Labour Market Institutions, Pay-Setting Systems and Employment

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What Is There to Learn from the Experiences of the Old EU Member States?

Old and new EU states

- **Old EU states**

  - **high unemployment**

  - **labour market institutions have contributed to this**

  - **need for dismantling overgenerous welfare systems and excessive labour market regulations to raise employment (efficiency reasons)**

  - **market-liberal reforms politically very controversial**

- **New EU states**

  - **institutions are built up from scratch**

  - **the issue is how generous welfare systems and how much regulations to introduce for social equity reasons**

  - **issues raised by more generous unemployment insurance and rises in minimum wages**

- **What can be learnt from (the mistakes of) the old member states?**
  - **the impact of specific institutions**
  - **the political economy of labour market institutions**

High growth does not necessarily mean low unemployment

- Theory
  - high productivity growth makes investment in hiring more profitable
  - high productivity growth deriving from rapid structural change increases frictional unemployment
- Empirical knowledge
  - correlation between reduction in total factor productivity growth in OECD countries and increases in unemployment
  - but productivity growth (or the productivity level) is not standard argument in unemployment equations
  - one-to-one correspondence between growth of productivity and real wages
- Best to regard growth and employment as two separate issues
  - separate policies might be needed
  - sometimes conflicts between growth and employment policies

Labour market institutions and unemployment

- Differences in labour market institutions explain around 50 % of differences across countries and over time in unemployment in the OECD
- Important factors
  - unemployment benefit levels
  - duration of benefits
  - amount of active labour market policy
  - degree of unionisation
  - coverage of collective agreements
  - degree of co-ordination of collective bargaining
  - labour taxes (?)
  - degree of employment protection (??)

	Unemployment change 1980-87 to 2000-01	Employment-friendly changes	Employment-hostile changes	Net of employment-friendly changes
Ireland	-9.8	4	1	3
Netherlands	-7.4	5	0	5
UK	-5.3	6	2	4
Denmark	-2.6	4	2	2
France	0.1	1	4	-3
Germany	0.3	2	1	1
Italy	1.7	2	2	0

Unemployment change = -0.42 – 1.21 (Employment-friendly changes – employment-
(4.3)   hostile changes)

$R^2 = 0.51$ N = 20

Labour-market institutions

- unemployment benefits
- active labour market policy
- the wage-setting system

Unemployment benefits

- Strong social welfare motives for income insurance
  - at least 50-60 % replacement ratio for low incomes
  - universal coverage

- But strong evidence that generous unemployment benefits cause unemployment
  - studies of individuals´ unemployment duration
  - studies of aggregate unemployment

- More generous benefits are possible with a stricter benefit regime
  - requirements on geographical and interprofessional mobility
  - requirements to accept lower-paying jobs
  - requirements to accept jobs which pay less than the going market wage for the job

- Reservation wages and search intensity
  - Estonia (Hinnosaar): search intensity but not reservation wages
  - Sweden (Harkman): reservation wages but not search intensity

- Close monitoring of the unemployed require large resources of the labour market administration
  - possibility of multiple equilibria

Channel resources from passive benefits to income tax credits on employment income!

- **Employment income tax credits for low-wage earners**
  - **US: Earned Income Tax Credit**
  - **UK: Working Family Tax Credit**
- **Similar work incentives as low unemployment benefits**
  - **Disincentive effects on hours worked in the income region where the tax credit is phased out**
  - **Positive net employment effect in the US**
  - **Disincentive effects are a smaller problem the lower the basic marginal income tax rate**
  - **Employment income tax credits should fit Estonia with low marginal tax rates better than, for example, Sweden**

Active labour market policy

- **Low spending in Estonia**
- **Favourable effects on unemployment in OECD panel equations**

  - misleading results

  - open (registered) unemployment but not total unemployment or regular employment

- **Disappointing results of large Swedish programmes in the 1990s**

  - zero or negative results of training programmes on employment probabilities of participants

  - better results for participants of some subsidised employment programmes

  - but subsidised employment has large crowding-out effects on regular employment

  - this applies especially to youth programmes

- **Positive, significant effects of training programmes in Estonia (Leetma and Vörk)**

