

# Labour Market Reforms, Pay Setting and Employment

## **Distinguish between long-term growth and employment**

- Short-term variations in GDP and employment growth are strongly related over the business cycle – Okun's law
- Growth increases the return to investing in hiring and training of new employees
- But growth driven by structural change increases frictional unemployment
- High employment increases the return to investment in real capital, which is positive for growth
- No robust empirical support for a strong relationship between long-term growth and employment

- Best to regard long-term growth and high employment as two distinct issues
- Policies stimulating growth need not raise employment
- Policies stimulating employment need not raise long-term growth
- Growth and employment policies can conflict with each other

## **Reductions in unemployment 1983-2003**

<b>Ireland</b>	<b>10.1</b>
<b>Netherlands</b>	<b>7.2</b>
<b>UK</b>	<b>5.9</b>
<b>Denmark</b>	<b>2.8</b>
<b>Belgium</b>	<b>2.5</b>
<b>Spain</b>	<b>2.3</b>
<b>Portugal</b>	<b>1.6</b>

## **Increases in unemployment 1983-2003**

<b>Finland</b>	<b>3.8</b>
<b>Germany</b>	<b>2.5</b>
<b>Luxembourg</b>	<b>2.2</b>
<b>Austria</b>	<b>2.1</b>
<b>Greece</b>	<b>1.5</b>
<b>Sweden</b>	<b>1.3</b>
<b>Italy</b>	<b>1.2</b>
<b>France</b>	<b>1.1</b>

## Unemployment levels

	<u>1983</u>	<u>2003</u>
<b>Spain</b>	<b>13.7</b>	<b>11.4</b>
<b>France</b>	<b>8.5</b>	<b>9.6</b>
<b>Greece</b>	<b>7.9</b>	<b>9.3</b>
<b>Finland</b>	<b>5.5</b>	<b>9.2</b>
<b>Germany</b>	<b>6.4</b>	<b>8.9</b>
<b>Italy</b>	<b>7.7</b>	<b>8.9</b>
<b>Belgium</b>	<b>10.8</b>	<b>8.2</b>
<b>Portugal</b>	<b>8.0</b>	<b>6.4</b>
<b>Denmark</b>	<b>8.4</b>	<b>5.5</b>
<b>Austria</b>	<b>3.4</b>	<b>5.5</b>
<b>UK</b>	<b>10.9</b>	<b>5.0</b>
<b>Ireland</b>	<b>14.9</b>	<b>4.8</b>
<b>Sweden</b>	<b>3.5</b>	<b>4.8</b>
<b>Luxembourg</b>	<b>1.6</b>	<b>3.8</b>
<b>Netherlands</b>	<b>11.0</b>	<b>3.7</b>

# Decomposition of unemployment

- Structural (equilibrium) unemployment
  - a badly functioning labour market
- Cyclical unemployment
  - cyclical lack of aggregate demand
- Empirical studies on OECD panel data
  - supports the view that structural unemployment is important
  - around 50 % of differences in unemployment are explained by differences in *labour market institutions*

### **Factors contributing to unemployment in almost all studies**

- **High unemployment benefits**
- **Long duration of unemployment benefits**
- **High degree of unionisation**
- **High coverage of collective agreements**

### **Labour taxes**

- **Contribute to unemployment in some studies**
- **No effect in other studies**

### **Employment protection**

- **No effect on overall unemployment in most studies**
- **But effect on the composition of unemployment**
  - **higher youth unemployment**
  - **higher long-term unemployment**

### **Active labour market policy**

- **Reduces open unemployment in most studies**

### **Co-ordination (centralisation) of collective bargaining**

- **High co-ordination is positively associated with low unemployment**
- **Unclear whether or not decentralised bargaining at the firm level *per se* is also related to low unemployment**

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

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

**R<sup>2</sup> = 0.51    N = 20**



# Political-economy obstacles to labour market reforms in continental Europe

- Misconceptions of how the economy works
  - no need for wage restraint
  - raise wages to stimulate consumption
- Analytical myopia
  - large weight on concrete and short-term costs
  - small weight on “abstract” and long-term benefits
- Conflicts of interests between previously employed (insiders) and unemployed (outsiders)

