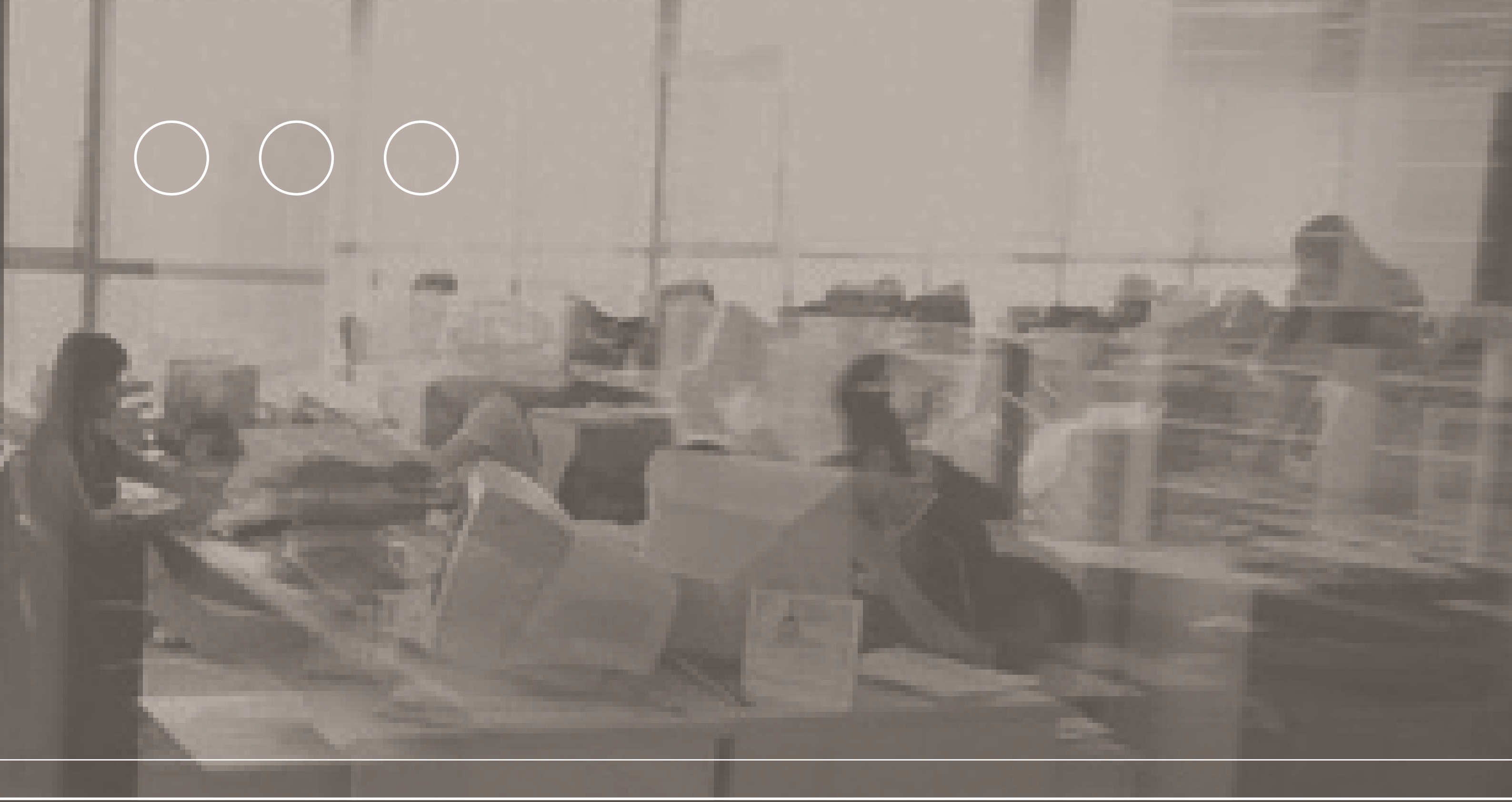

Structural **reforms** and macro-economic policy

European Trade Union Confederation

Structural **reforms** and macro-economic policy

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overview

Introduction – Reiner Hoffmann 5

Part I : Structural reforms: What has been done so far? 9

- Lack of structural reform and low growth performance in the euro area – Ronald Janssen 11
- Labour markets in transition: Combining flexibility and security in Central and Eastern Europe - Sandrine Cazes and Nesprovova Alena. 15
- The trade union's view on labour market policies: the case of the Czech Republic – Pavel Janicko 21
- Labour market reforms in Italy – Claudio Treves 23

Part II : Structural reforms : The way ahead 25

- A trade union agenda for structural reform – Ronald Janssen 27
- The Open Method of Coordination six years on: From flamboyant promises to unrealistic expectations – Niklas Noaksson 37
- Labour market reform: A perspective from Sweden – Åke Zettermark 48
- Getting trapped in low wage jobs: The experience from France – Emmanuel Mermet 51

Part III : Structural reforms and the European macro-economic policy regime 53

- Monetary policy and structural reforms in the euro area –Ad Van Riet 55
- Potential output: A questionable concept – Gustav Horn 62
- The Stability and Growth Pact: Stability without growth? – Cathérine Mahieu and Henri Sterdyniak 69
- The euro area drifting apart – Jörg Bibow 76
- Labour market re-regulation in the UK – Richard Exell 87

Order form 93

introduction

Reiner Hoffmann

'Reforms, reforms, reforms', that is the conventional wisdom of many European policy makers when discussing the dismal growth performance of the European economy. In this view, Europe's main problem is labour markets institutions which would prevent the economy from adapting fast enough to the realities of globalisation and technological change.

However, two key questions are rarely addressed by this conventional wisdom. The first one is how the agenda of structural reform of European labour market should exactly look like. Will any reform of labour market regulation do the job? Or do we need to distinguish between reforms that are conducive to productivity and innovation and between reforms that destroy the knowledge basis by subjecting workers to precarious working conditions? The second question is whether labour market reforms are enough. Will labour market reforms produce higher growth and more and better jobs all out of their own? Or is the helping hand of growth- friendly macro-economic policy necessary?

To address these questions and to raise more awareness amongst policy makers of the importance of these issues, the ETUC organised on 20and 21 March 2006 a conference on structural reform of labour markets and macro-economic policy making in Europe. The papers collected in this book are a selection of the different interventions that were made at this conference.

A first part focuses on the state of play concerning structural reform in Europe. Is it really the case that Europe and its member states have been sitting idle in the face of globalisation? On the basis of data from the OECD, the IMF and the European Commission, a first paper from Ronald Janssen (ETUC) finds that many European member states have implemented reforms of key labour market institutions since the mid-nineties. Employment protection for specific groups has been loosened up; taxes on labour have been cut, while unemployment benefits systems have been eroded. This sheds doubt on the claim that Europe is facing a slump in growth because of its perceived irresponsiveness to structural change.

Sandrine Cazes and Alena Nesporova (International Labour Office) complements the picture by looking at the central and eastern European countries in particular. The transition from a planned to a market economy has implied major transformations for these countries and they now have loose employment protection and low unemployment benefits which cover only a relative small part of registered unemployed. However, this increase in labour market flexibility for business was not matched by an increase in workers' security: Access to active labour market policies as well as decent income support in unemployment remained too limited. At the same time, good economic growth did not translate into much job creation, thereby reducing job prospects for retrenched workers. Finally, Cazes and Nesporova call for a true social dialogue to rebalance the mix of flexibility and security in Central and Eastern Europe.

