Labour Market Institutions, Pay-Setting Systems and Employment.

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

by

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I want to begin by thanking you for the invitation to give this speech on *Labour Market Institutions, Pay-Setting Systems and Employment – What Is There to Learn from the Experiences of the Old EU Member States?*

Let me state from the beginning that I am in no way an expert on the labour markets of the new EU states and certainly not on Estonia. On the contrary, I hope to learn a lot from this visit.

Having said this it is, of course, clear that your labour market situation is very different from the one in the old EU states. The typical Western European situation has been one of high unemployment in the context of what most economists regard as overgenerous welfare systems and overregulated labour markets. Our economic-policy debate over the last decades has, as you know, been one of how to reform labour markets, usually in a market-liberal direction, something which has usually been extremely difficult to achieve politically.

Estonia and most of the other new EU states also have serious labour market problems with high unemployment. But still your situation seems to be very different from ours. You are in the position of building up your labour market institutions and welfare systems almost from scratch. You start today from a very market-liberal situation with weak regulations and welfare systems where there for reasons of social equity is a strong case for introducing more generous systems.

So, whereas the issue in the old EU states has been to what extent existing welfare systems and regulations should be dismantled, the issue in a country like Estonia seems to me to be how far you should go when building up your systems. On the one hand, I would guess there are political pressures to let labour market and welfare institutions converge on the standards of the old EU states. On the other hand, you have the benefit of having learnt how the institutions in the old EU countries have contributed to high unemployment and stagnation. So, there is a difficult balance to stirke between equity and efficiency objectives.

I take it from the little I know about Estonian labour markets that these should be issues raised for example by the introduction of more generous unemployment benefits and the decisions to gradually increase minimum wages.

The focus of my speech is on what you can learn from the old EU states when you balance equity and efficiency considerations in the development of your institutions. My point of departure is that you have much more to learn from our mistakes than from our successes. I shall try to say something about lessons both for the specific design of various institutions and about the political economy of labour market institutions. My overall focus will be on the possibilities to combat unemployment.

My first point concerns the relationship between *economic growth and employment*. Non-economists usually equate these two things and believe that a process of high growth must necessarily also cause low unemployment. Such a view might lead to a complacent attitude when it comes to unemployment in the new EU states: one can be very certain that you will have high growth over a long period of convergence on the higher income per capita levels in Western Europe. One might think that this should more or less automatically solve your unemployment problem in the long run.

One should warn against having such a complacent attitude to high unemployment. The relationship between unemployment and growth is a complex one. Theoretically it is not at all clear how it looks. On the one hand, higher growth makes it more profitable for firms to invest in more hiring and subsequent training of employees, just as a reduction in the real interest rate does. But on the other hand, to the extent that high growth derives from a high pace of structural change, the growth process will be associated with large re-allocations of labour between sectors which tend to increase unemployment.

The empirical picture is not clear either. It is true that the decline in the growth of total factor productivity that occurred in Western Europe from the mid 1970s appears to be correlated with the rise in unemployment. But, on the other hand, we usually do not introduce variations in productivity growth as an explanatory variable when we try to explain unemployment: instead it seems that changes in productivity growth translate more or less one-to-one to changes in real wage growth, in which case there will be no – or only small – effects on employment.

For these reasons I believe it is best to view employment and long-run growth as two separate issues. It is not necessarily the case that the same policies are effective in promoting both employment and growth; sometimes growth and employment polices could also be in conflict.

Instead, the lesson from the experiences of the OECD countries seems to be that it is differences labour market institutions in a broad sense that explain differences across countries and also over time in unemployment. A substantial part – say 50 % - of unemployment differences seems to be explained by differences in such labour market institutions as unemployment benefit levels, the duration of unemployment benefits, the amount of active labour market policy, the degree of unionisation and coverage of collective agreements, the degree of co-ordination of wage bargaining, and possibly also labour taxes and employment protection regulation. There also appears to be a correlation between the amount of labour market reforms made in these various areas and the changes in unemployment that has occurred in OECD countries between the early 1980s and today, as has, for example, been shown by a British colleague of mine, Steve Nickell.