# Active labour market policy

- Unfavourable results in Sweden in the 1990s
- Similar unfavourable results in Germany and France
- Focus on activation measures
- According to some studies substantial effects on outflows from unemployment
- Difficult to believe that activation measures can make a large difference at the aggregate level with low demand
- Only effective if unemployment is going down anyway (Denmark, the Netherlands, UK, and Sweden)

# Deregulations of the product market

- Politically easier than labour market reforms even if particular interest groups may have to be fought
- Elimination of monopolistic behaviour raises output and employment
- Wages are restrained to the extent that monopolistic rents are reduced

## **Increase pay-off of work for low-wage earners relative to receiving benefits**

- Employment tax credits
  - US Earned Income Tax Credit
  - UK Working Family Tax Credit
- General tax rebates for all low-wage earners
  - expensive
- Targeted tax rebates on long-term unemployed and welfare recipients
  - less expensive
- Politically more acceptable than direct benefit cuts
- Less of stigmatisation effects than hiring subsidies for employers
- Negative effects on long-term growth?

## **Tax cuts for household-related services**

- High taxes have more distortionary effects for in this market than in most product markets
- Higher price sensitivity because of substitution possibilities with respect to own work
- Alternative to labour market programmes with smaller crowding-out effects on regular employment

# Limited reforms in many areas rather than huge reforms in a few areas

- Minimises risks that reforms will not work
- The Dutch way
- Easier to get political acceptance
- Reforms may complement each other
  - unemployment benefits
  - wage setting

Table 3.1

Coverage of collective agreements and unionisation<sup>a)</sup>

Country	Total economy (2001)		Market sector (mid 1990s)	
	Coverage	Unionisation	Coverage	Unionisation
<b>Old EU member states</b>				
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 <sup>b)</sup>	36	29	35	19
<b>New EU member states</b>				
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		
<b>Other countries</b>				
Australia	22 (23) <sup>c)</sup>	23		
Canada	32	30 <sup>g)</sup>		
Japan	21	22 <sup>h)</sup>	21	24
New Zealand	45 <sup>d)</sup>	22		
Norway	70-77 <sup>e)</sup>	55 <sup>h)</sup>	62	44
Switzerland	53 <sup>f)</sup>	23 <sup>h)</sup>	50	22
US	15	14 <sup>h)</sup>	13	10

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

Table 3.2

## Bargaining levels

Country	National guidelines	Inter-sectoral level	Sectoral level	Enterprise level
<b>Old EU member states</b>				
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
<b>New EU member states</b>				
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
<b>Other countries</b>				
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