Pavel Janicko (CMKOS) confirms the previous analysis from the point of view of the Czech Republic. There is too much focus on labour market reforms deregulating workers' rights and weakening trade unions and insufficient focus on the social dimension of transition and structural change, on a well-functioning employment service, on investing in human capital and on ensuring decent wages.

Claudio Treves (CGIL-Italy) describes how the previous government pushed through labour market reforms weakening workers' rights and spreading insecurity throughout the work force while the real problem of Italy's overspecialisation in medium-tech sectors was ignored.

In a second part, the question is addressed which kind of structural reforms are necessary for the European economy. Ronald Janssen (ETUC) starts out from the basic principle that globalisation requires a well functioning labour market promoting upward (as opposed to downward) flexibility of workers. Put differently, Europe can and should not compete with China by cutting wages and working longer but by upgrading the economy and its workforce. Therefore, a trade union agenda for structural reform has two basic pillars: One pillar is to set decent working standards so that business has to resist to the temptation of addressing competition by going down the wrong route of simply exploiting its work force. The other pillar is to invest more and massively in the new social agenda of skills, upward mobility and gender.

The paper also argues that the two pillars are closely interlinked with each other and that the way to reform is to build the new social agenda of skills and mobility on the basis of robust workers' rights guaranteeing fair wages and working conditions.

Niklas Noaksson (former ETUI-REHS) focuses on the method that is being used in Europe to deliver more structural reforms. After describing the open method of coordination, as it has been used in the European Employment Strategy since 1997, Noaksson draws attention to the reforms introduced by the 2005 relaunch of the Lisbon strategy. It appears the reform of the strategy to deliver structural reforms is copying the strategy used by the OECD. As a result, bilateral contacts between Commission and member states take a more prominent role. Also, the role of country specific policy recommendations has been reduced. To improve delivery of reforms, national social partners and parliaments should be associated more closely and the European Union structural funds should be used to encourage those member states that comply with the Lisbon guidelines.

Ake Zettermark (SACO) describes how trade unions in Sweden handle structural reform. Trade unions and workers in Sweden are found to be quite open to change, as illustrated by the fact that 80% of Swedish and Danish workers actually are of the opinion that changing jobs every few years is a good thing to do. However, this is no coincidence. Economic policy and labour market policy are very much supporting workers when confronted with structural change: Unemployment benefits are high, jointly run social partner funds provide retrenched workers with immediate assistance in looking for a new and productive job from the moment they receive notification of dismissal, and the so-called industrial collective agreement focuses wage formation on the objective of creating new jobs and decreasing unemployment.

Emmanuel Mermet (CFDT) stresses that France provides the counter-example of how structural reform and macro-economic policy should not be done. In France, the emphasis is on expanding the low wage sector by artificially subsidising low paid jobs. Jobs paying between the minimum wage and 1.6 times the minimum wage enjoy substantial cuts in social security contributions. However, this unbalanced focus on low wages works to create a 'low wage trap' and comes at the expense of the incentive to invest in education, training and to raise productivity. Moreover, in trying to push for lower job protection, the French government has simply ignored the role social partners and social dialogue should play in implementing reforms such as these. Mistakes have also been made on the macro-economic policy side. Tax cuts have benefited the rich who have mainly used the money to save more. France has raised government deficits by cutting taxes but this has done little to boost domestic demand.

The papers of the third and final part make the link between labour market reforms and macroeconomic policy. Ad van Riet (European Central Bank) provides the point of view from the side of monetary policy makers. Here, the focus on price stability is considered to be essential. On the one hand, the focus on price stability allows the ECB to react to those structural reforms which have an impact on the medium-term outlook for inflation. On the other hand, a stable level of prices creates transparency, making the need as well as the potential benefits of structural reforms more visible for everyone to see.

Gustav Horn (IMK) warns European policy makers in general and the European Central Bank in particular not to make the mistake of turning low potential growth into a self-fulfilling prophecy. Policy makers should not exclusively focus on structural reforms to increase the medium term rate of potential non-inflationary growth. They should also pay due attention to the need of stabilising the economy around full potential by using active aggregate demand policies. If not, labour market hysteresis might turn cyclical unemployment into structural unemployment. Failure to stabilise aggregate demand and activity will also result in a lower investment ratio depressing total factor productivity growth, thereby resulting in a reduced growth potential for the economy. Pragmatism should prevail and given a benign inflation outlook, the ECB should strive to 'test the waters' by triggering a virtuous cycle of falling unemployment, higher growth, falling structural unemployment and higher productivity growth.

Cathérine Mahieu and Henri Sterdyniak (Office Français des Conjonctures Economiques-OFCE) argue that the Stability and Growth Pact is not delivering what is urgently necessary, that is a real coordination of macro- economic policy in and inside the euro area. In a monetary union, with its single interest rate regime, flexible fiscal policies become even more important to address country-specific shocks and national divergence. However, the European fiscal policy framework is governed by rigid and overly simplistic rules. The Stability Pact is basically constructed to constrain discretionary fiscal policy makers instead of allowing fiscal policy to address the real economic needs of the member states. Mahieu and Sterdyniak propose a reform of the Stability Pact that is based on the central idea that European surveillance of member states' fiscal policies should be limited to preventing any negative spill-over to the rest of the euro area. Binding rules should be limited to dealing with externalities. According to the authors, this could be done by offering member states the choice of an inflation target between 1.5 and 5%. The European Commission and Finance Council is then responsible for watching over the compatibility of these national inflation targets with euro area wide price stability (defined between 1.5 and 3.5%) as well as for watching over the fact that each country respects its engagement on delivering its contribution to price stability. In this way, euro area wide price stability as well as flexible fiscal policy making can be combined with each other. Logically, such a policy setting requires a permanent dialogue between the finance ministers of the euro group with the European Central Bank.

Jörg Bibow (former Franklin College, Switzerland) fundamentally questions the argument that countries of a monetary union need substantially more wage and price flexibility in order to avoid the euro area from drifting apart. Indeed, with Spain rapidly recovering from the 2001, France and Italy recovering slowly and Germany not recovering at all, economic divergence is rapidly widening inside the euro area. Can wage flexibility, which basically works through the channel of competitiveness and real exchange rate depreciation, solve the problem? Bibow observes that the equilibrating mechanism of wage flexibility also has an important internal dimension. Wages are not only costs for competitiveness but also incomes for consumption. Wage moderation in Germany and more buoyant (nominal) wage growth in Spain have resulted in an additional depressing effect on German growth while sustaining private consumption in Spain. On top of this, other powers of divergence work to reinforce the wage moderation channel. In a monetary union with a single interest rate, divergence of inflation (resulting from diverging wage growth) delivers low real interest rates for the inflationary country and high real interest rates for the country with low growth and disinflation. All of this has now resulted in Spain running a giant current account deficit of almost 10% of GDP and Germany becoming the world champion in exports, with the first country enjoying continuing high growth and the latter country having seriously depressed growth. The basic policy message that European policy makers should urgently understand is that wage flexibility is not a substitute for flexible use of macroeconomic policies. Instead of calling for even more competitive wage dumping in the euro area, policy makers should focus more on getting the macroeconomic policy regime right by, amongst other things, adequately reacting to symmetrical demand shocks that have hit the euro area as a whole.