   - similar results for other transition economies

Calculated effects on unemployment of an increase in programme participation of one percent of the labour force

Study	Open unemployment	Total unemployment
Layard, Nickell & Jackman (1991)	-1.53	-0.53
Zetterberg (1995)	-1.49	-0.49
Jackman, Layard & Nickell (1996)	-0.06	0.94
Scarpetta (1996)	-0.51	0.49
Elmeskov, Martin & Scarpetta (1998)	-1.18	-0.18
Nickell & Layard (1999)	-0.18	0.82
Blanchard & Wolfers (2000)	-1.43	-0.43

Total unemployment is the sum of open unemployment and programme participation

Reasons for differences in results

- **Far too large programme volumes in Sweden**
- **Programmes were used for income support and for requalifying the unemployed for unemployment benefits**
- **More need for re-training and easier to identify needs in transition economies**

Policy lessons

- Larger programme volumes require more of subsidised employment
- Crowding-out effects can be accepted if programmes are targeted on long-term unemployed or those that risk becoming long-term unemployed
- Separate activation programmes and programmes designed for income support and to give meaningful activities for the most-difficult-to-place
- Need for regular and careful evaluation of programmes
- A case for more focus on activation measures

  - lower recruitment costs for employers and less need to raise wages

  - but limited effects at high unemployment

  - activation measures can reinforce reductions in unemployment that are already taking place

Table 3.1

Coverage of collective agreements and unionisation[a]

Country	Total economy (2001)		Market sector (mid 1990s)	
	Coverage	Unionisation	Coverage	Unionisation
Old EU member states				
Austria	98	40	97	34
Belgium	100	69	82	44
Denmark	85	88	52	68
Finland	90	79	67	65
France	90	9	75	< 4
Germany	67	30	80	25
Greece		32		
Ireland				43
Italy		35		36
Luxemburg	60	50		
Netherlands	78	27	79	19
Portugal	62	30	80	< 20
Spain	81	15	67	< 15
Sweden	94	79	72	77
UK[b]	36	29	35	19
New EU member states				
Cyprus	65-70	70		
Czech Republic	25-30	30		
Estonia	29	15		
Hungary	34	20		
Latvia	< 20	30		
Lithuania	10-15	15		
Malta	60-70	65		
Poland	40	15		
Slovakia	48	40		
Slovenia	100	41		
Other countries				
Australia	22 (23)[c]	23		
Canada	32	30[g]		
Japan	21	22[h]	21	24
New Zealand	45[d]	22		
Norway	70-77[e]	55[h]	62	44
Switzerland	53[f]	23[h]	50	22
US	15	14[h]	13	10

Notes: [a] Coverage refers to the percentage of employees covered by collective agreements and unionisation to the percentage of employees with union membership; [b] Figures do not include Northern Ireland; [c] The parenthesis refers to the coverage of wage awards (see Section 1.1) and to 2000; [d] 1997; [e] 2000–01; [f] 1994; [g] 2000; [h]1996–98.

Table 3.2

Bargaining levels

Country	National guidelines	Inter-sectoral level	Sectoral level	Enterprise level
Old EU member states				
Austria	Pattern bargaining		XXX	X
Belgium	Centrally agreed guidelines for wage increases with the government 2003–04	XXX	X	X
Denmark	Pattern bargaining	XX	XX	X
Finland	Tripartite national pay agreement 2003–04	XXX	XX	X
France			X	XX
Germany	Pattern bargaining		XXX	X
Greece	National general collective agreement 2002–03	XX	XXX	X
Ireland	Tripartite national pay agreement 2003–04	XXX	X	X
Italy	Social pacts with government 1993 and 1998 setting guidelines for the wage-bargaining process		XX	X
Luxemburg			XX	XX
Netherlands	Centrally agreed ceiling for wage increases with government 2003; tripartite national wage freeze 2004–05	XX	XXX	X
Portugal			XXX	X
Spain	Centrally agreed guidelines for wage increases 2003	XX	XXX	X
Sweden	Intersectoral agreements setting guidelines for the wage-bargaining process; pattern bargaining		XXX	XX
UK			X	XXX
New EU member states				
Cyprus			XXX	X
Czech Republic	Tripartite national agreements on minimum wages		X	XXX
Estonia	Tripartite national agreements on minimum wages		X	XXX
Hungary	National guidelines for wage increases agreed with government and tripartite national agreements on minimum wages	X	XX	XXX
Latvia	Tripartite national agreements on minimum wages	X	X	XXX
Lithuania			X	XXX
Malta				XXX
Poland	National guidelines for wage increases agreed with government and tripartite national agreements on minimum wages		X	XXX
Slovakia	Tripartite national agreements on minimum wages		XX	X
Slovenia	Tripartite national pay bargains	XXX	XX	X
Other countries				
Australia	National wage awards for minimum wages	X	XX	XXX
Japan	Pattern bargaining			XXX
New Zealand			X	XXX
Norway	Pattern bargaining; tripartite agreement on guidelines for wage increases 2003	XX	XXX	X
Switzerland			X	XX
US				XXX