I shall comment more in detail on three types of labour market institutions that might be of interest for your policy discussion:

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

Let me begin with *unemployment benefits*. There is a very strong welfare motive for why society should provide its citizens with income insurance in the event of unemployment. For me this is a very strong argument for an unemployment insurance system providing at least a 50-60 % replacement rate for low-wage earners (perhaps up to the median wage or somewhat below that) and with universal coverage.

But at the same time we know that more generous unemployment benefits cause unemployment. This is a very robust empirical result both in studies of effects on individuals´ duration of unemployment and in macroeconomic studies of the factors affecting aggregate unemployment: indeed the unemployment benefit replacement rate and the duration of benefits seem to be the variables that occur most frequently in aggregate unemployment equations based on OECD panel data.

One conclusion one can draw from the Western European debate concerns what is usually labelled the *strictness of the benefit regime*, that is the requirements in terms of which job offers to accept if an unemployed is to keep his/her benefit and the degree of monitoring of the unemployed. The stricter the benefit regime the more generous can benefits be without adverse unemployment effects. For this reason, there has been a tendency recently in many countries to enforce stricter requirements on the unemployed: that they have to search for jobs in a wider geographical area and outside the own profession as well as to accept a lower wage than in the earlier job. (Somewhat paradoxically, it appears that mild sanctions (small and temporary reductions of benefits) in the case of unemployed not searching actively for jobs are better than very harsh sanctions (permanent loss of the whole benefit), because employment officers in practice often shun back from applying very harsh sanctions.)

In Germany there is right now an ongoing discussion on whether the unemployed should also be obliged to accept jobs that pay less than the going market wage for those jobs; the idea is that such a requirement would help speed up the downward adjustment of wages in high-unemployment sectors where there is a need for such adjustment. The underlying hypothesis is then that a major adverse effect of high unemployment benefits comes via higher reservation wages. Here I noted with some interest that a study for Estonia (by Marit Hinnosaar) had not been able to find any such effect, but only an effect on the job search intensity of the unemployed, which by is exactly the opposite result that has found in a similar study for Sweden (by Anders Harkman, who found only an effect on reservation wages, but not on search activity). One sometimes gets such empirical results, but from a theoretical point of view there is, of course, a very strong case for why the unemployment benefit level should be a determinant of the reservation wage: any reasonable model of bargaining between employees and employers would predict that the bargained wage should be set as a mark-up over the unemployment benefit.

However, in practice it may not be so easy to substitute tight monitoring of the unemployed for low benefits. Efficient monitoring does require that the labour market administration has enough resources, which is a problem everywhere and, as I have understood from my reading, a particularly serious problem in a country like Estonia. It is always a problem when unemployment is high: indeed there are likely to be multiple equilibria. If unemployment is low, as in Sweden in the 1970s and 1980s, a system with high benefits and close monitoring of the unemployed probably works well: but when unemployment is high, such close monitoring is not possible and means that high benefit levels have much more adverse unemployment effects. (With high unemployment, monitoring also often tends to focus on formal search methods, like writing formal applications and so on, rather than on more informal and probably much more efficient ones.)

In many Western European countries there is an ongoing debate on how to re-direct public expenditures from passive benefits to employment subsidies. A good model here is the US system of *Earned Income Tax Credit* and the UK system of *Working Family Tax Credit*, which both provide an income tax credit for income from employment – but not from benefits – for low-income households. In principle these systems have a similar incentive effect – increasing the after-tax income difference between working and not working – as low unemployment benefits.