Finally, Richard Exell (TUC) stresses that labour market institutions should not only be seen in relationship to flexibility. It should also be remembered that all of these institutions were introduced to promote a desirable social purpose. Exell then provides an overview of UK policy since 1997 which has been a policy of re-regulating the labour market and giving workers more, not less rights. A minimum wage has been introduced, workers have been given a right to paid holidays and the trial period for new workers has been reduced from two years to 1 year. Stronger worker rights have certainly not impeded on job growth since 1.5 million new jobs were created over this period in the UK. With aggregate demand as the driving motor of job creation, the main lesson that Europe should learn from the UK is not the flexibility of its labour market but the flexibility in using macro-economic policy.

Reiner Hoffmann,
Deputy General Secretary ETUC

PART 1
Structural reforms: What has been done so far?

PART 1
Structural reforms: What has been done so far?

LACK OF STRUCTURAL REFORM AND LOW GROWTH PERFORMANCE IN THE EURO AREA

Ronald Janssen[1]

Introduction

In Europe, and in particular in the euro area, with its low growth performance, the official policy debate is almost exclusively focussing on the economy's supply side. Time and time again, it is argued that the euro area is constrained by rigidities, in particular labour market rigidities, which hold the economy back and keep it from returning to higher rates of economic growth. It is claimed that labour market institutions such as unemployment benefits keep the unemployed from actively seeking and taking up new jobs. Regulatory intervention limiting working hours to a weekly maximum supposedly reduces the extent to which workers are available to the firm. And job protection legislation is being accused of damaging total job performance as well as job prospects for weaker labour market groups such as women, young people and older workers. According to this analysis, the problem is the lack of ambitious and painful structural reforms of the labour market. To revive the economy, the argument goes that we need to deregulate European labour markets and make them more flexible by dismantling a number of rights which are protecting wages and working conditions.

The aim of this article is to evaluate whether and to what extent this 'structural' or 'supply side' view of Europe is correct. In order to do so, we first look at macroeconomic indicators on the basis of which the general situation of the economy can be assessed. This allows us to see whether the problem at this moment is a general lack of supply or, on the contrary, a lack of aggregate demand. As a second step, we present indicators taken from various institutions such as the IMF, the OECD and the Commission which measure the pace of structural reform of labour markets in various euro area member countries.

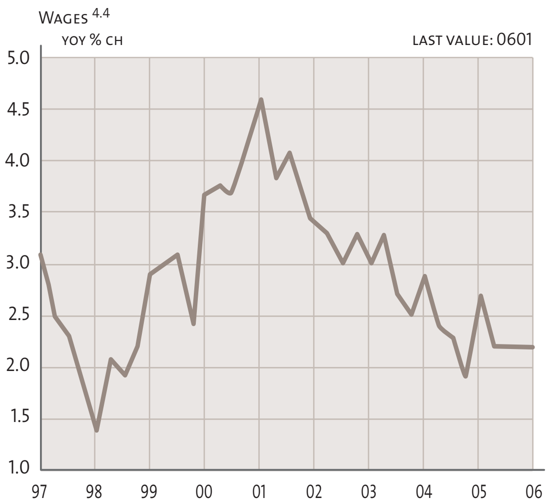
Euro area economy 2001-2006: Supply or demand side constraints?

For the sake of argument, let us suppose to start with that the economy is indeed faced with major supply side constraints and that growth dynamics are systematically running into a lack of available labour force. If the economy were in such a situation, then it would be highly likely that this would lead to some very particular trends. Firstly, the scarcity of the labour force would put workers in a strong

1 Economic Advisor, ETUC

bargaining position. As a result, we would see high and accelerating wage growth. High wage growth would also lead to high and accelerating inflation, as well as falling profit rates. Furthermore, we would see a pattern where growth was based on domestic demand and where the external side was making a negative contribution to growth because of deteriorating competitiveness. Also, with expanding domestic demand and imports, coupled with a dismal export performance, the deficit on the current account would be soaring.

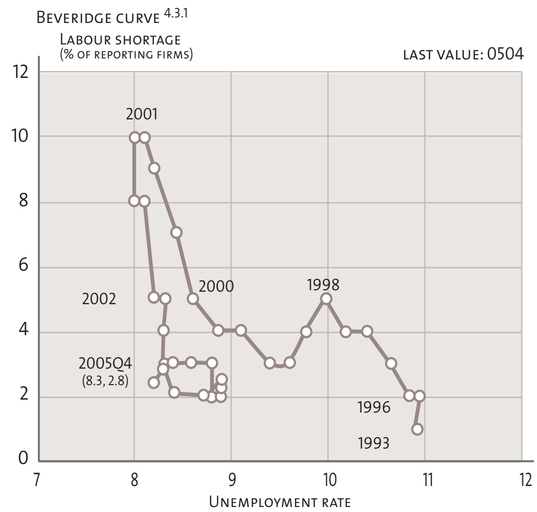
What do we see in reality? Is the euro area economy indeed characterised by these trends?
Actually, what we see in reality is exactly the opposite. Euro area wage formation is under substantial downward, not upward pressure. As can be seen from the graph below, since the beginning of 2002 the trend has been for wage growth to fall. Nominal wage growth in 2005-2006 has now reached a low of 2 to 2.5%, which is below even current inflation. Also, systems of wage formation and collective bargaining are under pressure in some core euro area countries. In Germany, for example, opening clauses have been undermining the institution of sectoral collective bargaining and have resulted in zero nominal effective wage growth.



Source: Commission, DGII website, Key indicators of the euro area

What about the other indicators? The rest of these macroeconomic indicators tell a similar story. Despite substantial oil price shocks, as well as tax shocks, headline inflation in the euro area remains at an all-time historical low, whereas core inflation has been falling to a level as low as 1.5%. Average profits in the euro area are rising to such an extent that firms are sitting on piles of liquidity and are using this liquidity to buy back their shares instead of investing in new capacity and new jobs. Overall economic growth is low and is to a certain extent based on exports, whereas domestic demand, in particular household consumption, remains weak. Finally, and again despite a rising oil bill, the euro area is not recording a deficit on its current account.

An additional indicator can be derived from the so-called 'Beveridge curve', a curve linking unemployment levels with vacancy levels. The graph below shows that the share of firms reporting a labour shortage and difficulties in recruiting (skilled) labour has fallen enormously and is now limited to 2% of all firms, down from 10% at the end of the business cycle peak in 2001[2]. Seen from the other angle, this means that 98% of firms now experience no difficulty in finding and hiring new workers. Notice also that the Beveridge curve seems to have shifted to the left over recent years. Basically, this means that labour markets are performing better and that the 'matching' process of jobs and workers is running more smoothly. This, in turn, may point to policies implementing labour market reforms as described in the next point.



Source: Commission, DGII website, Key indicators of the euro area

To sum up, all these indicators and trends are not pointing to an economy that is plagued by major supply side constraints. The euro area cannot be

[2] For comparison purposes: in the second half of the nineties, when the US economy was enjoying its 'new technology' boom, as many as 90% of US firms were reporting difficulties in attracting workers.

described as an economy that is in the process of 'overheating'. It is rather the opposite that is true: the euro area is suffering from 'undercooling', with aggregate demand being below the level of aggregate supply. This suggests that a traditional 'Keynesian' demand push could help greatly in reviving euro area economic performance.

