 11.4, down one-tenth of a percentage point from last year and down two full points since 1996.

There is a clear relationship between economic freedom and numerous other cross-country variables, the most prominent being the strong relationship between the level of freedom and the level of prosperity in a given country. Previous editions of the *Index* have confirmed the tangible benefits of living in freer societies. Not only is a higher level of economic freedom clearly associated with a higher level of per capita gross domestic product, but those higher GDP growth rates seem to create a virtuous cycle, triggering further improvements in economic freedom. *This can most clearly be understood with the observation that a ten point increase in economic freedom corresponds to a doubling of income per capita.*

The reason that I am devoting so much of my testimony to the topic of economic freedom is because I hope to impress the centrality of internally generated policy change

as the key to development. To be blunt, countries control their own fate, including the U.S.

In the 2007 edition of the Index, one chapter is dedicated to a cross-country study of labor regulations, which is the issue of interest in this hearing today. It was written by Johnny Munkhammer, an economist from Sweden who has a unique and invaluable perspective. Here is an extended quote from Munkhammer's chapter, "The Urgent Need for Labor Freedom in Europe and the World,"

> For several weeks during the autumn of 2005, riots raged in the streets of Paris. Every night, hundreds of cars were burned, shops were vandalized, and violence ruled. French President Jacques Chirac concluded that his nation was suffering from a profound "malaise," a word that indeed captures the reality of economic and social problems in many European countries. After centuries of economic leadership, Europe must now face the truth that its governing institutions—especially its labor markets—are deeply flawed. Those who finally took to the streets, native and immigrant citizens alike, were severely affected by unemployment.
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> France may be the most stubborn defender of the so-called European social model, characterized by vast government intervention in the economy, but many other governments in Western Europe are committed to the same philosophy. Presidents and prime ministers devote speeches to nostalgic messages and promise to maintain and protect the existing social model. Their rhetoric translates into policies that are a new kind of protectionism for traditional jobs, a protectionism that is reflected in the widespread official resistance to a single European Union (EU) market in services, disapprovals of business mergers, and an anxious debate about the "Polish plumber" representing free flows of labor within the EU.
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> We Europeans are clearly at a crossroads. Either we look to the future and learn from successful market-oriented reforms, or we look back to the past and continue trying to shield old occupations from international economics. It is a choice between openness and protectionism, between modernization and nostalgia—indeed, between government intervention and freedom itself. The problems of Europe are not born overseas, but are innate to the process of internal economic development and change. That is why a tighter adherence to a failing model will only exacerbate current problems and lead to more unrest in European cities. Rioting and decline is a destiny that no European wants to face.
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> Yet there is reason for optimism. Never before have so many countries been so deeply involved in the global economy, and the benefits of globalization—economic growth, employment, and competition—are ever clearer. Never before have so many countries made successful free-market reforms, which is an inspiration for others. Almost all European countries can point to at least one

successful reform, and as we copy each other's successes, the future should rapidly become much brighter.

In my view, of all the areas that are still in need of substantial reform, the most important is the labor market. People—especially the young—want jobs and freedom, not dependence on government.

…

Consider that between 1970 and 2003, employment in the U.S. increased by 75 percent. In France, Germany, and Italy, it increased by 26 percent. In 2004, only 13 percent of unemployed workers in the U.S. were unable to find a new job within 12 months; in the EU, the figure was 44 percent. In the EU, average youth unemployment is 17 percent. In the U.S., it is 10 percent.

But the best comparisons can be made within Europe itself. Denmark has an employment rate of 76 percent, but Poland is far lower at 53 percent. Youth unemployment is above 20 percent in Greece, Italy, Sweden, France, Belgium, and Finland and below 8 percent in Ireland, the Netherlands, and Denmark. In the EU's 15 member states, between 1995 and 2004, the development of employment was also very different between the countries. In Ireland, the Netherlands, and Spain, the increase in employment was the highest; in Germany and Austria, it was almost zero.

What were the differences between the successful countries and the others? First of all, the labor market was substantially freer in the countries that succeeded in creating new jobs. Second, payroll and income taxes were more than 10 percentage points lower in the five best economies (in terms of job creation) compared to the five worst. Third, the levels of contribution from the state for unemployment and sick leave were lower in the best economies.[15] What the successful countries have in common are freer labor markets, lower taxes, and lower contributions.