Notes: XXX = dominating level
XX = important, but not dominating, level
X = existing level

Sources: *Industrial Relations in the EU Member States and Candidate Countries (2002), Collective Bargaining Coverage and Extension Procedures* (2002), individual Eiroline country reports. For New Zealand: Bray and Walsh (1998).

The impact of various wage-setting systems

- Highly co-ordinated collective bargaining promotes wage moderation and low unemployment (everything else constant)
- High unionisation and coverage of collective agreements contribute to high wages and high unemployment (everything else constant)
- Unclear how decentralised bargaining at the firm level compares with sectoral bargaining (everything else constant)
- Decentralised bargaining *together* with low unionisation and low coverage of collective bargaining seem to lead to low wages and low unemployment
- High unionisation, high coverage of collective bargaining, and high co-ordination reduce wage dispersion, mainly at the bottom of the scale
- Bargaining institutions are extremely persistent

Fig. 3.2

THE RELATIONSHIP BETWEEN BARGAINING CO-ORDINATION
(CENTRALISATION) OF COLLECTIVE BARGAINING AND THE
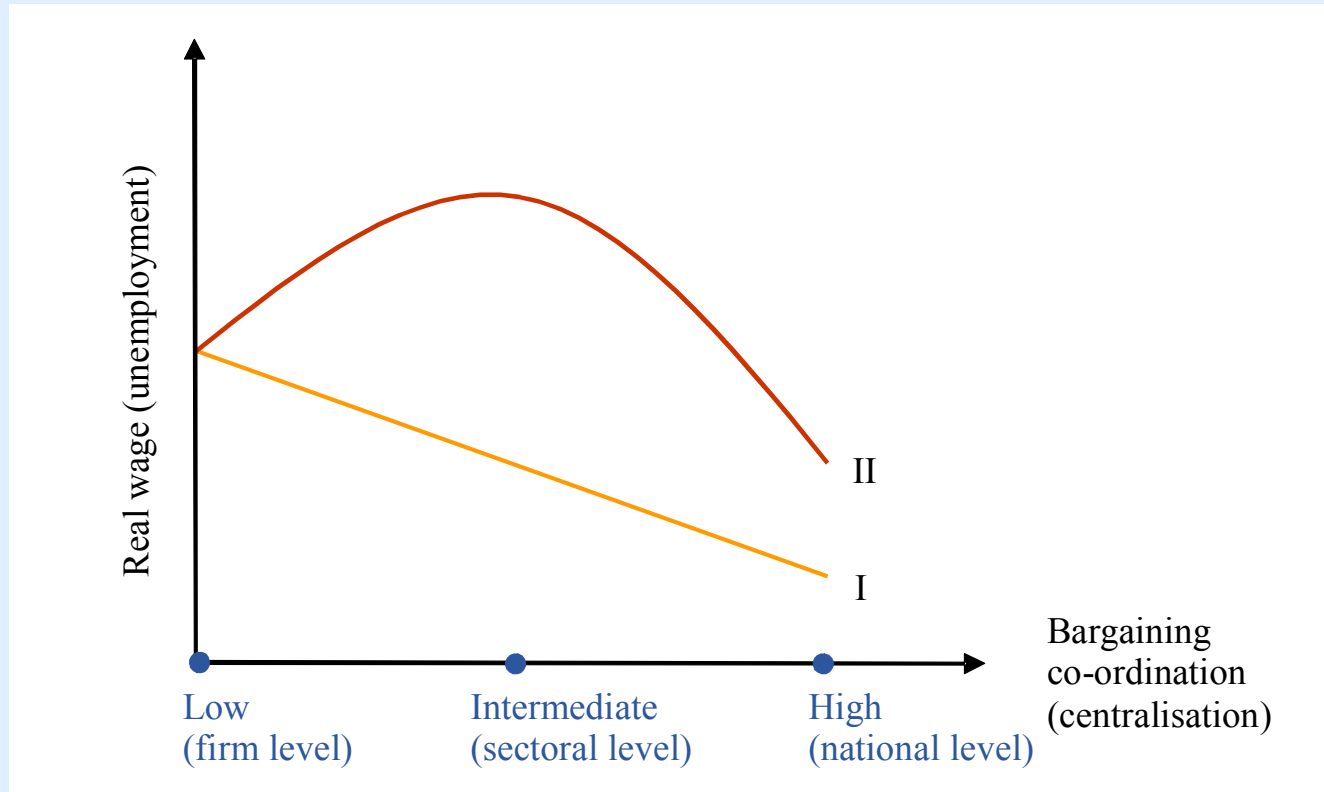REAL WAGE (UNEMPLOYMENT)

