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FOUR MYTHS ON EMPLOYMENT

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FOUR MYTHS ON EMPLOYMENT (*)

The creation of jobs is today the main goal of the social and economic policies of most industrial countries. This is particularly true of Europe. The poor employment performance of most European countries over the last twenty years has brought employment policies to the forefront of political and social debate.

Employment is the key economic policy objective of the countries of the European Union (EU) as established in the Essen European Council of December 1994. Building on the strategy outlined in the December 1993 White Paper on Growth, Competitiveness and Employment prepared by the European Commission, the countries of the EU have agreed on an action plan that includes measures to do with vocational training, the employment intensity of growth, the reduction of non-wage labour costs, the impact of labour market policies on incentives, and help for the groups hardest hit by unemployment.

The renewed political interest in the employment problem has sparked a major research effort by the academic community. It has become increasingly clear that the underlying forces that hinder the generation of employment are very complex and multidimensional. They lie partly in the traditional domain of economics (i.e. the incentives of the economic agents, the workings of the markets) but cannot be fully apprehended without the insights and the tools of other disciplines such as sociology. The role of the culture of a society (for example, its values and the prevailing attitudes toward work) and its institutions (firm, family, state) is brought coherently into the analysis by adopting a sociological approach, which should complement economics in a comprehensive discussion of employment creation.

This multidisciplinary research effort is not easy, given the traditional communication difficulties across academic disciplines. Nevertheless, the need for just such a broad view led to the *First international conference on the creation of employment*, which is

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at the root of this book. Both the conference and the book are the result of the commitment of the International Graduate School of Management (IESE) to a long-term research effort in this field. It is only natural that IESE's multidisciplinary approach to business education should have been reflected in the nature of the Conference.

The conference took place in Barcelona in the fall of 1994 and brought together economists, philosophers, sociologists and business leaders from several countries to discuss policy proposals that could help in generating employment, particularly in Europe. Some of the papers presented at the conference are collected in this volume.

This introductory chapter will discuss four common fallacies about the difficulties of generating employment in industrial countries. It does not claim to be a survey of the present state of knowledge regarding employment creation (1). Rather, by way of a presentation of the papers included in this volume, it looks at a few common misunderstandings surrounding the factors that contribute to job creation.

Three of the myths that will be examined here are directly or indirectly discussed in detail in the chapters that follow. We will, thus, put the contributions of this book in a wider context. The fourth myth, which concerns the relationship between employment and trade, is not covered in this volume and will, therefore, be the subject of a more complete discussion. It can be seen as a selective survey of a topic which is currently hotly debated.

1. Employment and technological change

There has always been a misunderstanding about the impact of technological change on employment. This mistaken perception was already present with the industrial revolution and has been recurrent in periods of fast technological progress. Our first myth can be stated as follows:

Myth 1. Given the current trends in technological change, there are not going to be enough jobs for all the population. The citizens of industrial societies will have to accept «technological» unemployment and adapt to an increase in leisure time.

The fear of technological unemployment is widespread, particularly among European citizens as they see that each successive period of economic expansion over the last twenty years has been unable to bring unemployment back down to the level attained in the previous cyclical peak.

It is certainly true that western societies will have to adapt to a reduction in work time. However, this is nothing but the continuation of a secular trend and a reflection of the increased well-being of society. This greater social well-being stems precisely from the total factor productivity increases which technological change has brought about. This increase in real income has itself led to an increase in the value that citizens attach to leisure.

Despite these arguments, the main problem with this first fallacy is that, although widely acknowledged to be a misconception, it is still common. It is based upon the idea that the total number of jobs is fixed, determined by what is required to produce the goods and services demanded in the marketplace. If technological change makes it possible to satisfy demand with a smaller amount of labour, so the theory goes, then those jobs are lost.

Of course, this argument is false. As Prof. Layard points out in his contribution to this volume, aggregate demand is not the main constraint on the availability of jobs. If need be, monetary and fiscal authorities can always transitorily generate more demand. Moreover, technological change –with the subsequent increase in total factor productivity– generates real returns, either in the form of lower final prices for goods or in the form of higher wages and profits. These are increases in real income, which in the end result in higher demand. Although technological change may create direct job losses in a particular sector, the increase in income improves the demand for labour elsewhere in the economy.

Indeed, jobs cannot be created simply by artificially increasing the aggregate demand of the economy. The true constraint on employment creation is that of inflation. The inflation target determines the level of aggregate demand, but the number of jobs compatible with that inflation level is entirely determined by the supply side of the economy. In fact, by what Prof. Layard calls the «employability» of the labour force.

The employability of a worker depends on her willingness to take up a job and on how well she meets the requirements of the job market. The more «employable» the labour force, the higher the level of employment that will be compatible with a given inflation target. The explanation is simple. When aggregate demand peaks, the «employable» workers limit the resurgence of inflation since they are able to compete for the new jobs. Non-employable workers cannot bid for the new jobs and the expansion of aggregate demand may lead to wage inflation. The paper by Prof. Layard exploits the notion of «employability» to outline a plan to reduce long-term unemployment. This kind of unemployment is the natural target for measures that attempt to reduce the number of unemployed without increasing the rate of inflation, since long-term unemployed workers exert no downward pressure on labour markets.

The notion of «employability» is intimately linked to the implications of technological change for labour markets. Rapid technological change displaces workers with outdated abilities and creates demand for workers with different skills. Technological change does not create aggregate unemployment. It triggers profound changes in the structure of labour demand. The difficulties for employment appear to be due to the inability of the labour supply to adjust quickly to the new demands of the labour market, so that enough employable workers are available. A decline in the employability of labour means that only a smaller number of jobs will be compatible with a given inflation target.