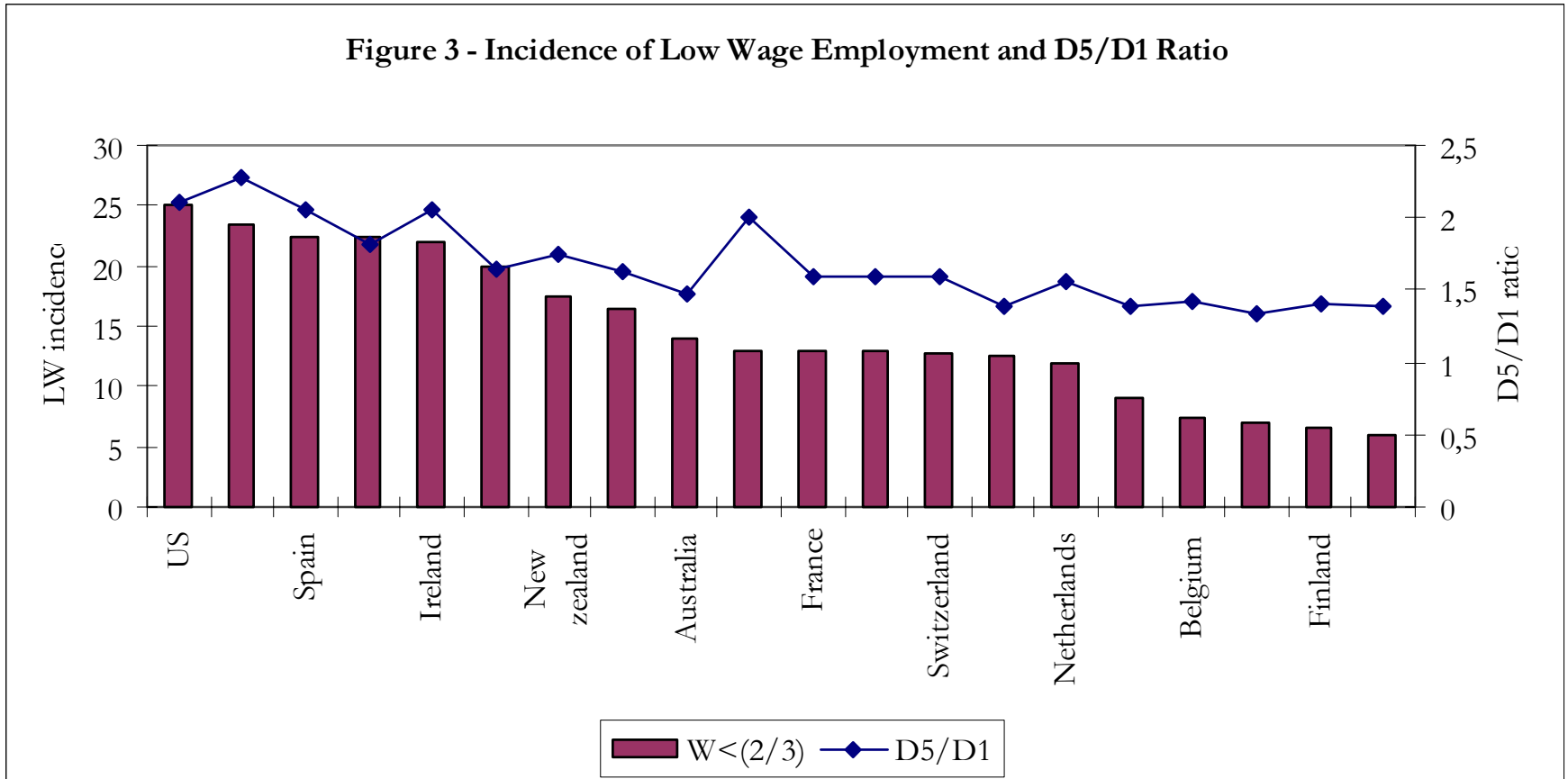
Sources: *Industrial Relations in the EU Member States and Candidate Countries (2002)*, *Collective Bargaining Coverage and Extension Procedures (2002)*, individual Euroline country reports. For New Zealand: Bray and Walsh (1998).