In, for example, Sweden and Germany, there has been a discussion of whether one could introduce such employment income tax credits. Now, a problem with doing this is that if they are not to become too expensive the tax credits must be phased out at higher incomes, which will add to the marginal effects of the tax and benefit system in the income region where the phasing-out takes place. So against the increased incentive for work at the bottom of the income scale will be a negative incentive working in the direction of reducing hours worked higher up in the income scale.

For the US, studies have found a net positive employment effect of these tax schemes. It is more uncertain if this would be the case in say Sweden if we were to introduce such a system, because we have so high marginal tax rates: adding the phasing-out of an employment tax credit would give very high marginal effects. The potential benefits of such a system are much greater if one starts out with low labour taxes in general as you do, since the distorting effects of high marginal effects increase non-linearly.

I do not know whether you have had any discussion of these issues in Estonia, but it appears to me that if you have the benefit of starting out from a system with rather low unemployment benefits you should be very careful in avoiding setting up a system with too generous benefits and instead go for a system of moderately high unemployment benefits that are combined with generous employment tax credits for low-wage earners.

Let me then move over to the topic of *active labour market policy*. Here I take it that you are currently spending very little on such policies in Estonia, but that you are trying over time to build up much more of them.

What can one say in general about active labour market policies? It is a standard finding in unemployment equations trying to explain cross-country and time-series differences in unemployment in the OECD countries, that more spending on active labour market policy tends to reduce unemployment. But this result is misleading, since it to a large extent just captures that large placements of unemployed in various labour market programmes must for arithmetic reasons reduce the number of people registered as openly unemployed.

Indeed, if one tries to recalculate the results from such studies and looks instead at what we in Sweden label total unemployment, the sum of participation in programmes and open unemployment, or at regular employment (excluding programme participation) it is unclear whether there are any favourable effects.

As you know, Sweden tried to meet the large increase in unemployment that we had in the first half of the 1990s with large expansions of labour market programmes (in the mid 1990s they encompassed around 5.5 % of the labour force). These programmes have been subjected to careful evaluations, which show very disappointing results. Training programmes do not seem to have increased the employment probabilities of participants: on the contrary they seem according to many studies to have reduced them. The best results for the individuals participating are obtained for some programmes of subsidised employment, although these programmes appear to crowd out regular employment to a very large extent. This appears to be the case especially for youth programmes.

Here I read with quite some interest the study on Estonian labour market programmes by Reelika Leetmaa and Andres Vörk, where results look very different with large and significantly positive employment results from training programmes, something which also appears to be the case for some of the other new EU states.

I am not surprised by these differences. I believe that a main problem with the Swedish programmes in the 1990s were their size: they were just too large to be able to run in an efficient way and they were used in a deep downturn when it was not obvious where to re-direct labour. Also we used programme placements to a large extent as an income support measure rather than as a measure to really improve the employment prospects of participants.

So, as long one keeps the programmes on a rather small scale – which probably could be a lot larger than you have now – I think they could make a valuable contribution, provided that they are not used as an income support measure or to requalify unemployed for unemployment benefits. It also appears reasonable that you could benefit more from a larger proportion of training schemes than we can, as there probably is more of a need to provide part of the labour force with new skills, which can more easily be identified.

But I would also believe that there is a place for more programmes of subsidised employment, especially for the long-term unemployed, as a way of acquiring necessary work experience. Such programmes will be associated with crowding-out effects, but if the programmes can be targeted on the long-term unemployed, there will still be a net employment benefit to the extent that one prevents long-term unemployed from dropping out of the effective labour force, which implies more wage-restraining competition for the available jobs.

An additional lesson from our experiences is the need to keep apart programmes designed to activate the unemployed and work-fare income support programmes for the most-difficult-to place unemployed. This has constantly been a problem for Swedish active labour market policy: that programmes designed to activate the unemployed are mixed up with programmes with the main objectives of giving the most-difficult-to-place income support and meaningful activities. These objectives often take over and distort the incentives to activate the unemployed.