One further issue is the potential impact of what is usually known as labour-saving technological change: technical progress which is biased against the use of labour. However, this sort of technical progress does not change our argument in any fundamental way. Technological change will be biased to the extent that firms have an incentive to invest in this type of technology. This will basically be determined by the current and expected evolution of the relative price of productive factors per unit of output.

If the unit labour cost of low-skill labour tends to grow comparatively faster than that of skilled labour, this will lead to investment in technologies that save on low-skill labour. With an unchanged labour supply –that is without changes in “«employability»– the adjustment takes place either through wages or reduced employment.

The contribution of Prof. Jacques Drèze in this volume rightly stresses the importance of preserving an undistorted relative price of labour. As the author points out, taxes on the use of labour give rise to an inefficient allocation of resources in the economy. This is particularly important for low-skill labour. For this type of labour, in most European

countries the private cost of employing an additional worker is substantially higher than the corresponding social cost. This inefficient pricing leads to the under-utilization of this type of worker.

The evidence regarding the importance of technological change over the last twenty years is mixed. Overall technical progress has, if anything, slowed down in comparison with the previous two decades, as is reflected by the decline in the rate of growth of total factor productivity detected in most studies on this subject. However, there is some suggestive, albeit limited, evidence of the importance of biased technological change as a factor behind the changing pattern of demand for labour. For example, Berman et al. (1994) find a strong correlation between the use of non-production workers and investment in R&D; and Drèze and Sneessens (1994) report on two studies carried out in the UK and France that estimate production functions and find evidence of technical change that is significantly biased in favor of skilled workers.

To sum up, technological progress does not lead to the destruction of jobs. Rather, it modifies the distribution of jobs in the economy. The overall number of jobs is determined, fundamentally, by the employability of the labour force. Excessive real wage increases (relative to productivity improvements) and/or the structure of taxation and other benefits may contribute to biased technical change and therefore to the substitution of capital for labour and of skilled labour for unskilled labour. The source of the problem, however, is the distorted relative price, not technological change. Moreover, if high taxes reduce the demand for low-skill workers, changes in their employability can limit the impact on unemployment.

2. Employment and aggregate demand

The pervasive influence of the new classical economics in the formulation of economic policy has led to the development of a second employment fallacy, which I believe merits discussion. This myth wipes out aggregate demand from the employment debate.

Myth 2. Unemployment due to insufficient aggregate demand is nothing to be concerned about. Either there is no such thing as insufficient demand or, if it does exist, it leads only to temporary unemployment, which should not be a matter of policy concern since fine-tuning the economy to eliminate these cyclical fluctuations would be counterproductive.

This myth is of a different nature. First, the presupposition that there can never be insufficient demand is open to question. Moreover, there are also reasons to be concerned about purely cyclical drops in demand.

Prof. Jacques Drèze provides the main arguments behind what is sometimes known as the neo-keynesian response. The basic message is that the incompleteness of contingent markets and the lack of coordination in the markets for goods may explain why the markets can achieve an equilibrium with low demand. The possibility of insufficient demand is reinforced by the process of globalization and increased interdependence between industrialized economies. Since expansionary aggregate demand policies entail risks in terms of budgetary balances and inflation, countries have an incentive to free ride on the expansionary policies of their partners, and an overall low demand equilibrium is a distinct possibility.

In any case, the existence of economic cycles and the appearance of cyclical unemployment is accepted by mainstream economists and policy-makers. It is true, as we said earlier, that the number of jobs is determined by the supply side of the economy and not by aggregate demand. Nonetheless, the existence of temporary drops in demand should be a matter of concern for at least two reasons.

First, given the rapid changes in technology and the existing training and welfare systems, there is a clear risk that unemployment spells due to temporary drops in demand will lead to a decrease in the employability of the labour force.

Second, certain features of the labour market (which we shall come back to in the next section) generate persistence mechanisms, whereby cyclical drops in demand can have long-lasting effects on employment. Bean (1994a) provides a summary of the features of the labour market which lead to this «hysteresis» effect. As an example, it is argued that if firing and hiring costs are high, firms may take on additional workers only if they expect a sustained recovery in demand. As a result, employment will be slow to react in periods of recovery and high levels of unemployment will persist. Other persistence mechanisms are the result of the dual structure of the labour market, with differences in the behaviour of insiders and outsiders as regards wage negotiations and attitudes towards work.

Recent claims that demand policies should be used in the fight against unemployment (see, for example, Blanchard et al., 1994 and Alogoskoufis et al., 1995) can therefore be justified from a theoretical perspective on several accounts. However, this is still not a predominant view among practitioners, particularly in terms of the policy prescriptions of most international organizations. Their recommendations give a clear priority to fiscal consolidation and the fight against inflation. While recognizing that it is dangerous to advise policy-makers to engage in fine-tuning and that there is no long-term trade-off between inflation and unemployment, the proponents of active demand management emphasize the high costs in terms of employment and output which may result from a combination of sharp drops in aggregate demand and the hysteresis effects that are pervasive in employment markets.

3. Employment and the structure of labour markets

There seems to be a growing consensus among the main international organizations with regard to the need to liberalize labour markets in order to improve the employment situation in industrialized countries (2).