A look at the results for various countries in the labor freedom category in the *Index* provides further proof of the connection between labor freedom and employment. Table 1 (*in the Index, chapter 2*) shows all of the nations of Europe, including their EU affiliations, ranked according to their labor freedom scores in the 2007 *Index*.

Countries like Georgia, the U.K., Switzerland, and Denmark enjoy higher scores in labor freedom and have experienced better employment outcomes generally. Countries with low scores like Germany, Italy, Portugal, and Sweden have suffered weak employment and outright stagnation.

Comparing the 15 countries that were members of the EU in 1995–2004 to EU-25 and non-EU countries is illustrative. In Britain, the labor market is relatively free

and earns a score of 82.7 percent, whereas in Sweden, it is highly regulated and earns a score of 52 percent, compared to the EU-15 average of 59.7 percent. The 10 countries that recently joined the EU have raised their average labor freedom by nearly a full point, but the scores of non-EU economies average nearly five full percentage points higher. Yet the average income between 1995 and 2004 grew by 29 percent in Sweden, 37 percent in EU-15 countries, and 72 percent in Britain. The income of the poorest 10 percent of the population grew by only 10 percent in Sweden, compared to 59 percent in Britain. The worst off were better off where the labor market was freer.

The larger lesson is that Europe's more "advanced" economies have generally created more complex restrictions on labor freedom in the name of protecting workers. This relative wealth has been a convenient excuse for stagnant growth and higher unemployment, but the apology is losing its validity as many Eastern and Middle European countries experiment successfully with freedom.

Labor Protectionism and Unemployment

The Summer 1997 issue of the *Journal of Economic Perspectives* published two articles discussing labor rigidity in Europe. Horst Siebert emphasized that the concert of rigid labor institutions in Europe was clearly driving higher unemployment rates there, emphasizing the tightening of policies during 1960s and 1970s. While he observed differences among European states, he concluded by focusing on one common feature: "Job protection rules can be considered to be at the core of continental Europe's policy toward the unemployment problem: protecting those who have a job is reducing the incentives to create new jobs." A contrasting opinion was provided in Stephen Nickell's econometric overview, which reported, "there is no evidence in our data that high labor standards overall have any impact on unemployment whatever."

Table 1 presents unemployment rate averages by decade for ten countries reported by BLS.

Table 1. Unemployment Rates on the rise

	1960–1979	1980–2004	Change
USA	5.5	6.2	0.8
Japan	1.5	3.3	1.7
Netherlands	4.6	6.5	1.9
Canada	5.7	8.5	2.8
Sweden	1.9	5.1	3.2
UK	3.6	8.3	4.7
Australia	2.9	7.7	4.8
Italy	3.5	8.3	4.8
Germany	1.4	7.2	5.9
France	2.8	9.8	7.0

Source: Author calculations using U.S. BLS data.

After 1980 it is clear that America has continued its productivity leadership (with higher income distribution generally), while European countries suffer high unemployment rates. The "humane" policies of labor protectionism appear to have backfired, creating a less humane social arrangement.

Nickell (1997) emphasized the diversity of European unemployment rate experiences ("from 1.8 percent in Switzerland to 19.7 percent in Spain") and policies. Nickell's approach is a good one—he assembles macroeconomic performance data for 20 OECD countries, measured over two periods (1983–88 and 1989–94), and assembles an impressive array of labor policy measures, which he uses as explanatory variables. Nickell says at one point that "roughly speaking, labor market institutions were the same" in the 1960s and 1990s. He concludes that unemployment rates are dependent on some policies (e.g., generous unemployment benefits, high taxes, high minimum wages, and weak universal education), but not the conventional culprit: labor market rigidity.

However, Nickell in 1997 has been updated by Nickell in 2005. His assessment has changed in less than ten years because the empirical evidence has changed, as he expressed in his recent paper with Luca Nonziata and Wolfgang Ochel (2005). The authors find that "changes in labor market institutions" and rigidities since 1960 have indeed occurred, and these are the root causes, with employment protection accounting for 19 percent of the rise of unemployment. I think it is fair to say that the consensus view of economists today has evolved along the same lines.

A deep new data set published by the World Bank in 2003 and published in the *Quarterly Journal of Economics* (Djankov *et al.* 2004) makes a definitive case that the "Regulation of Labor" (the title of the paper) can be harmful to macroeconomic outcomes. The Djankov labor data cover 85 countries over dozens of labor categories, including the size of the minimum wage, strike laws, protections from dismissal, generosity of social benefits, and so on. The data are coded so that a maximum score of 1 represents the most rigid labor rule, while zero represents perfect flexibility. Importantly, this very deep data set represents laws during a single year, 1997, which precludes some uses that would be available with a time series.