## 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

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



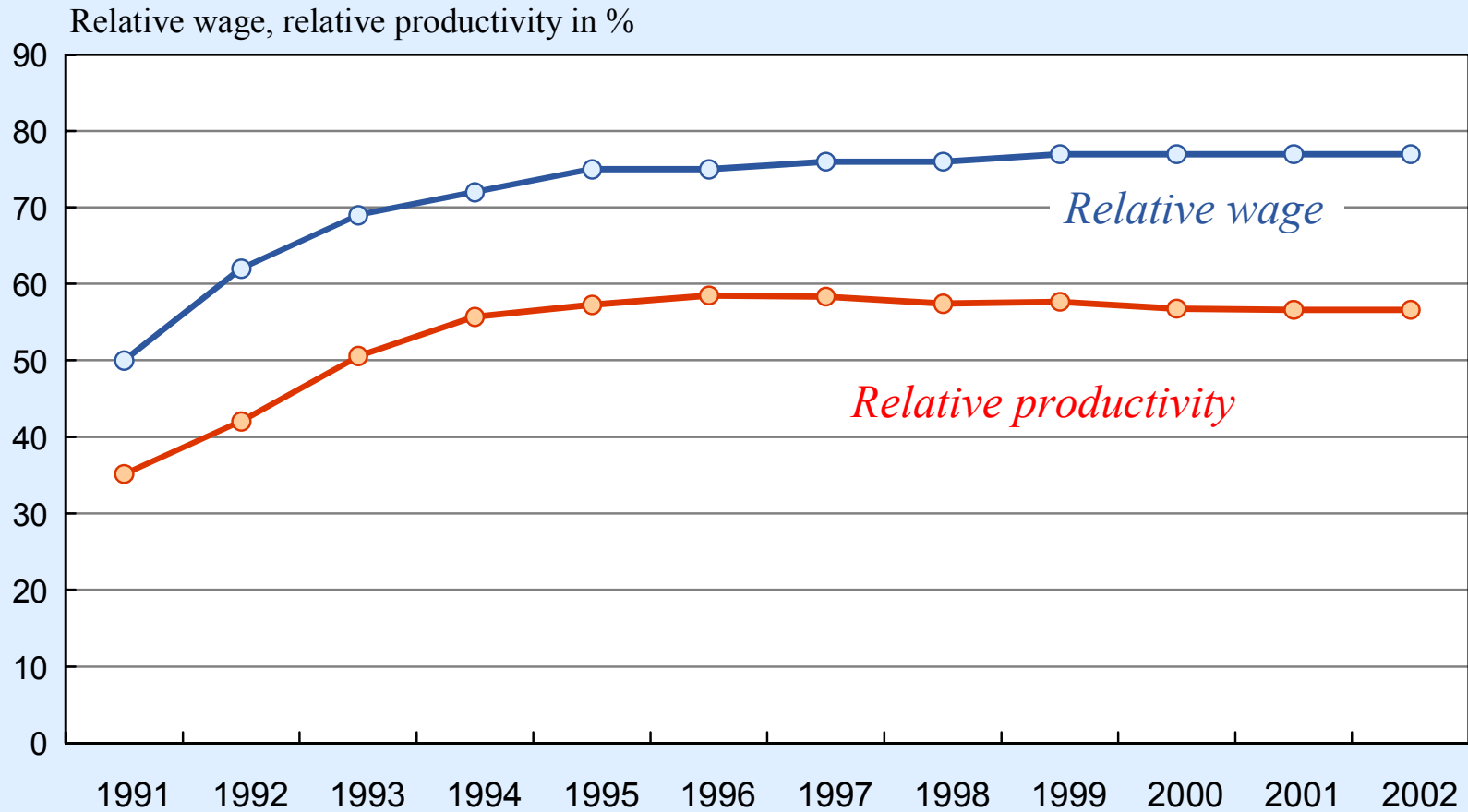
Source: Claudio Lucifora (2004)

## **Conclusions on wage-setting systems**

- No reason for smaller European economies to abandon co-ordination strategies
- But more relative-wage flexibility is desirable
- Huge relative-wage distortions between western and eastern Germany
- Politically more difficult to reform wage-setting system than to do other labour-market reforms