This view has been strongly influenced by the relative employment performance of the US and the EU over the last twenty years. As José Viñals points out in his chapter, both grew at an average annual rate of 2 to 2.2 per cent over the period, but the US was able to increase employment yearly at a rate of 1.6 per cent, while Europe managed only 0.5 per cent. If the Spanish case is worth examining, it is because not only did Spain not create employment, it actually destroyed employment, at a rate of -0.4 per cent per year.

General political trends as well as the development of new thinking in economics have contributed to the increasing popularity of the deregulation of markets, and in particular of the labour market. Much as it is true that prices set freely by private economic actors tend to clear markets (and so, in principle, do wages), I believe that this state of opinion has led to the development of a third myth, which can be stated as follows:

Myth 3. The deregulation of labour markets, in terms of both wage-setting procedures and contractual conditions, will facilitate the creation of employment and thus contribute to an overall improvement in living standards.

The fundamental problem with the deregulation of labour markets is not that it would not generate more employment. It would probably do so. The key issue is whether such a deregulation would lead to the ultimate goal of employment creation, which is the improvement of living standards for a wide majority of the population.

There are at least two reasons to doubt that a thorough deregulation of labour markets is the right strategy to create jobs that will lead to a widespread increase in living standards.

The first argument is based upon the observation of trends in employment and real earnings in the United States. Richard Freeman states it clearly when he points out that fully employed American workers with low wages have living standards below those of similar workers in Europe, despite the fact that the US enjoys a higher overall standard of living. The strong US performance in employment creation has been accompanied by an increase in wage inequality among workers with different skills, and an actual decline in real wages for the low-skilled. Concomitantly, US society has seen worrying signs of the growth of a permanent underclass, with sharp increases in poverty rates and in crime (this point is also made in the paper by Prof. Drèze). As Prof. Freeman writes, «countries that maintained the earnings of the less skilled seemingly ‘paid’ in terms of high unemployment; while the US ‘paid’ for its growth of employment through falling real earnings».

The second reason to question full deregulation has to do with the imperfect nature of labour markets. Although it is probably true that most labour markets in Europe are over-regulated, this does not imply that the best policy is to dismantle all regulations. There are some sound reasons for regulating certain aspects of the labour market. Reforms should scrap unnecessary rigidities and restrictions, but preserve the regulations that attempt to correct the imperfections of the market.

Prof. Drèze argues that full labour market flexibility would subject workers to excessive income uncertainty. On the one hand, this could lead to inefficient levels of volatility in aggregate demand. More fundamentally, workers invest in human capital, which cannot be diversified away as easily as other forms of wealth. This may justify a reduction of income volatility through some degree of rigidity in real wages.

There are other considerations that could justify some degree of regulation of labour markets. Prominent among these are the existence of an asymmetric distribution of information in the market and the problem of time inconsistency in the contractual relationship (3).

Asymmetric information can be important insofar as workers may have difficulties in assessing the characteristics of the jobs that are being offered (for example, in terms of health and safety), whereas employers are likely to be much better informed.

The problem of time inconsistency refers to the acquisition of firm-specific knowledge by workers. Once this know-how has been acquired, the firm has no incentive to give the worker an appropriate reward; anticipating this, the worker might be discouraged from investing in socially profitable firm-specific training.

It is useful to assess clearly the cases where some regulation of the market is justified in terms of efficiency, since this provides a benchmark for labour market reform. Although full deregulation should not be the objective, the above account of the main justifications for regulation makes it clear that some markets are in need of substantial changes to bring them closer to an optimal level of state intervention. This is, of course, the case of the Spanish market.

The papers by Viñals and Sebastián included in this volume provide a complete analysis of the large number of distortions prevalent in the Spanish labour market. Their discussion suggests that few of these regulations improve the efficiency of the market. Much to the contrary, they have been at the root of its extremely poor performance over the last twenty years.

It is useful to classify the distortions of the Spanish labour market in two categories. First, we have restrictions on the nature of contracts in terms of their duration and the costs and flexibility of starting and terminating the contractual relationship (i.e. temporary versus indefinite contracts, severance pay, part-time contracts). Second, there are restrictions on the nature of the working conditions that can be established in the contract (i.e. mobility across production centers and professional categories, flexibility in the structure of pay, flexibility of working time).

In principle, these limitations constitute restrictions on the choice of the optimal use of labour by firms. They have, of course, an indirect effect on the price of labour. In particular, they lead to real wage inflexibility. This is specially the case for the limits on the types of contract. They have generated an insider/outsider structure in the Spanish labour market which, apart from considerations of fairness, leads to profoundly negative macroeconomic effects by reinforcing of real wage inflexibility. Adjustments to changes in the economic cycle take place via quantities rather than via wages.

These consequences in terms of the imperfect adjustment of the labour market are, of course, very important, since they mean that a higher rate of unemployment is compatible with non-accelerating inflation. Viñals argues that rigidities in markets other than the labour market worsen the situation (4), so that the non-accelerating inflation rate of unemployment (NAIRU) in Spain is as high as 19.5 per cent.

Other market distortions affect the process of wage formation. These include: 1) the existence of a significant tax wedge which adversely affects the relative price of labour, and in particular low-skill labour; 2) the availability of unemployment benefits, which negatively affect the willingness to engage in job search; 3) the level of minimum wages; and 4) the rules that govern collective bargaining.

The fact that the Spanish labour market is full of government interventions does not mean that all of them should be eliminated. As we have argued before, labour markets are far from being perfect markets, and some degree of regulation might indeed be optimal, if it adequately corrects those imperfections.