Table 3.3

Unemployment rates under various bargaining regimes (ceteris–paribus differences to decentralised systems) in various studies[a]

A: Studies finding a hump-shaped relationship between bargaining co-ordination and unemployment

	Study	Intermediate co-ordination	High co-ordination	Measure of bargaining structure[b]
1	Zetterberg (1995)[c]	2.6	- 1.5	Centralisation
2	Bleaney (1996)[d]	3.5	- 2.1	Centralisation/ co-ordination
3	Scarpetta (1996)[e]	0.9	- 12.0	Centralisation
4	Elmeskov et al. (1998)[f]	1.3	- 2.4	Centralisation
5	Elmeskov et al. (1998)[g]	1.2	- 4.4	Centralisation/ co-ordination
6	Elmeskov et al. (1998)[h]	6.9	- 4.6	Co-ordination
7	Cukierman & Lippi (1999)[i]	5.8	3.2	Centralisation
8	Daveri & Tabellini (2000)[j]	5.8	- 7.2	Geographical[k]
9	Nicoletti et al. (2001)[l]	3.6	- 2.2	Centralisation/ co-ordination
	Average	**3.5**	**- 3.9**	

B: Studies finding a monotonic relationship between bargaining co-ordination and unemployment

	Study	Intermediate co-ordination	High co-ordination	Measure of bargaining structure[b]
1	Layard et al. (1991)	- 4.7	- 10.4	Co-ordination
2	Zetterberg (1995)[m]	- 0.4	- 2.4	Centralisation
3	Scarpetta (1996)[n]	- 6.2	- 12.3	Co-ordination
4	Bleaney (1996)[o]	- 2.0	- 3.9	Co-ordination
5	Elmeskov et al. (1998)[p]	- 0.8	- 5.7	Co-ordination
6	Hall & Franzese (1998)[q]	- 2.6	- 5.1	Co-ordination
7	Iversen (1998)[r]	- 3.3	- 4.1	Centralisation
8	Nickell & Layard (1999)[s]	- 4.6	- 6.0	Co-ordination
9	Blanchard & Wolfers (2000)[t]	- 4.4	- 8.9	Centralisation
10	Belot & van Ours (2001)[u]	- 2.6 (0)	- 5.2 (0)	Co-ordination
11	Belot & van Ours (2001)[v]	- 1.9	- 1.9	Co-ordination
12	Nickell et al. (2003)[x]	- 7.2	- 14.4	Co-ordination
	Average	**- 3.4**	**- 6.7**	