**Fig. 3.4**

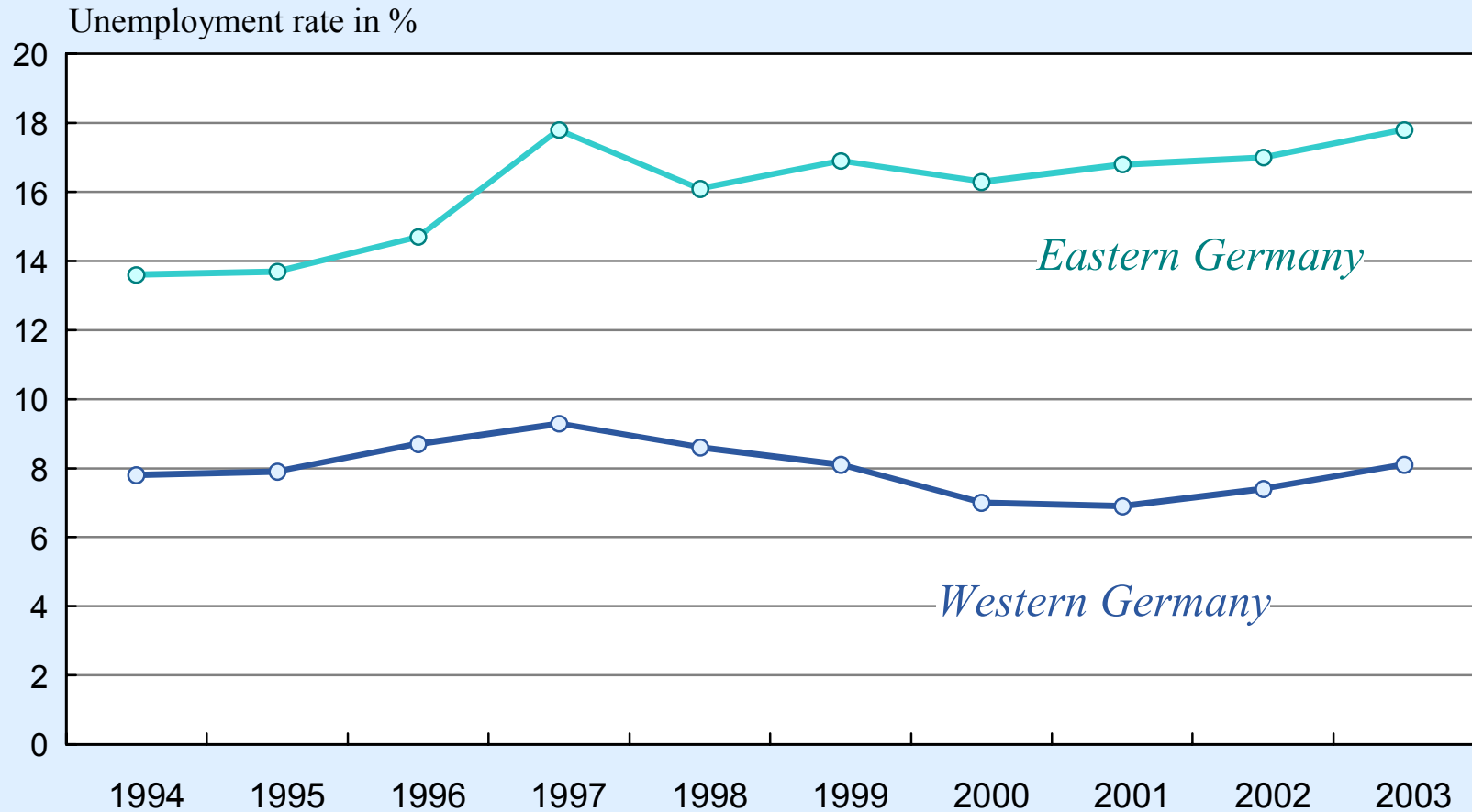
## RELATIVE WAGE PER EMPLOYEE AND RELATIVE PRODUCTIVITY PER EMPLOYEE IN EASTERN VERSUS WESTERN GERMANY



Source: Federal Statistical Office, Germany.

**Fig. 3.5**

## UNEMPLOYMENT RATES IN EASTERN AND WESTERN GERMANY



Source: Federal Employment Services, Germany.

## Possible reforms in Germany within the present system

- Larger possibilities for *opening clauses*
  - agreements between employer and local works council
  - or approval by local employees in ballot
- “*Sifferlösa avtal*” at higher levels
  - peace obligation
  - possibilities of “recall”
  - to reduce as well as to raise relative wages
- *Profit-related pay*
  - more hirings on average over the business cycle
  - less cyclical employment variability
  - higher-level collective agreements must allow for trade-offs at the local level

# Likely scenarios

1. Reforms of the current system
2. Slow reductions of unionisation and coverage of collective agreements
  - only slow improvement in the labour market
3. Anglo-Saxon revolution at some time
  - need for massive legal interventions