Even though one could argue that most of the interventions in the Spanish labour market are intended to correct some sort of market failure, Viñals and Sebastián show that the extent of intervention is leading to very counterproductive effects in terms of employment. Viñals and Sebastián consider that the most harmful features of the Spanish labour market are the distinction between temporary and indefinite contracts, the extreme rigidity of contract

conditions, the system of collective bargaining, the high tax wedge and the favourable conditions of unemployment benefits.

Clearly, this sets a very ambitious agenda for action. Other recent contributions on this subject (see Blanchard et al. 1994) have narrowed down the list of urgent reforms, arguing that most of the employment destruction features of the Spanish labour market can be attributed to just a few of the distortions (the report by Blanchard and his colleagues focuses on the insider/outsider problem and on collective bargaining). Focusing reform is undoubtedly necessary if one wishes it to be politically and socially accepted. Nonetheless, selecting the components of the institutional system which need to be adapted is not an easy task. Some of the essays in this volume point to the need to look carefully at the match of the new labour regulations with other labour market institutions, and even with other aspects of society's institutions and culture.

A related issue is the extent to which in seeking to reform the Spanish (or European) labour market, one can draw upon the experience of other labour systems which have been more successful in creating employment. In this sense, the papers in this volume by Profs. Freeman, Alvarez and Whitley sound a note of caution with regard to the transferability of labour market institutions across national boundaries.

Richard Freeman provides a start in developing a conceptual framework. His contribution goes beyond the basic idea that by importing the US labour market and social institutions into Europe one might simply be exchanging unemployment for greater inequality and poverty. According to Freeman, labour markets and the whole system of labour relations are complex, dynamic systems with many independent but interrelated actors. The effectiveness of alternative institutions is not independent of the whole set of existing labour relations.

Freeman provides an interesting example of the complexity of the interactions between institutions in the labour market. A few years ago, both Spain and Germany introduced fixed-term contracts, but their impact in the labour market was quite different. The existence of a well-developed apprenticeship system meant that German firms continued to be interested in permanent or open-ended contracts to a far greater extent than their Spanish counterparts.

These ideas are articulated by the notions of the fitness and super-modularity of institutions advanced by Freeman. These are concepts which focus the attention of policy-makers on the need to carefully evaluate the interrelationship between institutions before borrowing models applied elsewhere. The questions to be asked are the following: Will the benefits of the new institution be significant, given the specific set of other institutions already in place? Will these benefits outweigh the costs of introducing the institution? And, most fundamentally, is there a need to 'import' more than one institution in order to get the full benefit of change or reform?

The discussion of labour market reform in Spain provides an interesting case study of the potential use of this conceptual framework. As argued before, the changes in the range of possible labour contracts and their applicability has to be appraised in a comprehensive manner. As Sebastián makes clear in his contribution to this volume, the recent reform (1994) has rightly abolished the fixed-term contract when it is not justified by the nature of the economic activity (seasonality), and has rightly developed part-time contracts and apprenticeship contracts. This is a model in which indefinite contracts are the standard contractual form, since they provide the appropriate incentives to both parties in the

agreement with regard to the investment in job-specific skills. However, indefinite contracts should not mean jobs for life. In practice, the high cost of dismissal for indefinite contracts implies that firms are tempted to use part-time and apprenticeship contracts where indefinite contracts would be more appropriate. One could, therefore, argue that the reform should have been combined with a substantial decline in firing costs.

Freeman also distinguishes two interesting dimensions of institutions, which should be taken into account when assessing the transferability of specific institutions to different social and labour systems: malleability and catalytic power. Malleable institutions are institutions which are robust, in the sense that they work well under different social/labour systems, even if not fully implemented. Catalytic institutions are those which have the potential to spur change in other parts of the system.

When assessing the recommendations for labour market reforms in the EU, and in particular in an over-regulated market such as that of Spain, it is interesting to assess the proposed changes taking these dimensions into account.

The 1994 reform of the labour market in Spain gives the social agents considerable freedom to determine labour relations within the setting of the collective agreements. However, actual change in labour relations and new regulations of working conditions will crucially depend on substantial changes in the attitudes of the key social agents (see Sebastián), which itself may require a change in the way these institutions (unions, employers' federations) operate. One can therefore conclude that this particular change envisaged by the reform is fundamental. It could be the catalyst of far-reaching reforms in the Spanish labour market, changing the nature of the interaction between the two sides of industry and possibly leading to new actions and collaboration between these agents in other very important areas, such as professional training.

It is more difficult to find examples of malleable institutions that could easily be adapted to the Spanish labour market. Arguably, one could include under this heading changes in social security contributions or a reform of the unemployment benefits system. Changes in these areas are possible without requiring complementary changes in other types of labour market institution.

The contributions of Profs. Alvarez and Whitley in this book go even further than that of Prof. Freeman and argue that changes in the labour market should be compatible with (or may trigger changes in) other aspects of the business system, touching upon cultural, political and financial features of society.

Alvarez uses the example of the worldwide diffusion of entrepreneurship ideas to argue that the values and ideas that a society has on economic issues are very important in terms of the acceptance and effectiveness of policy changes. According to Alvarez, in order for job creation to thrive, the ideas regarding the role of entrepreneurship in generating employment must become a shared belief among the members of society. This can be achieved only if certain domestic social groups adopt a leadership role in spreading these values and in importing business practices from abroad and adapting them to local circumstances.