Table 3.4

Unemployment rates under various rates of union density and coverage of collective agreements (*ceteris– paribus* differences to 15% union density or coverage) in different studies[a]

	Study	45%	75%	Explanatory variable
1	Layard et al. (1991)	2.5	4.9	Coverage
2	Scarpetta (1996)[b]	1.8	3.6	Union density
3	Elmeskov *et al.* (1998)	0	0	Union density
4	Hall & Franzese (1998)	0	0	Union density
5	Iversen (1998)	0	0	Union density
6	Nickell & Layard (1999)[c]	2.8	6.5	Coverage
		3.7	9.0	Union density
		6.5[d]	15.5[d]	Total
7	Nickell & Layard (1999)[e]	2.4	4.8	Union density
8	Nicoletti et al. (2001)[e]	2.1	4.2	Union density
9	Belot & van Ours (2001)[f]	1.8 (0)	3.6 (0)	Union density
10	Belot & van Ours (2001)[g]	4.7	9.4	Union density
11	Nickell et al. (2003)[h]	0 (2.1)	0 (4.2)	Union density

Notes:

[a] The table shows how much higher the unemployment rate is at 45% and 75% density or coverage rates compared to 15% density or coverage rates when other factors are controlled for.

[b] Equation (2) in Table 2.

[c] The equation explains the log of the unemployment rate. In the calculation of the effect on the unemployment rate, we have assumed that unemployment at 15% density and coverage rates is equal to the average rate of unemployment among the countries studied during the estimation period.

[d] The sum of coverage/density effects.

[e] The dependent variable is non-employment and not unemployment.

[f] See footnote (u) to Table 3.

[g] Equation (2) in Table 3B. The equation interacts various labour market institutions with each other (for example union density and co-ordination). The entries in the table refer to the effects of changes in union density under decentralisation. At higher levels of co-ordination there are no significant effects.

[h] Equation (1) in Table 5. The figures not in parenthesis are long-run effects. The figures in parenthesis are impact effects. The regression equation interacts union density and co-ordination. The effects in the table are evaluated at the sample average of co-ordination.

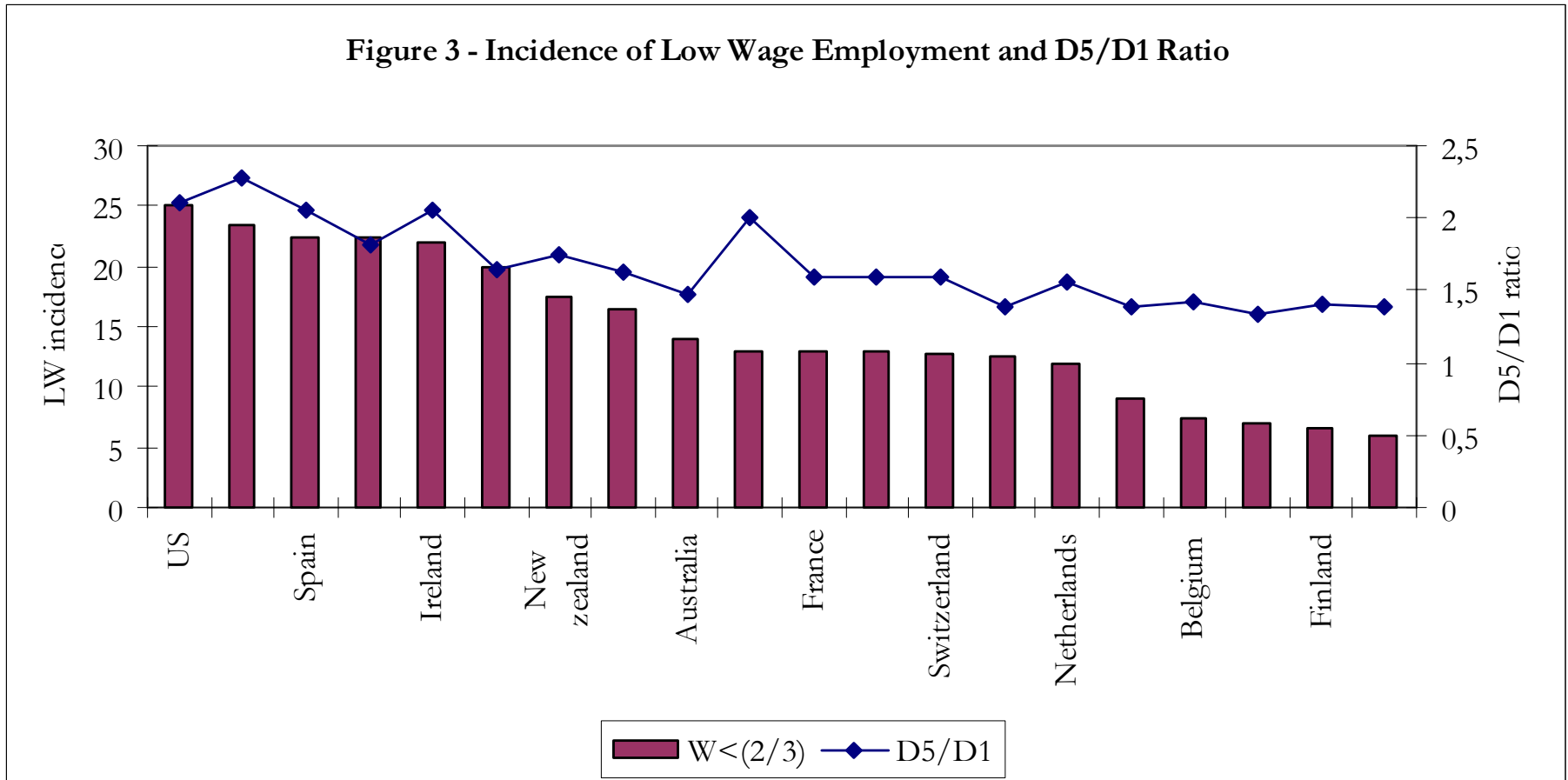Source: Calculations by the EEAG.