Efficient active labour market policy also requires qualified evaluations. It is a good idea, as was done in Sweden, to set up a specific government body, which can develop a permanent expertise to do evaluations on a regular basis. The statistical methods used for such evaluation can also be used for a more efficient selection of unemployed to various programmes by giving a better basis for judging which programmes are likely to give the best results for which persons.

The OECD has drawn the conclusion that active labour market policy should be re-directed away from large placements in programmes of long duration to more of counselling and *activation* of the unemployed (as well as monitoring of search effort). As I said, I do believe that too large programme volumes are harmful. I do also in principle believe in the merits of activation efforts that increase the search intensity of the unemployed, but I sometimes feel there is an overoptimism on what can be achieved. The theory is that larger search intensity should reduce recruitment time for firms opening up vacancies and this way reduce both their direct hiring costs and restrain wages. Theoretically the effects are clear, but it is difficult to believe that the effects will be very large in situations with few vacancies and many unemployed, as firms´ recruitment costs are then low anyway and wage pressure is not very high. Such activation measures seem to work the best when unemployment is falling anyway and this process can be reinforced, as seems to have happened in countries like Ireland, the UK, the Netherlands, and Sweden in the 1990s.

Then I come to the *wage-setting system* and how that affects employment. Comparing wage-setting systems across countries there are huge differences. Looking at degrees of unionisation and coverage of collective agreement there are really three distinct groups:

1. The Nordic countries and Belgium with high unionisation rates and very high coverage of collective agreements.
2. Most continental European countries with lower unionisation rates (sometimes as in France and Spain very low) but still with high coverage of collective agreements.
3. Anglo-Saxon countries (among which one should also include most of the new member states, including Estonia, as well as Japan) with both low unionisation and low coverage of collective agreements.

The differences are also large if one looks at how collective bargaining, when it occurs, takes place. In most Western European countries the main locus of bargaining is the sectoral level. In some cases bargaining is also very co-ordinated, sometimes with bargaining taking place in a centralised fashion, sometimes with bargaining being co-ordinated more informally through the establishment of common norms. Sometimes the government is involved in the co-ordination attempts, sometimes not. The most prominent examples of highly co-ordinated bargaining are Belgium, Finland, and Ireland, but the Netherlands, Spain, and Sweden are also examples. Most of the countries with highly co-ordinated bargaining are small, highly open economies.

Then we have again the Anglo-Saxon group encompassing also most of the new EU member states, where collective bargaining, when it takes place, occurs almost exclusively at the firm level.

What do we know about the impact of various wage bargaining systems? In the existing studies on panel data from the OECD countries highly co-ordinated wage bargaining – holding everything else constant – is associated with low unemployment. It is less clear how bargaining at the sectoral level compares with decentralised bargaining at the firm level. According to one set of studies sectoral bargaining tends to result in the highest wage levels and therefore the highest unemployment of various bargaining systems. In this case there is thus a hump-shaped relationship between bargaining co-ordination and unemployment.

In other studies – holding everything else constant - decentralised collective bargaining at the level of the firm leads to even higher wages and higher unemployment than bargaining at the sectoral level. If so, there is a monotonic relationship between bargaining co-ordination and unemployment.

All the studies agree that – again holding everything else constant – high co-ordination leads to lower unemployment than decentralised collective bargaining: 4 percentage points on average according to studies finding a hump-shaped relationship and as much as 6.7 percentage points according to those finding a monotonic relationship. One should note that the effects found are very large: if one takes them at face value a high degree of co-ordination of collective bargaining is perhaps the most important factor influencing unemployment.

The effects of different degrees of co-ordination in the studies that have been made are large also relative to the effects of different degrees of unionisation and coverage of collective agreements. It is a consistent finding that low unionisation and low coverage of collective agreements – everything else constant - is associated with low unemployment, but the effects of differences here are smaller than the effects of differences in collective bargaining co-ordination.