According to Whitley, employment relations –whether in developing countries or in western societies– evolve in the context of sets of norms and rules that govern four fundamental systems: the exchange relationships between economic actors (the cultural system); the role of the state (the political system); the distribution and pricing of capital (the

financial system); and the development, certification and exchange of skills (the labour market system). Whitley stresses that the complex interactions of these systems affect the deployment of business strategies and the development of employment relations and labour management practices. The paper by Whitley makes it clear that long-term employment patterns and the impact of efforts to change them are highly constrained by the nature of the dominant institutions in each economy.

Although these ideas are less formalized than those presented by Freeman, it is not difficult to illustrate their relevance in the case of wide-ranging labour market reforms, such as the one that has been implemented in the Spanish labour market. Prof. Sebastián points out in his paper that the reform implemented thus far leaves a substantial degree of discretion to the judiciary in the termination of contracts. As a consequence, the effectiveness of the reform is contingent upon the interpretation of the spirit of the law by the judges. Early indications are not encouraging, since they do not reflect a market-oriented view of contract termination (see Ortega, 1995). If the reform fails on this account, it may be a consequence of the lack of simultaneous reforms in other areas of Spanish society, in particular the political system and the widespread popular perception of the paternalistic role of the state.

Yet another example of the interaction between labour institutions and other broader aspects of society is given by the greater importance given to collective agreements in determining working conditions. The effectiveness of the reform could be seriously undermined by the fact that the institutions which represent workers and employers in the labour markets are weak, and rely on political actions to achieve their goals, much as shown by Prof. Whitley in the case of France. The new role of collective bargaining is therefore a risky bet. It may act as a catalyst if it leads to change in the organizations that represent labour and employers. It may lead to the failure of the reform if these institutions do not rise to the challenge.

4. Employment and trade

Several recent developments in the international economy have led to the reemergence of another well-known fallacy: that trade destroys employment in some trading partners to the benefit of others. This myth can be put bluntly.

Myth 4. Trade with an increasingly competitive Third World is putting at risk the social fabric of the developed world: destroying jobs in Europe and increasing wage disparities in the US, thus condemning low-skill workers to increasing poverty.

The argument is, of course, that Third World countries compete on the basis of very low wages (5) and that, as a consequence, they displace labour-intensive sectors in the developed world. This displacement takes place in the domestic and export markets and in some versions of the theory it can also occur through foreign direct investment (FDI) or the delocalization of domestic plants. The debate is further cluttered by arguments over the extent to which the competitiveness advantage is due to wage differentials or, rather, to differences in total labour costs, including social costs and working conditions.

In Europe, two factors have coincided to raise concern over the employment effect of trade with the Third World: the growing integration of the world economy (Third World countries are to an increasing extent adopting export-led strategies and are becoming much more receptive to foreign direct investment) and the surge of unemployment in the 1980s.

There is a heated debate over outward FDI: what is known as the delocalization problem (6). In the US, the issue has come to the forefront of economic and social debate in relation to the observed widening of wage differences within the US labour force and also as a result of the policy of commercial integration with a developing country such as Mexico.

Assessing the employment effects of trade involves difficult theoretical and empirical problems and it is therefore not surprising that it is the subject of great controversy. Three broad categories of studies have been conducted and we shall briefly review their approaches and main results.

a) The employment content of imports

The classic methodology that has been used to assess the employment impact of trade is the analysis of the so-called factor content of trade (7). Essentially, this method attempts to measure the employment displaced by trade by looking at the labour content of net trade flows, taking into account the effects on intermediate production. It is assumed that in the absence of trade, the jobs involved in the production of exports would not be available and, at the same time, that the domestic production of imports would increase domestic employment. The precise amount of domestic labour that would be employed by the substitution of imports is computed assuming that domestic and foreign productivity are the same.

Needless to say, this is a very crude approximation to the employment impact of trade and is plagued by theoretical pitfalls. Some of these problems have long been recognized. For example (8), if imports were produced domestically, the price would be higher and the quantity produced would be lower, so that the effect on total spending on previously imported goods is uncertain. Moreover, it is also unclear to what extent imports can be replaced by domestic production using the same quantity of labour per unit of output. In principle, it seems reasonable to assume that, since the product would otherwise be imported, domestic production is less efficient and involves a higher labour cost per unit of output. Most probably, domestic production would entail the use of less labour-intensive techniques. Additionally, it may even be that the products cannot be produced domestically, in which case imports would not be taking the place of any domestic employment [unless, of course, one assumes that spending would be redirected to goods which can be produced domestically (9)]. Finally, and this is probably the main criticism of this method, the approach disregards the general equilibrium effects. In particular, reduced exports would lead to changes in factor demands, which, in turn, would affect labour market conditions.

Nonetheless, the employment content method is a simple and easily understood methodology. Some authors have recently come up with sizable estimates of the employment impact of trade. For example, Sachs and Shatz (1994) argue that in the U.S., trade –mostly with the developing world– resulted in a drop of almost 6 percent in manufacturing employment between 1978 and 1990. The calculations of these authors show that the decline in employment was concentrated in low-skill jobs.

b) Changes in international relative prices and their impact on relative factor prices (i.e. the wages of skilled versus unskilled workers)

The unsatisfactory theoretical basis of employment content studies has led to the application of the conventional general equilibrium trade framework: the Heckscher-Ohlin

model. The advantage of this approach is that under the precise assumptions of the model (that is, imposing perfect competition and constant returns to scale) the theory establishes a clear link between trade and factor markets through one of the famous theories of international trade: the Stolper Samuelson theorem. In the case of two goods and two factors, this theorem establishes the existence of a positive partial correlation between relative international prices and relative factor prices. If the price of the good which is relatively intensive in one factor goes up, so does the relative price of that factor.