Fig. 3.3

EARNINGS DISPERSION
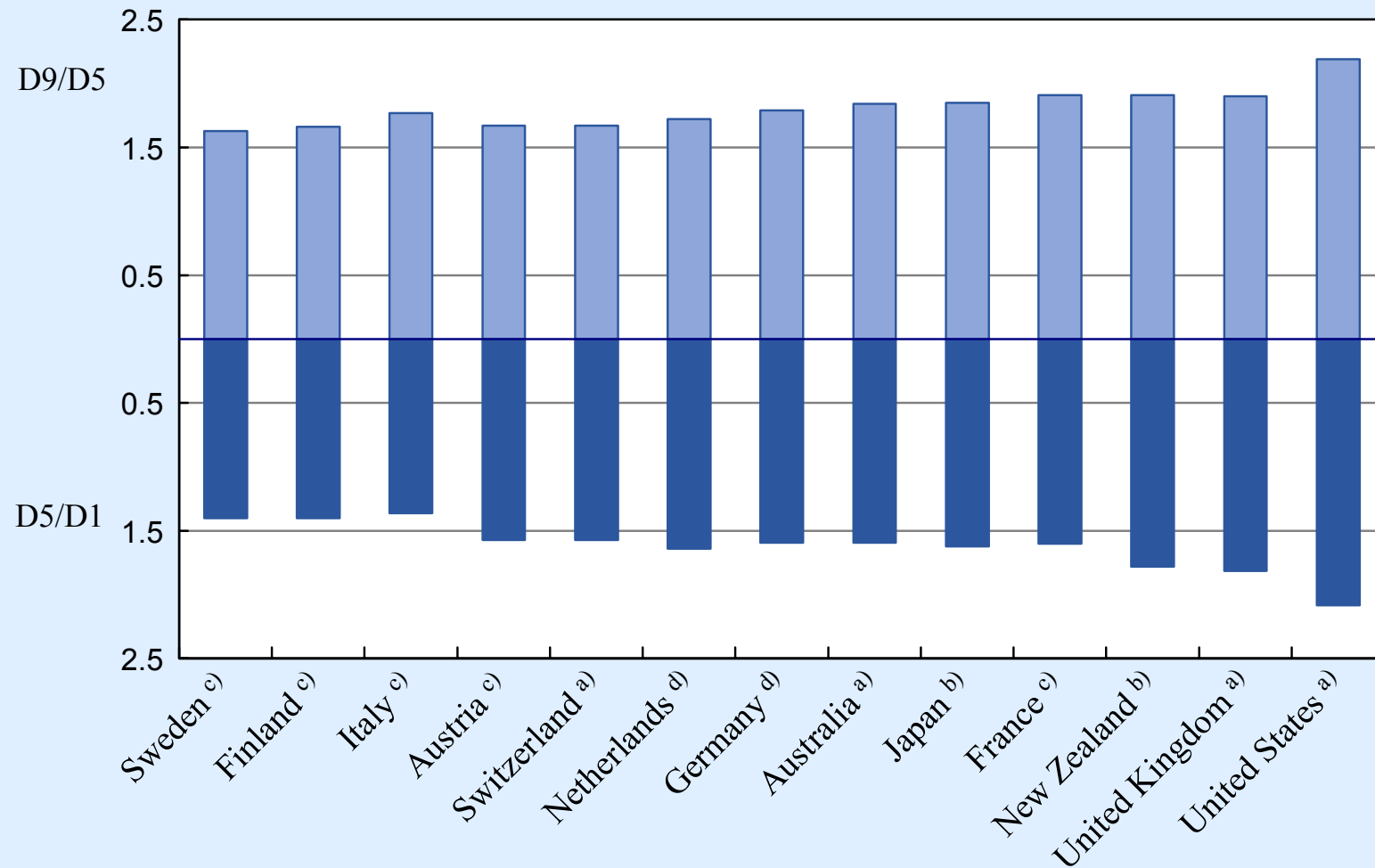
Notes: D9, D5 and D1 refer to earnings deciles. a) 1998; b) 