One issue remains to be addressed. It can be argued that low wage and price inflation, while not testifying to a situation of overheating, does not necessarily point to a situation of major slack in the economy. It may be the case that the economy simply finds itself at a point where the level of aggregate demand is exactly in line with the level of aggregate supply, and where inflation is low precisely because of this balance between aggregate supply and demand. However, when linking the changes in different indicators with each other, it can be seen that there is major slack in the euro area at the present moment. Indeed, what we are observing is not simply low (wage and price) inflation, but falling inflation and wage trends. The deceleration of wage and price inflation is driven by the fact that slack is taking hold in the economy, and that the level of aggregate demand is falling behind the level of potential supply, thereby slowing down the rate at which wages and prices are increasing.

Indicators of structural reforms being undertaken

The conventional wisdom has it the Lisbon process is not working because governments have not been engaged in reforming their labour markets. Is this 'received wisdom' accurate?

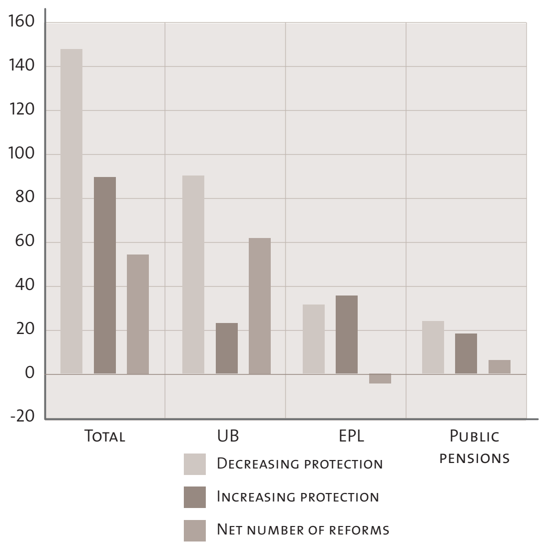
The question whether European governments are undertaking structural reforms of their labour markets is not an easy one to answer. With 25 different members (12 in the euro area) which all have their distinct labour market institutions and labour market policies, a straightforward overview of labour market reform cannot be made easily. Nevertheless, international economic institutions such as the IMF, the OECD and the European Commission have developed indicators to describe the extent to which structural reforms have actually been delivered.

IMF indicators

On the basis of the labour market reform database by the Italian De Benedetti foundation, the IMF (2005) has tried to assess the pace of structural reform of labour markets in the euro area over the period 1997-2002. Basically, the database mentioned can be used to count the number of reforms implemented in three main areas: reform of unemployment benefit systems, reform of employment protection legislation, and reform of public pension schemes. A distinction is made between what are called 'flexibility enhancing' and 'flexibility decreasing' reforms, with the latter decreasing and the former increasing social or labour market protection for workers.

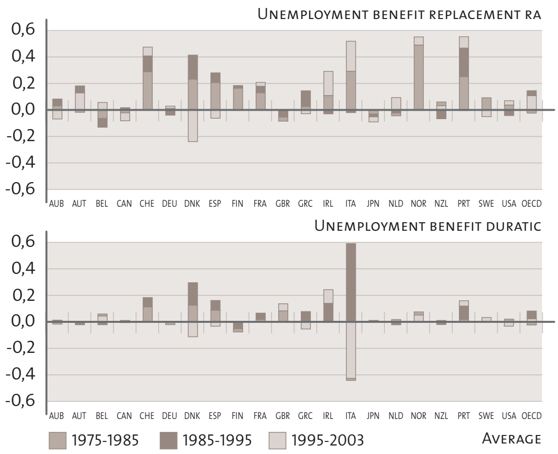
The graph below shows that, in contrast to the popular wisdom, many reforms have been carried out. Governments have been particularly active in the area of unemployment benefit reforms, where the OECD slogan of 'Make work pay' has apparently provided a strong momentum for reform. Close to 100 reforms lowering the level of protection have been implemented. And with only 20 reforms strengthening benefit systems, the net number of reforms of the negative type is high. Reforms of job protection schemes, on the other hand, appear to have cancelled each other out in net terms, whereas the net number of public pension reforms is slightly positive.

IMF on the number of structural reform measures in the euro area

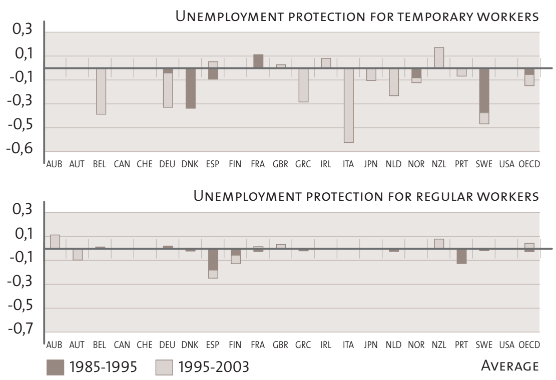


OECD indicators

Although the angle is somewhat different, the indicators coming from the OECD tend to confirm the picture of ongoing reforms being implemented. Whereas the IMF/De Benedetti indicators count the number of reforms, the OECD tries to capture the level of regulation and the pace of reform by calculating statistics such as average benefit replacement rates or average duration of unemployment benefits. The graph below indicates that, over the period 1995-2003, reforms of benefit systems have decreased benefit rates in Austria, Belgium, Sweden and Denmark. Benefits were increased in Ireland and in Italy (in both cases from a very low level). In the case of Italy, higher replacement rates were accompanied by reductions to benefit duration. Note that the famous Hartz reform, limiting unemployment benefits to a period of only one year, is not picked up by these indicators since they cover the period up to 2003.



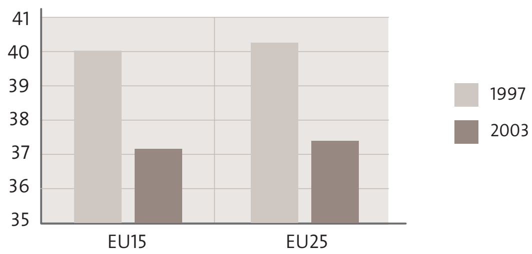
The OECD also reports on measures undertaken in the area of job protection. Here, the indicator is a score ranging between 0 (no job protection at all) and 6 (maximum job protection). Policy since 1995 turns out to have been active in reducing job protection, in particular for temporary workers. Here, Belgium, Germany, Greece, Italy, the Netherlands and Sweden (to a more limited extent) have been active. With regard to job protection for regular workers, however, only Spain, Finland and Austria have undertaken policy action resulting in a fall in job protection.



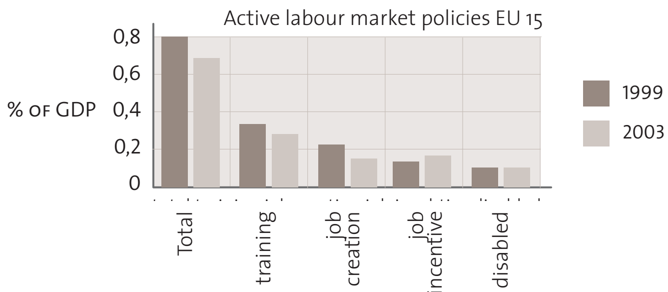
European Commission indicators

Finally, the European Commission (2005) highlights other aspects of labour market reforms. From 1997 to 2003, governments in the EU 15 substantially reduced taxes on labour, as can be seen from the graph below. Again, this probably needs to be seen against the background of the process of the European employment guidelines, where one guideline explicitly calls upon member states to reduce the tax burden on labour.