Two important remarks should be made with regard to this theorem. First, it does not establish a link between international prices and the growth of unemployment or real wages. Nonetheless, changes in relative factor prices are a key determinant of the growth of employment and wages for the different categories of labour. As pointed out by Sachs and Shatz (op. cit., page 15), the theorem is developed under the assumption of full employment and wage flexibility. With fixed factor supplies, this means that if there is an increase in the demand for skilled workers due to the shift of production toward skill-intensive sectors, this will be exactly compensated by the shift within sectors from skilled to unskilled employment. Sachs and Shatz argue that low-wage competition will do more than reallocate labour between and within sectors, due to the presence of labour market imperfections.

A second point is that the theorem is useful empirically provided that one can control for the evolution of factor supplies and technology, since these are the other determinants of relative factor prices. Lawrence and Slaughter have used this framework to analyze the evolution of the relative wages of skilled and unskilled (10) labour in the US.

These authors show that during the 1980s the international relative price of the goods that make intensive use of production workers (relative to non-production workers) actually increased slightly, and that only after controlling for the evolution of total factor productivity in the two kinds of industries (that is, using what is sometimes known as «effective» prices), one finds a relative decline of the price of goods that are intensive in production workers (11).

This evolution is consistent with an increase in the relative wage of non-production versus production workers. This is what was observed in practice in the US during the 1980s, and the fact that the relative supply of non-production workers also increased during the period means that the demand shift compatible with the evolution of relative «effective» prices was indeed substantial.

Lawrence and Slaughter conclude that trade (through the change in relative «effective» prices) was not, however, the main force driving the evolution of relative factor prices over the period. If that were the case, one would have observed a decline in the use of non-production versus production workers in all industries, and precisely the opposite was detected. Lawrence and Slaughter argue that biased technical change which favours the demand for non-production workers is the only explanation for the observed shifts in relative wages, prices and employment by skill categories in the 1980s (12).

The use of the Stolper-Samuelson theorem provides guidance in the empirical analysis, but one must remember that it is a theoretical result whose validity is unclear in the context of imperfectly competitive markets. In such a situation (see, for example, Helpman and Krugman, 1985, chapter 9) it may well be that trade benefits all factors if the changes in relative factor prices are not too large and are outweighed by the gains from exploiting scale economies. Taking into account the imperfect competition perspective, the issue of the effects

of trade on employment has recently been tackled by Oliveira (1994) and Neven and Wyplosz (1994).

Oliveira uses regression analysis with a sample of 25 industries from 12 OECD countries and finds that import competition reduces wages and employment only in those industries characterized by product homogeneity and highly fragmented market structures. Moreover, he finds that the trade variable contributes positively to wages in other types of industry where product differentiation and investment in intangibles are important. In those cases, trade benefits all factors of production involved in the exporting country. These are suggestive results. However, and in contrast with the econometric results obtained by Revenga (1992), which we review later, there is a problem with the interpretation of the parameters, given the partial linkage of the specification with the underlying theory.

Neven and Wyplosz look at the evolution of relative prices, real output and the use of labour in two categories of European industry: labour-intensive and technology-intensive industries. By selecting these types of industry they attempt to disentangle the technology from the trade shocks. Although they do not control for changes in TFP, they argue that the price of both technology-intensive and labour-intensive goods falls over time relative to the overall price level. Output increases in high-tech industries relative to total output, and falls in labour-intensive industries. This might indicate that labour-intensive industries were subject to a negative trade shock, whereas in the case of high-tech industries the data would be consistent with a positive technology shock. Employment data corroborate this interpretation. Relative employment falls in the labour-intensive industries and it also falls in high-tech industries, albeit to a lesser extent. This could be the result of the higher labour productivity of these sectors, but it is also consistent with labour-saving technical progress.

c) The labour market approach: import competition and the adjustment of labour markets

The preceding discussion makes it clear that despite its theoretical soundness the general equilibrium method is difficult to implement in practice. Labour economists have followed quite a different approach. They have focused on the estimation of labour supply and demand equations where import prices appear as a significant explanatory variable.

Revenga (op. cit.) estimates such a system of equations for a sample of 38 US industries and uses quarterly data corresponding to the period 1977-1987. She finds that the large decline in import prices brought about by the strong appreciation of the dollar had significant effects on wages and employment. Her estimates suggest that, *ceteris paribus*, a 10 per cent reduction in import prices leads to an average employment reduction ranging from 2.5 to 4 per cent, and to a wage decline of between 0.5 and 1 per cent. These results seem to indicate that labour markets in specific industries are particularly sensitive to import competition, but the adjustment takes place through the reallocation of labour across industries rather than through a decline in industry-specific wages (13).

d) What can we conclude?

The studies based on the factor content method have led to unjustified alarm about the effects of trade on employment and wages. Despite its intuitive appeal, this methodology is not sufficiently reliable and the results obtained by this strand of research cannot be the basis of policy formulation.

A more insightful analysis has been obtained by the research undertaken looking at the evolution of relative prices. The trade theory tradition has contributed by pointing out that the evolution of international relative prices, factor supplies and factor prices is not consistent with the idea that trade has a dominant role as a factor explaining high unemployment (or low wages) for unskilled workers. Some of the work by labour economists has tackled the issue by looking directly at the effect of import prices on employment markets across industries. The results, at least for the US, are not inconsistent with the aggregate picture. Trade effects at the level of specific industries are significant, but there is a substantial adjustment of employment across industries, which need not affect aggregate (manufacturing) employment. A similar intersectoral mobility effect could take place between manufacturing and services, although there is no formal evidence of this so far.