1997; c) 1996; d) 1995.
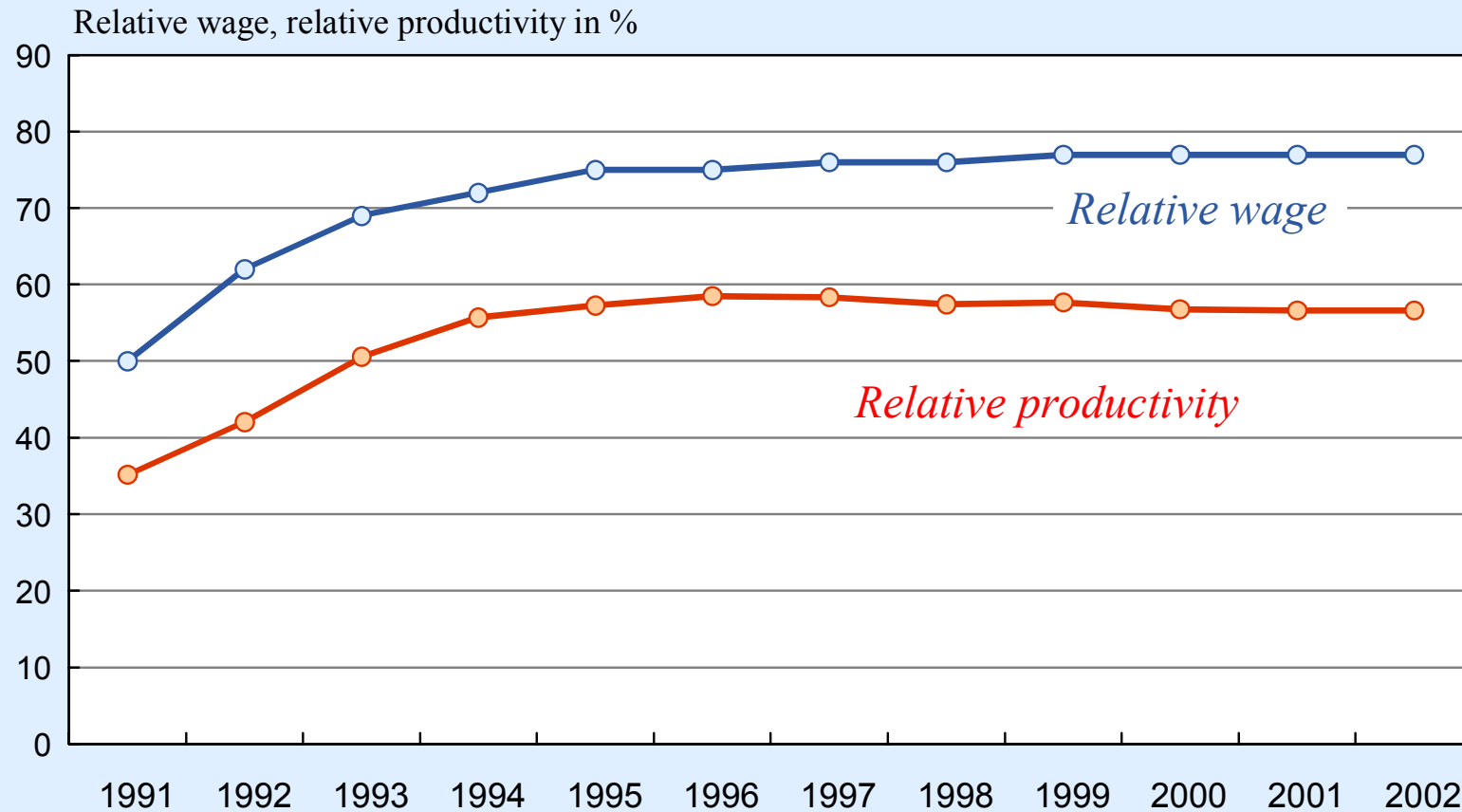Source: OECD database on earnings deciles; calculations by the EEAG.