Nevertheless, Djankov *et al.* (2004) find that an increase in the employment laws index is associated with an increase in black market activity, a reduction in labor force participation, and an increase in unemployment rates (averaged over the decade). The econometric tests are not robust and report an R^2 of 0.13, with the labor regulation variable significant at the 5 percent level.

I am hopeful that the excellent new data sets in place will be improved in years ahead and that, with greater knowledge of how institutions and outcomes relate to one another, countries will be even better armed to lower the barriers to riches.

What Would a New Labor Regulation Do to the U.S. Economy?

Many voices are calling for new policies to address a vulnerable U.S. workforce, including ideas such as wage insurance, flex-time, and mandatory paid leave. There may be merit to all of these ideas, and yet they all remain problematic. The premise that the U.S. workforce is vulnerable is the first problem – suggestions of anxiety are simply overblown. Indeed, many of the statistics used to emphasize new pressures on the

workforce are actually evidence of new flexibility, such as the rising number of temporary jobs. A second and related problem is that many policy solutions are defined by government intrusion into an otherwise optimally functioning private sector.

- Rule 1 of economic policy should be: Do no harm. The economy is strong, so an airtight case must be made for any new rules aimed at fixing a labor market that is not broken.

- Rule 2 of economic policy is: Consider the incentives.

The idea of mandatory paid leave is especially problematic. My colleague, James Sherk, recently published a Heritage study (web memo #1450, http://www.heritage.org/Research/Labor/wm1450.cfm), which I quote:

> Few oppose allowing workers to take time off work to recover from illness or allowing parents to tend to sick children. Today, the vast majority of businesses provide their workers with some form of paid sick leave: 74 percent of companies provide paid sick leave, while 82 percent provide other paid vacation days that workers can use to care for a sick relative.
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> [The Healthy Families Act as considered in the Senate (HFA, S. 910)] would make this widespread and voluntary practice mandatory. The legislation would require businesses employing 15 or more workers to provide at least 7 days of paid sick leave per year and would prevent companies from disciplining employees who abuse this leave. This would radically change the current system of voluntarily provided sick leave by encouraging widespread misuse.
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> Like the FMLA, the HFA would make it difficult for employers to verify that workers taking sick leave are actually sick. The act would allow workers to take up to 3 days of leave without any medical certification that the leave is necessary.
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> For absences exceeding three consecutive work days, workers would need a doctor's certification. However, the HFA does not allow employers to challenge a doctor's certification, even when they strongly suspect that it is fraudulent. Under the FMLA, employers have found that workers who are not injured can usually find a doctor who will certify that they have a chronic condition, such as back pain, that requires time off work.
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> Abuse is rampant in countries that require mandatory paid sick leave. In Sweden, for example, the government pays sick workers 80 percent their salary while on leave for an indefinite period of time. At any given moment, 10 percent of Sweden's workers are on sick leave, and over three-fifths tell pollsters that they take the leave when they have no health problems.

So one core incentive problem is that a new mandatory leave requirement is subject to abuse by some workers, which is essentially a penalty on the honest workers.

A larger concern is that any Congressional mandate on employers amounts to a mandatory benefit, which will come at the expense of take-home pay. It is widely known that earnings have not kept up with productivity growth in the U.S. It is also widely known that the reason is that the cost of employee benefits are rising and soaking up almost all of the compensation growth. Bottom line: total compensation for workers is growing at the same pace as productivity, but there is a divergence between take-home pay versus benefits. By mandating more benefits in new labor regulation, congress will be basically giving American workers a pay cut.

Third, there will be a new incentive for employers to discriminate. The good employers will make blind hiring decisions, but unscrupulous employers will have a powerful incentive to avoid employees that are most likely to qualify for the newly mandated benefits. For example, young women who are most likely to take paid maternity leave will face quiet discrimination. Good employers will face higher costs, whereas bad employers will get a competitive advantage. And it all makes economic sense – perhaps why they call mine the dismal science. Nonetheless, the reality of bad incentives means that mandated labor regulations rewards bad behavior and so should be avoided.

Those are three strikes against new labor regulations, or at least three cautions to consider in designing new rules carefully.

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