Unfortunately, the evidence available for the European labour market is still very slim, and results which are valid in the US need not apply in Europe, where labour market rigidities may limit or hinder intersectoral employment flows.

To summarize, the belief that trade liberalization contributes to the destruction of employment is unfounded. An expansion of trade results in lower prices, which should lead to an increase in consumer surplus and ultimately to an overall increase of demand. Of course, such a beneficial demand increase is unlikely to spread evenly over all sectors of the economy, and demand will increase more in some sectors than in others. In fact, as real income increases, demand is likely to go up proportionally more in services than in manufactures, which tend to have a lower income elasticity. The uneven distribution of demand growth across sectors leads to an uneven demand for different types of labour. As with the case of technological change, trade brings an overall welfare increase, but its full benefits require a swift adaptation of labour supply. As with technological change, trade (14) creates pressure for change in the structure of labour markets in the developed world. It is not the cause of unemployment but rather a catalyst of change in the labour market. Unemployment is created by the slowness of our institutions and markets in developing and exchanging skills to meet the changing needs of firms, consumers and society at large.

5. Conclusions

This volume together experts from several areas of sociology and economics, such as organizational sociology, labour economics and macroeconomics. The main purpose of the papers is to contribute to the debate on the definition of policy alternatives for the creation of employment, and this explains why, by and large, they are not unduly technical and remain accessible to a wide audience.

Policy proposals in the field of employment should be based on a multidisciplinary analysis which recognizes the multiple facets of modern societies. To this end, this book assembles contributions from two of the most relevant fields. A recognition of the social and cultural dimensions of the employment problem should enrich policy analysis and may facilitate the social acceptance (and political viability) of policy reform.

This introductory chapter has presented the main themes of the volume in a somewhat unorthodox fashion. As a non-specialist in this topic, I have tried to show how the contributions in the volume shed light on some popular misconceptions regarding the question of employment. Moreover, as an economist interested in the impact of economic

integration, I have thought it worthwhile to include a discussion of the relationship between trade and employment, a controversial issue that is not covered by the essays in this volume.

As concluding remarks to this chapter, I would like to highlight some of the main ideas coming out of this book which I believe should be present in the employment debate.

First, the emphasis on *the key role of the employability of the labour force*. It is a challenge to both the private and the public sector in industrial countries to increase the abilities of the population, and in particular of the less skilled, in order to meet the changing requirements of the demand for labour, changes that are due mainly to technological progress, but also, to a lesser extent, to economic integration.

Technological progress, even if unbiased, changes the structure of the demand for labour, and without appropriate action in the field of education and training, it may reduce the employability of the labour force, and thus the number of jobs. If technological change is biased against low-skill labour, it will be particularly important to ensure that the relative price of this kind of labour is not excessively high due to taxes and other regulations. The living standards of the low-skilled should be preserved by income support mechanisms that encourage firms to give employment to this population group and do not limit the incentives to join the labour force and look actively for a job. Considering that employability is enhanced by the fact of being in employment and given the difficulty of providing education and training for large numbers of unemployed people, there is a special need to eliminate the distortions that penalize the low-skilled. General education and training designed to adapt the labour force to a changing labour demand should be specially targeted to the young, in order to prevent them joining the pool of the long-term unemployed.

Economic integration, in the form of lower trade barriers and increased international trade and investment flows, has contributed only moderately to the changing nature of jobs in industrialized countries. Reports of a significant employment effect of trade are grossly exaggerated, due to the use of inaccurate methodologies. Trade appears to affect employment to a significant degree only at the sectoral level, within the tradables industries. The effects, however, disappear at the aggregate level if the economy has sufficient intersectoral mobility. As with technological progress, trade is a source of welfare gains, which translate into jobs, provided that the supply of employable people reacts appropriately.

The *second* central idea focuses on labour market institutions. The contributions in this book clearly indicate that an appropriate reform of labour markets need not involve, in general, their full deregulation, as there are sound reasons to regulate certain aspects of the relationship between workers and their employers. Nonetheless, in cases such as that of the Spanish market, the papers published in this volume justly show that profound changes are needed to liberalize an overwhelmingly rigid system.

The acceptance of the fact that some degree of regulation of labour markets and institutions is needed points to one of the key themes throughout the book: the question of labour market reform and the potential local adaptation of labour market institutions borrowed from abroad. The work presented in this volume emphasizes the interaction between labour market institutions and shows that any plan of *labour market reform should take into account broad packages of institutions as well as their relationship with other aspects of society and business culture*.

This means that policy changes may have unintended consequences or be ineffectual if unaccompanied by wide programs of reform that touch upon several institutions of society.

Incremental reforms -such as those advocated by Alogouskofis et al. (1995)- will be effective only if they focus on the few labour market institutions whose performance is independent of the rest of the system. Otherwise, the avenue of wide-ranging reforms is more promising. However, even there -as pointed out by Freeman in this book- there remains a high degree of uncertainty regarding the (distributional) outcome of reforms, and this explains the resistance to change in industrial societies despite the seriousness of the employment problem.