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Figure 3 - Incidence of Low Wage Employment and D5/D1 Ratio

Source: Claudio Lucifora (2004)

Fig. 3.4

RELATIVE WAGE PER EMPLOYEE AND RELATIVE PRODUCTIVITY
PER EMPLOYEE IN EASTERN VERSUS WESTERN GERMANY

Relative wage, relative productivity in %

Relative wage

Relative productivity

Source: Federal Statistical Office, Germany.

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Chapter 3

Conclusions

- Very favourable results for highly co-ordinated collective bargaining in studies based on OECD data are not matched by similar results for individual countries
- No reason to recommend Estonia and other new EU states to adjust to EU standards in terms of industrial relations systems
- A decentralised system gives more relative-wage flexibility
  - important with rapid structural change
  - easier to introduce profit sharing and other types of profit-related pay
  - easier with larger wage dispersion based on performance within firms
  - but inter-firm wage dispersion could slow down productivity growth due to structural change
- Weak trade unions give equity argument for state legislation
  - low minimum wages have small costs but equity benefits
  - a case for differentiation of minimum wages
  - but income tax credits and targeted employment subsidies are more efficient

Huge political-economy difficulties of reforming labour markets in old EU member states

- Few reforms in most old EU states
- Only a few exceptions: the UK, the Netherlands, Ireland
- Reforms are not made until there is a perception of a deep economic crisis
- Germany is a good example of this
  - changes in benefit levels, benefit strictness, and active labour market policies
  - but not in pay-setting systems and employment protection
  - huge political risks
- Risks of policy reversals like in France and Sweden

Political-economy explanations

- **Analytical myopia**
  - easier to identify short-run costs than long-run benefits
  - easier to identify losers than winners
  - reforms only when budgetary pressures
- **Status-quo bias**
  - higher weight attached to losses than to gains
- **Conflicting interests of insiders and outsiders**
  - very difficult to reform pay-setting systems and employment protection

Political-economy conclusions

- The new EU states could benefit from the lessons from the old states
- When devising your systems you know more about the drawbacks of generous welfare systems and highly regulated labour markets than we did
- You also know more about the political-economy difficulties of rolling back overgenerous welfare systems and deregulations
- These are arguments for making a different equity-efficiency trade-off than in the old EU states
- Make the systems a bit less generous and less regulated than you really want in order to have a safety margin in case you would like to roll back the systems later on