Tax wedge on labour



It is striking to notice that, in contrast to the budgetary resources that have gone to cut taxes, spending on active labour market policies has actually fallen from 0.8% of GDP to around 0.7%. Only the domain of 'job incentives' has received slightly more support. Given the continuing policy messages on the need to 'activate the unemployed', this is a rather peculiar development. Instead of doing less, more could and should have been done in order to provide the unemployed with active labour market assistance.



Conclusions

The official policy line that supply side rigidities in labour markets are holding back the euro area's economic growth performance, and that individual member states are not implementing the reforms, should be treated with a great deal of scepticism. We have seen that several macroeconomic indicators are consistently pointing to a problem not on the supply side but on the aggregate demand side. We have also documented the fact that governments have not neglected structural reforms and have been engaged in a considerable number of them.

The policy conclusions following from this are pretty straightforward. The euro area should urgently undertake demand side action to pull the economy out of its growth slump. While aggregate demand policy is indeed no substitute for structural reforms, demand policy does make it possible to put a stop to the situation of the euro area 'muddling through', and to restart the engine of growth and investment. There is an opportunity here to cut unemployment without reigniting inflation, and this opportunity should not be missed.

Another policy conclusion arising from the analysis in this paper is that structural reform policy, as implemented in the euro area over the past 7 to 10 years, has been too much modelled on the principle that the welfare state and worker protection should be slimmed down. Not only does such an approach serve to undermine household confidence, thereby prolonging the slump in growth, but this deregulatory approach to structural reform is also at odds with the need to target those reforms guaranteeing upward (instead of downward) flexibility. Trying to address the global competition from low-wage economies by cutting wages and working longer hours is not the way to go. Instead, labour market reforms should be targeted at those policy areas which strengthen Europe's comparative advantage (human capital, innovation, etc) while at the same time preventing firms from taking the 'easy way' out by dragging working conditions further down.

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LABOUR MARKETS IN TRANSITION: COMBINING FLEXIBILITY AND SECURITY IN CENTRAL AND EASTERN EUROPE

Sandrine Cazes and Alena Nesporova[1]

1. Introduction

Globalisation, technical progress and demographic changes brought about an increased need for flexibility: firms have to make quasi constant adjustments to their operations and their labour force in order to adjust to fluctuations in demand and stay competitive; however, increasing flexibility alone may not improve labour market efficiency, as all stakeholders need some stability and security as well. In a context of high volatility for example, there would be no investment in human capital, in new technologies and in capturing new labour markets. Thus, policy-makers, including the social partners involved in discussions and advocacy on economic and social security systems are facing the crucial challenge of determining the forms of regulation that should accompany rapidly evolving labour markets. The search for a better combination of flexibility and security has been increasingly emphasised within the European Union as being indispensable to improve competitiveness and at the same time maintain the European Social Model. This paper starts with a comparative analysis of recent labour market developments and changes in employment patterns in the Central and Eastern Europe (CEE) countries. Then, it examines how labour market institutions and policies evolved during the transition to meet the employment challenges. Finally, it presents and advocates the flexicurity approach for CEE countries.

[1] International Labour Office, Geneva

2. What happened on the labour markets of CEE countries over the last years?

Positive trends, persisting problems

During the period of 2000 – 2004, all CEE countries finally embarked on solid economic growth (see table 1); however, until 2004 only the Czech Republic, Hungary, Poland, Slovakia and Slovenia, the five most advanced economies, managed to exceed their 1989 GDP level, albeit in the new structure of GDP. While the other countries had not yet reached their pre-transition levels, they recorded in general higher growth rates in the period under investigation, strengthening their catching up process. In 2005, increasing exports contributed to accelerating GDP growth for the eight new EU members (EU8) indicating positive impact of accession on these economies.

However, economic recovery did not translate into significant labour market improvement in the region. Indeed, in the Czech Republic, Lithuania, Poland and Romania, employment even declined during the period 2000-2004, while the other countries achieved a positive, although very modest, net employment growth (see table 1). Participation rates did not perform too well either: only four countries - Bulgaria, Hungary, Latvia and Slovenia – recorded increasing participation rates between 2000 and 2004. Moreover, while in 2000 still four of these countries exceeded the average participation rate of the EU15, four years later none of them did and even the two countries with the highest activity rates - Czech Republic and Estonia - remained 0.6 percentage points below the EU15 average[2] (Graph 1). As for the employment rates, comparisons with the EU15 average reveal that in 2004 only Slovenia had its rate slightly above the EU15 average while all other countries had lower employment rates, including the Czech Republic and Romania, which four years before had been above or close to the EU15 average. Thus economic growth can still be characterized as nearly jobless for the region, despite huge employment losses in particular during the transition crisis in the early 1990s.

In comparison with employment and labour force participation rates, unemployment rates evolved generally more favourably in the region: they declined in the majority of the CEE countries, in particular Bulgaria and the Baltic States (see Table 2). However, a drop in unemployment may

Table 1 GDP and employment average annual growth rates in per cent, 2000-2004

Country	GDP	Employment
Bulgaria	4.9	+1.11
Croatia	4.1	+0.67
Czech Republic	3.1	-0.24
Estonia	7.2	+0.58
Hungary	3.9	+0.46
Latvia	7.5	+1.01
Lithuania	6.7	-0.28
Poland	3.1	-1.14
Romania	5.3	-1.66
Slovakia	4.1	+0.35
Slovenia	3.4	+0.63

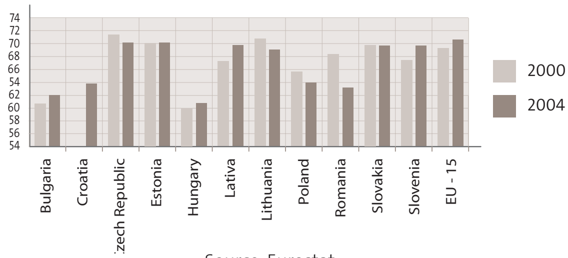
Source: UNECE database, authors' calculations.

reflect different type of dynamics across the subregion: in Lithuania for example, the steep decline in unemployment can be explained by the combination of continuous withdrawals from the labour market and rising employment on the one hand, and a rather large emigration of people after the country's accession to the EU in May 2004 on the other. Most of the labour migrants have been young people seeking better employment opportunities mainly in the United Kingdom and Ireland as could be deduced from sharply declining youth unemployment presented below[3] . In the other Baltic States, Slovenia and Bulgaria, decreasing unemployment rates are mainly linked with growing employment rates. In the Czech Republic, Hungary and Slovakia unemployment decreased only slightly. In contrast, the situation deteriorated in Romania and Poland. However, in the first country, the sharp fall in employment was fully translated into the declining participation rate limiting an increase in unemployment. Changes in Poland have been more dramatic and worrying as this particularly high unemployment rate is combined with low economic activity as already pointed. Labour market developments in this country contrasted with other CEE countries, with the exception of Romania.