However, one should not look at the effects of various aspects of wage setting in isolation. Decentralised collective bargaining usually goes hand in hand with low unionisation and low coverage of collective bargaining, as in Estonia and the other Baltic states. So, what one should do is to compare the whole package of decentralised collective bargaining, low unionisation, and low coverage of collective agreements with other bargaining systems. Then the decentralised variant, of course, looks much more favourable. (One should perhaps also take into account that unemployment benefits usually are much less generous and labour taxes lower in countries with weak and decentralised union movements.)

The most established result on pay-setting systems is probably that high unionisation, high coverage of collective agreements and highly co-ordinated collective bargaining all seem to reduce wage dispersion, and mainly so at the bottom of the wage scale.

The most evident examples of this is, of course, the compression of wages between eastern and western Germany, where the average relative wage is 77 %, whereas relative productivity is only 57 %. In general, lower wage dispersion also means a lower share of low-wage employment in the economy, which works in the direction of lower total employment.

On the whole I believe it is impossible to draw very clear-cut conclusions on which wage-setting systems are the best. There are some reasons to doubt the very large unemployment-reducing effects of highly co-ordinated wage bargaining in studies attempting to account for cross-country differences: one usually has problems finding large wage-reducing effects within countries when one compares periods with high co-ordination with periods with sectoral bargaining or even more decentralised bargaining.

For this reason I do not see any strong arguments for why a country like Estonia should try to change its industrial relations system in any fundamental way. One might expect that you – like many of the other new EU countries – might be subjected to pressure from EU institutions and from the old EU countries (especially from social democratic governments and trade unions there) to adapt to more of Western European standards with more of collective bargaining and more co-ordinated/ centralised such bargaining.

One could, of course, argue that as a small open economy it might be natural for you to adopt a system based on highly co-ordinated collective bargaining, but I would assume that it might be very difficult to get there, as bargaining systems are usually very persistent: so if you try to change the system, there is a large risk you would end up like many of the Western European countries with un-coordinated sectoral bargaining which might produce bad macroeconomic outcomes.

I would also believe that your present system allows for a high degree of relative wage flexibility. This may be very important for holding down unemployment in the process of rapid structural change that you will be experiencing. One clear advantage of decentralised wage bargaining at the level of the firm is that it makes it easier to introduce schemes of profit sharing or profit-related pay by trading off the compensation from such arrangements against lower base wage levels, which can only be done at the level of the firm. I have no idea of how important such schemes are in Estonia, but research suggests they are beneficial for both employment (by reducing the fixed costs of labour) and productive effort. On the whole, decentralised wage bargaining also seems to make it easier to introduce more of individual performance-related pay systems within firms in order to increase incentives for effort and productivity.

Just as with unemployment benefits, there are important trade-offs between efficiency and equity when it comes to the wage-setting system. The weaker are trade unions and the smaller the role for collective agreements, the stronger are the arguments that the state should guarantee some minimum standards through legislation, such as minimum wages. Indeed, this is usually done in countries with a small role for collective bargaining, whereas there is no such legislation in for example the Nordic countries. I believe the lesson from empirical research is that the costs of this in terms of lost employment are low (or non-existent) as long as minimum wages are set at a fairly low level, at the same time as the equity gains can be important because they prevent outright abuse of the interests of uniformed employees or employees with weak bargaining capabilities.

I believe the experiences from Western Europe provide a strong case for differentiating minimum wages for different groups: for example, it appears that the employment of especially young people can be very seriously affected by across-the-board minimum wages, which often are set too high for this group.

I can see a role for minimum wage legislation if minimum wages are set rather low. They can have a useful role in reducing social conflict in a society with weak unions. But in general income tax rebates for low-wage employees and employment subsidies to employers for targeted groups are less risky ways of helping these groups, as employment and after-tax wages will be affected in the same direction.