The *third* main message refers to the demand side of the economy. Although the solution to the employment problem lies in the supply side and in the reform of labour market institutions, *demand management aspects cannot be disregarded*. Demand may be insufficient because of several market imperfections. But even if the shortfall of demand is purely cyclical, its (negative) effects on employment can be long-lived, and may justify a counteracting intervention. The persistence mechanisms operating in the labour market are, it is true, mostly the result of labour market regulations and institutions. But, as we have already indicated, the nature of the labour market is such that these regulations (and their costs in terms of the persistence of negative demand shocks) cannot be simply swept away. □

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- (1) Among the main contributions on this subject in recent years, see, for example, Drèze and Bean (1990), Layard et al. (1991) and Bean (1994b).
 - (2) See, for example, the OECD Jobs Study (OECD, 1994). The recent International Labour Organization (ILO) Employment Report (ILO, 1995) is, however, an exception to this trend.
 - (3) See, for example, Begg et al. (1993; pages 106 - 108).
 - (4) Imperfections in other markets allow firms to pass on to consumers a substantial part of the wage increases. Although Viñals does not explicitly formalize his argument, this feature shows up neatly in the simple model used by R. Layard. A recent report by Mackinsey Global Institute (1994) has stressed the importance of product market restrictions as a factor underlying poor employment performance.
 - (5) The argument should refer to low wages per unit of output, with the underlying idea that it is not hard for developing countries to obtain the physical capital and the technology that will allow them to obtain high levels of productivity.
 - (6) Robert Lawrence (1995) reports on the pattern of wages and employment of U.S. multinationals in the U.S. and abroad. According to his data, the ratio of production to non-production workers has fallen both in the U.S. and abroad. Similarly, relative wages of production workers have fallen worldwide. These trends are not consistent with a substantial effect of outward FDI on U.S. wage inequality.
 - (7) Another popular methodology is the input-output accounting decomposition of employment changes, taking into consideration the evolution of (apparent) labour productivity and the composition of final demand (see, for example, OECD 1992). Such a decomposition is open to even more criticisms than the factor content approach (see, for example, Baldwin 1995).
 - (8) Some of these points are discussed by Wood (1994).
 - (9) Wood (op. cit.) has attempted to correct for some of these problems. He computes the factor content of exports from the South to the North assuming that the input combination used in the South is the result of cost minimization at the prevailing factor prices. Data on factor use and some extraneous information on the elasticities of substitution make it possible to calibrate the technology parameters, which are then used to infer the “counterfactual” factor use in the North at the North’s factor prices. Wood obtains very high estimates for the effect of North-South trade on employment, but his methodology is subject to controversy (see, for example, Krugman, 1994). In related work, Deardoff and Staiger (1988) show that the factor content method can be used to assess directly the effects of trade on factor rewards only under very restrictive assumptions on preferences and technology. Under more general specifications, the results are substantially weaker.

- (10) Lawrence and Slaughter do not actually work with skill categories but instead distinguish between production and non-production workers, a classification which -they argue- is closely correlated with skill categories. Despite some sharp criticisms of the use of this proxy (see Leamer, 1994), data presented by Berman et al. (1994) confirm the usefulness of the variable.
- (11) When total factor productivity (TFP) grows fast, observed prices may be misleading indicators of price changes. The percentage change in effective prices is computed as the difference between the percentage change in observed prices minus the percentage change in TFP. Lawrence and Slaughter find that TFP grows faster in industries which use skilled workers and this more than compensates the evolution of observed prices. Sachs and Shatz (1994) rightly point out that the Stolper-Samuelson theorem requires the use of “effective” prices, since it assumes that the countries have the same technology. These authors criticize the data set used by Lawrence and Slaughter, argue that the price of computers should be removed from the sample, and use a different statistical technique (simple regression with a computer dummy). Their results indicate that the relative price of unskilled-intensive goods falls, but that this fall is softened by the effect of the evolution of total factor productivity. This implies that TFP grows faster precisely in the industries which are intensive in unskilled workers, which is exactly the opposite of what is found in the Lawrence and Slaughter data. However, the results obtained by Sachs and Shatz are not statistically significant for the case of effective prices and, therefore, do not invalidate the evidence presented by Lawrence and Slaughter. Moreover, the latter’s results have been extended to Germany and Japan (Lawrence, 1995).
- (12) Leamer (1994) has also been critical of the results obtained by Lawrence and Slaughter. Although his results are very preliminary, his contribution points to the need to estimate fully specified models where the link between relative factor prices, technological change and changes in relative prices is well established. He uses 1976-86 data for 450 manufacturing industries to assess the relation between initial input use and payroll savings. In a simple Heckscher-Ohlin model with constant international relative prices, the parameters of such a regression provide an approximation to the changes in relative wages due to changes in input requirements. His surprising results indicate that technological change has tended to favor an increase in the relative wage of unskilled labor.
- (13) In the US this is consistent with the finding that most of the widening gap between the wage of the skilled and the unskilled takes place within industries.
- (14) The fact that this section has argued that trade does not significantly affect aggregate wages and employment should not prevent discussion of a potential indirect effect of trade pressure. Import competition could have an indirect effect on wages and employment if it created or accelerated labor-saving technical change. There are not many systematic studies which have dealt with this issue. Neven and Wyplosz (op. cit.) have looked at how German labour-intensive industries have changed technology, presumably as a response to increased competitive pressure from low-wage countries. Their work is still exploratory. They measure technology changes by statistically significant changes in some proxies of input composition. They find that only a small number of these industries have reacted to foreign competition by increasing the human capital content of production (thus demanding fewer unskilled workers). Their results give support to the view that the trade effects on employment –even if they take place through the indirect effect on technology– are very much industry-specific.

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