Despite some converging trends in total unemployment during the 2000-2004 period (significant decline in the new EU members together with a slight increase in the EU15), unemployment rates have remained still high and well above the EU15 average. As noted earlier, differences among countries

2 The difference being more profound for male than for female workers (see forthcoming Cazes, Nesporova 2006)
3 This also seems to be the case of Slovakia and Bulgaria , despite so far the candidate status of the latter,as some anecdotal evidence confirms.

Graph 1. Labour market participation rates (population 15-64) of CEE countries



Source: Eurostat.

are substantial as the Polish unemployment rate is more than three times higher than that of Hungary and Slovenia. Data broken down by gender indicate that improvements in the unemployment situation were more beneficial for men than for women. Nevertheless, despite systematically higher unemployment levels for both sexes in the CEE sub-region, compared with the EU15, the gaps between the "new" and "old" Europe are more profound for men than for women due to significantly lower (albeit increasing) male unemployment in the EU15. CEE youth unemployment rates were on average twice as high as the aggregate rates across Europe in 2000 (Table 2). However, countries with low aggregate unemployment rates like Romania and Slovenia had relatively higher youth unemployment rates (see the fourth column) pointing to a disproportionately worse position of young people in their labour markets. In general, unlike in the EU15 with almost stable youth unemployment, the CEE countries recorded on average absolute reductions in youth unemployment between 2000 and 2004 but at the same time a relative deterioration of the labour market position of youth compared with adult workers. Comparisons of youth unemployment rates by sex show that in about half of these countries male rates are higher while in another half female rates are higher, climbing to 41.4 per cent in Poland. Another particular concern in the region relates to the very high shares of long-term unemployment in total employment (unemployment with duration over one year), well above the average of EU15. Moreover, unlike in the EU15, it further increased in most countries between 2000 and 2004 so that only Hungary and Latvia recorded the share of long-term unemployment in total unemployment below 50 per cent.

Table 2 Aggregate (UR) and youth (YUR) unemployment rates, 2000 and 2004.

	2000			2004		
	UR	YUR	YUR/UR	UR	YUR	YUR/UR
Bulgaria	16.4	33.7	2.05	11.9	24.4	2.05
Czech Rep.	8.7	17.8	2.05	8.3	21.1	2.54
Estonia	12.5	23.6	1.89	9.2	21	2.28
Hungary	6.3	12.1	1.92	5.9	14.8	2.5
Latvia	13.7	21.4	1.56	9.8	19	1.94
Lithuania	16.4	30.6	1.87	10.8	19.9	1.84
Poland	16.4	36.3	2.21	18.8	39.5	2.1
Romania	6.8	17.2	2.53	7.1	21.4	3.01
Slovakia	18.7	37.1	1.98	18	32.3	1.79
Slovenia	6.6	16.2	2.45	6	14.3	2.38
EU-15	7.6	15.3	2.01	8.1	16.6	2.05

Source: EUROSTAT, authors' calculations.

Towards flexibilization

The transition process gave rise to a flexibilization of employment, with the emergence of the atypical forms of employment and their looser regulation. Since 2000, this has been mainly manifested in the growing incidence of fixed-term contracts, which have been more widespread among men and have hit in particular young people and low-skilled persons who often remained stuck in these insecure types of employment. In contrast, part-time employment has not been (and still is not) popular in the sub-region and its low availability could in fact contribute to unfavourable demographic development as long paternal leaves raise discrimination of employers against women with smaller children who then decide not to have more children than one. Self-employment increased sharply in the first years of the transition period but then stabilized as economies recovered. The acceleration of economic growth since 2000 has led in most countries towards a decline in the share of self-employment in total employment[5]. Nevertheless, this proportion is on average still higher than in the EU15 (19 per cent versus 14.9 per cent in 2004, see table 3). Moreover, there are large differences across the countries in percentages of self-employed persons in total employment ranging from 9.6 per cent in Estonia to 46.8 per cent in

4 Between 2000 and 2004 the ratio of youth to aggregate unemployment deteriorated in the majority of countries in the sub region giving evidence that improving labour demand benefited mainly adult population at the cost of youth without work experience. Moreover, youth unemployment rate increased in absolute terms in the Czech Republic, Hungary, Poland and Romania, despite declining overall unemployment in the first two countries. This contrasts with significant improvements in youth unemployment rates in Bulgaria, Lithuania and Slovakia, which could at least partially be explained by higher departures of young people from these countries after the May 2004 enlargement of the EU in search for new employment perspectives in richer EU countries.

5 The only exceptions are the Czech Republic and Slovakia with rapidly growing self-employment and Estonia and Romania with the slightly increasing shares of self-employment. In Romania this decrease was combined with sharply falling employment, thus the absolute number of self-employed persons actually fell.

Romania. A large part of these variations can be explained by high proportion of farming in total employment and the fact that agriculture is mostly based on family farms in countries like Romania, Poland and Lithuania. With new job opportunities outside agriculture younger people leave small-scale farming and accept wage employment, which contributes towards declining self-employment. This is, however, not the case of Romania where the deteriorating labour market situation in general does not allow many people to leave agriculture. Thus there has not been any clear trend in self-employment across the region, with the exception of family (subsistence) farming evidently on decline as a result of improving employment opportunities. On the one hand, severe competition from international retail, catering and hotel chains ruling out of the market small local firms, the multinational enterprises often relying on their own suppliers from abroad and the emergence of better wage employment opportunities result in declining self-employment[6] . On the other hand, development of new IC technologies, which allow highly skilled specialists to start their own profitable businesses and the still imperfect legislation that makes possible substitution of labour contracts by service (civil) contracts, contributed towards an increasing trend in self-employment. The breakdown of self-employment by sex reveals that with the exception of Romania, men are significantly more involved in self-employment than women.

Table 3 Self-employment developments – shares in per cent of total employment by sex

	2000			2004		
	Total	Men	Women	Total	Men	Women
Bulgaria	11.4	-	-	10.4	-	-
Czech Rep.	15	18.8	10.1	18.8	24	12.2
Estonia	9	11.5	6.4	9.6	12.9	6.3
Hungary	15.1	18.8	10.5	14.2	17.6	10.1
Latvia	14.9	16.3	13.5	13.3	14.4	12.1
Lithuania	20	23.1	16.9	18.4	20.7	16
Poland	37.7	40.6	34.1	29	31.4	26.1
Romania	46.2	44.4	48.2	46.8	47.3	46.3
Slovakia	8.3	11.3	4.8	12.3	16.5	7.2
Slovenia	18	20.3	14.4	16.7	19	14
EU-15	14.9	17.8	11	14.9	18.1	10.8

Bulgaria: 2003 instead of 2004; Lithuania: 2002 instead of 2000; Poland: break in the series in 2003; Slovenia: 2001 instead of 2000. Source: Eurostat

Finally, although data on informal employment are scanty they suggest its declining tendency due to recent improvements in national legislations and better enforcement of legislation as well as stronger control of informal activity by labour offices and better collection of taxes by financial offices.