Let me end with a few words about the *political economy* of labour market and welfare institutions. In a way the new member states are in the very fortunate situation of being able to build institutions from scratch where you can use the knowledge about the working of various labour market institutions accumulated from the experiences of the old EU member states. We have found ourselves in a situation where we gradually discovered that our welfare systems are too generous and our labour markets too regulated. We have also learnt how politically difficult it it is to modify these systems.

Looking at labour market reforms in Western Europe, we have had a very long discussion about the need for them, but very little has been done in most countries. There are some examples, such as the UK, Ireland, the Netherlands, and to some extent Spain. But reforms have usually not been made until there has been a very deep crisis, involving stagnation and very high unemployment, and a very general perception of the depth of crisis. This certainly was the case in all these countries.

It certainly is the case in Germany, which has first now embarked on a path of labour market reform. It involves reductions in unemployment benefits, a stricter unemployment benefit regime with tougher requirements on the unemployed, and a general reform of active labour market policies. It does not so far involve any fundamental changes in a very rigid pay-setting system and very little of change in employment protection legislation. It has aroused a lot of discontent and some measures that are currently being phased in may still be reversed. The changes are made at very large cost for the government, which is almost certain to lose the next election because of its labour market reforms. In other countries, there are many examples of reforms being decided, but later being reversed after protests: this applies, for example, to benefit replacement rates in Sweden and France.

There are obvious political-economy explanations for these difficulties of reforming labour markets. I believe the most important ones are analytical myopia, a general status quo bias, and conflicting interests.

With *analytical myopia* I mean the tendency among the general public to focus on the certain short-term effects of labour market reforms, but discard the more uncertain and complicated long-run effects. It is, for example, very easy to see the short-term costs of reducing unemployment benefits for the unemployed in terms of reduced living standards. The potential benefits in terms of higher employment lie in a more distant future and cannot be calculated exactly: they also involve complex judgements on the effects on search effectiveness and reservation wages of individuals, and on how these effects in term influence wages in the economy and thus the hiring decisions of employers and so on.

It is also easy to identify the losers – who will form a very strong pressure group against changes – but more difficult to pinpoint the future winners. All this means that cuts in unemployment benefits are almost impossible to make in order to improve the functioning of the labour market: as in Sweden and Germany, it is usually only done when there are severe budgetary pressures in order to cut down on government expenditures.

The problem of *status-quo-bias* means that there are almost always a stronger constituency fighting reductions in benefits of various kinds than there is in favour of obtaining further benefits. Psychologists have pointed to how we seem to attach a much higher cost of losing something relative to an established norm relative to gaining something relative to it. This tendency is of course strengthened to the extent that it is easier to identify losers from a reform than winners.

Finally, there is the issue of *conflicting interests* among various interest groups. The majority of employees - employed insiders – will always be reluctant to reforms that favour the outsiders, the unemployed, at their expense. This is a probable reason why it often almost impossible to change current pay-setting systems (as in Germany) or minimum wage legislation (as in France) or employment protection rules (as in both Germany, France, and Italy), which would have their first-round effects on reducing the wages and benefits of insiders.

Now why am I saying all this? Because a main lesson from the old EU states is that there are overwhelming political-economy difficulties of changing labour market institutions in an employment-friendly way once too generous welfare systems and too much regulations are in place. Obviously, it is very difficult to find the right balance between equity and efficiency, or between employment and income distribution. But when devising your systems you have the benefit of knowing much more about the relationship between employment and labour market institutions than we did when our basic systems were devised. You also have the benefit of knowing from our experiences how difficult it is to roll back very generous welfare systems and highly regulated systems.

For me, these are very strong reasons why you should not try to converge on our systems, but stop well short of them when you build up your systems. Or put another way: when devising your systems, it would seem wise to make the systems a little bit less generous and less regulated than you really want in order to have a substantial safety margin in case you made the wrong judgement and later on would feel the need to deregulate and make the systems less generous.