3. Changes in labour market institutions and policies

How did the various labour market institutions contribute to solving labour market in Central and Eastern Europe? By "labour market institutions" we mean those institutions and policies that are designed to intervene in the labour market in order to improve the match between labour demand and labour supply, protect employment in current jobs, move workers to new jobs, encourage transition of persons between different employment statuses, and help restore equality and equity for diverse social groups in the labour market. They include employment protection legislation, active labour market policies, unemployment benefit schemes, taxes on labour and collective bargaining. CEE countries modified their labour market institutions and policies substantially during the transition process in order to respond to emerging and mounting employment challenges. In view of their impending accession to the European Union, they designed them in line with the experience of the EU countries. This process accelerated as the date of the EU entry approached. Table 4 summarises the main parameters of labour market institutions and policies in some selected CEE countries in 2003.

One important aspect of economic and social reforms undertaken in the course of the transition of centrally planned economies of CEE to a market system was to modify their national legislations so as to reflect new labour market realities. The objective of these legislative reforms was to enable enterprises to terminate employment for economic reasons, including restructuring, bankruptcy, and complete or partial liquidation of the enterprise, but at the same time to protect workers against unjustified termination, give them time to look for a new job during the notice period and compensate them for hardship in the form of severance pay. Also, the possibility of temporary employment was extended to make it feasible for employers to

6 Moreover, quite frequently, self-employment hides regular employment relations between employers and workers because employers force workers to accept civil contracts to avoid the payment of social contributions, insurance against occupational accidents etc. Thus, the recent efforts of the State to reduce this misuse of civil contract have certainly contributed to an overall decline in self-employment figures.

Table 4 Main characteristics of labour market institutions and policies (2003)

Country	EPL summary index	UB as per cent of average wage	Share of registered unempl. receiving benefits	Total expenditure on labour market policies as per cent of GDP	Of which on active measures	Payroll tax as per cent of wages contributed by employers and workers	Trade union density as per cent of TU members among all workers
Bulgaria	2.0	33	20	0.97	0.67	42.7	25
Croatia	2.7	25	22	0.55	0.06	37.2	42.5
Czech Rep.	1.8	22	34	0.44	0.17	35.2	30
Estonia	2.3	7	50	0.30	0.08	35.0	15
Hungary	1.6	26	34	0.88	0.51	36.8	25
Latvia	n.a	21	44	0.64	0.14	28.6	19
Lithuania	2.8	16	11	0.28	0.16	46.0	14
Poland	2.1	22	19	1.25	0.11	38.1	18
Slovakia	1.8	26	17	0.96	0.47	36.2	35
Slovenia	2.4	39	24	1.00	0.44	38.0	42

Sources: EPL calculations on the basis of OECD methodology; authors' calculations. National sources; UNECE (2003); OECD (2003);

recruit workers only for a fixed period and at the same time to prevent any misuse of temporary contracts. Finally, in view of the adverse social consequences of large-scale corporate restructuring, many countries introduced special rules for collective dismissals, in order to limit massive redundancies and give special protection to workers hit by such an event. Modifications to employment protection legislation (EPL) were clearly inspired by labour legislation reforms in economically advanced countries and especially the EU15 countries. The first column of table 4 provides summary EPL strictness index for the region, using the OECD methodology[7] developed by the OECD (OECD, 1999). It shows that the new EU members have on average more liberal legislation than the "old" Europe and are now very close to the OECD average (CEE average was 2.2 for 2003 compared to 2.4 for EU15 and 2.0 for the OECD – both figures are for 1999).

Thus, national labour legislations in the former socialist countries, which used to have very protective legislation under the old regime, have indeed developed in the direction of reducing workers' protection against employment termination and allowing employers more labour input adjustment. Importantly, the tendency towards deregulation concerns, in particular, contracts without limit of time and this is also the aspect where cross-country differences are smallest. The other columns of table 4 show significant differences among the countries with regard to the parameters of the unemployment benefit schemes (unemployment benefit replacement rates and shares of benefit recipients among jobseekers), expenditure on labour market policies and its distribution between active and passive policies, labour taxation and trade union coverage. These variations are only weakly correlated with the unemployment levels of these countries, which points to an uneven attention of the decision makers to employment challenges and their frequent lack of trust in their effective solution by labour market institutions and policies. It also shows that trade unions are quite weak in many of these countries so that social dialogue may not have much impact on labour market outcomes.

Some important characteristics have to be pointed out, as they may distinguish the CEE countries from the "old" EU and OECD countries. First of all, the unemployment insurance schemes are not generous in terms of the benefit replacement rates (the proportion of average unemployment benefits to the average wage), which do not even reach 40 per cent of the average national wage in any of these countries. Also, the share of unemployment benefit recipients among all jobseekers, i.e. not only those covered by unemployment registers, is rather low, in particular in Estonia, and have recently further declined. Second, the funds devoted to labour market policies as a percentage of GDP are very limited. Moreover, in the majority of the CEE countries, but in particular in those with high unemployment, the share of these funds spent on active labour market programmes is also low, since passive labour market policies, considered as entitlements required by law, absorb most of the available resources. The tax burden on labour is very high and employers and economists miss no opportunity to

[7] This index covers both permanent and temporary contracts, as well as collective dismissals, and looks at a range of detailed information, such as procedural inconveniences, notice period, severance pay, etc. It aggregates the indices for permanent contracts, temporary contracts and collective dismissals, attributing to them the weights of 5/12, 5/12 and 2/12 respectively. The value of all three partial indices as well as of the summary EPL index ranges from 0 – indicating very liberal regulation – to 6 – meaning very restrictive regulation.

blame it for depressed labour demand and low new-job creation. Despite recent reductions in payroll taxes in a number of these countries, their levels compare unfavourably with most other EU and OECD countries.

It can therefore be concluded that increased flexibilisation of labour markets in the CEE countries has not been sufficiently compensated by stronger protection of workers affected by redundancy through better assistance in re-employment provided by public employment services, broader access to active labour market programmes or decent income support in unemployment, despite high taxes on labour, which may work against new recruitments and raise the level and duration of unemployment.

4. Concluding remarks: towards flexicurity approach

The analysis of labour market developments in the CEE countries reveals persistent challenges facing these countries: jobless economic growth, low employment and labour force participation rates, and persistent unemployment. Employment relationships have also become much more flexible, as the share of time-bound contracts has significantly increased and some workers have been forced to accept civil contracts or work without any contract. In contrast, part-time employment has remained very limited and self-employment, after a steep initial rise, seems to have stabilized and even declined in this period of economic boom in most of the countries.

These labour market changes, combined with greater movement of workers between jobs and between different labour market statuses, seem to be a logical consequence of the process of globalisation, technological change and transition of the economy to a market system. The national enterprise sector has to adjust to the new market conditions and restore competitiveness through enterprise restructuring, closures and mergers but also emergence of new firms, and this brings along massive job destruction but also new job creation. This is the reason why employers, backed by some macroeconomists, have demanded labour market regulation to be made more liberal, in particular regulation of employment termination and use of temporary contracts, on the grounds of the negative impact of rigid legislation on labour demand and high unemployment. For workers, however, this has meant reduced protection against loss of jobs and income and has thus called for new forms of security outside the enterprise, through public employment services and social protection schemes. At the same time, employment, employability and income protection through employment services and labour market policies have remained poor in this region, despite rather high payroll taxes. Thus the liberalization of EPL during the last fifteen years, in the hope of boosting job creation did not produce the expected effects.

We also found (Cazes, Nesporova, 2003) that generally weak protection may have a negative impact on labour reallocation and productivity in increasing workers' perception of insecurity. We then conducted cross-country regressions to address various aspects of unemployment (total, long-term and youth unemployment rates) and aggregate labour input (employment rates and labour force participation rates). Our multivariate analysis, undertaken for the end of the 1990s, confirmed the previous finding that employment protection legislation had no statistically significant impact on unemployment rates in the CEE countries, but also revealed that more protection could actually contribute towards improving activity and employment rates. Moreover, more extensive use of active labour market policies has a significant and positive impact on economic activity and employment levels and reduces unemployment.

In Cazes and Nesporova (2006), the impact of labour market reforms on labour market outcomes has been updated for the period 1999-2003. The multivariate analysis of the effects of labour market institutions on the labour market indicators displayed partially different results from the previous ones. EPL has become statistically insignificant. Active labour market policies have further strengthened their positive effect on promoting economic activity and employment, as well as on reducing aggregate, youth and long-term unemployment rates in comparison with the end of the 1990s. The analysis also indicates that longer duration of payment of unemployment benefits may have negative effects on reducing economic activity and employment and on increasing youth and long-term unemployment. These findings imply that the countries should use active labour market programmes more extensively and stimulate unemployed persons to undertake more intensive job search and/or participation in these programmes in order to speed up their (re-)

employment. However, these programmes are effective in improving employability and promoting employment of jobseekers only when they are well designed and targeted, which requires good management and supervision by the parties concerned, i.e. governments and the social partners.

Policy implications of these findings are elaborated in Cazes and Nesporova (2006). They clearly emphasise the importance of the flexi-curity approach. Increasingly, there is a recognition of the need to find the right combination of adjustment flexibility for enterprises, as it is they who create new productive jobs, and employment and income security for workers, to support their motivation to engage in productive work and if necessary, to move to new jobs, improve their skills through training and/or participate in other employment promotion activities. However, this balance may be different for different countries. Therefore, only engagement of the three partners – the government and the representatives of employers and workers – in a true social dialogue can lead to the identification and implementation of appropriate policy options, acceptable to all sides and financially affordable, for restoring the optimum combination of flexibility and security.

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THE TRADE UNION'S VIEW ON LABOUR MARKET POLICIES – THE CASE OF THE CZECH REPUBLIC

Pavel Janicko[1]

Over the previous years, employment has declined and unemployment has risen in the Czech labour market. With an unemployment rate of 20% in the Moravian regions as opposed to an average unemployment rate of 10% there exist extreme regional disparities. Unemployment situation is also extremely high for vulnerable groups such as older workers, handicapped people and people of the Roma origin. Employment trends also diverge between industries and sectors.

The Joint Employment Report 2005 identified the following weak points for the Czech Republic's labour market:

- ensuring that wages grow in line with the growth in productivity
- lowering the relatively high tax burden on wages in order to make work pay, in particular for workers with low qualification
- raising the participation of older people in the labour market
- raising the efficiency of the integration of vulnerable groups in the labour market through active labour market policies as well as through implementing an antidiscrimination policy
- modernizing employment services
- investing more in human capital and increasing the share of tertiary education and retraining

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[1] Economist, CMKOS

The previous 'shopping list' is not necessarily the CMKOS point of view. According to CMKOS policy mistakes are at the basis of the dismal labour market performance. These involve the incompetent handling of the privatisation process, the implementation of a 'one-size-fits-all' model of a liberal market economy, the underestimation of the social aspects of transition from a planned to a market economy and ,last but not least, the attacks on trade unions to weaken their influence.

CMKOS also considers that the specific recommendations formulated by the European Commission are based on a somewhat selective set of information which has been provided by Czech economists with a straightforward preference for the liberal model. In this vision, too high labour costs and too generous system of social benefits are systematically seen as the main culprits. However, where the views of the trade union and economic experts converge is on the issue of developing active labour market policies and strengthening employment services.

On the aspect of flexibility of the Czech labour market, it is correct that the share of part time workers in the Czech Republic is significantly lower compared with some other EU member states. However, the reason for this is the very low level of wages making as well as the fact that those sorts of jobs are weakly protected by legislation. Nevertheless, Czech legislation is fully comparable with EU standards regarding flexible forms of work. In the indicators of labour market rigidity, as published by the OECD, the Czech Republic ranks in the average range. Moreover, the recent reform of the Labour code introduced new flexible forms of work such as, for instance temporary workers' agencies. CMKOS does not oppose this, provided more effort is made on the area of active labour market policies where the actual level of expenditure in the Czech Republic is only 20% of the European average.

Two documents guide labour market policy in the Czech Republic. One is the National Action Plan of Employment 2004-2006, including programmes for young jobseekers and long term unemployed as well as regional programmes for the development of North Bohemia and North Moravia. The other one is the National Lisbon Plan, constructed on the basis of the integrated European guidelines for economic and employment policy, and prepared and approved by the Czech government in 2005. CMKOS has strongly criticised the latter document because of its vague and even non acceptable statements.

The main criticisms of the CMKOS with respect to the National Lisbon Plan are:

- inadequate attention for the social dimension of the Lisbon strategy
- the role of social partners is missing
- excessive focus on allegedly too high indirect labour costs
- pension reform is pushed forwards, despite the fact that no consensus has yet been achieved
- no mention of the need to increase active labour market policy expenditures
- recommendations to increase the level of the minimum wage are missing
- recommendation to increase investments in human capital and to introduce legislation on lifelong learning is missing

This approach opens up a 'box of Pandora' on several sensitive issues. Also, the relationship between the National Plan for Employment and this National Action Plan is far from clear.

Conclusions:

Given the high level of unemployment, the actual state on our labour market is far from satisfactory. Meanwhile, the government is not sufficiently tackling this problem while, at the same time, more liberal recipes are being proposed by conservative politicians and economists. Unfortunately, these liberal recipes also appear the National Lisbon Plan. However, spreading flexible forms of work on the labour market is not a solution. What the Czech Republic needs is the creation of new jobs offering quality of work, decent pay and a high level of social protection.

LABOUR REFORMS IN ITALY 1993-2006

Claudio Treves[1]

Over the period 1993-2006 Italy introduced different types of labour market reform, with social consensus being pursued in a number of cases. However, under the Berlusconi government (2001-2006) this was not the case and social dialogue was used to divide social partners instead of building a shared consensus.

The reforms under the Berlusconi government were characterised by the following:

- Starting from the observation that Italy's performances are still far from the Lisbon targets, an attack was launched on labour market regulation which, according to government, needed to be removed or changed significantly.
- Using the argument of globalisation, it was claimed that companies should be left free to compete and should therefore be freed from social burdens which should by taken over from business' shoulders by society.
- Protection at the workplace level (including protection against unfair dismissal) was to be removed
- Temporary work is considered to be equivalent to an open ended labour relationship, and it should be left to each individual company to choose which type of work relationship it prefers.
- In order to foster competitiveness, more "flexible" working arrangements have been promoted and/or introduced, (e.g. on call work, staff leasing jobs).

This approach to labour market reform has triggered deep social unrest throughout the Berlusconi term of office, with for example a manifestation of 3 million workers in Rome in March 2003. As a result, the most provocative proposals (e.g. reduction of protection against unfair dismissal) could not be introduced. However, law n°30/03 was passed in 2003 and started to produce its effects in 2004.

Recent surveys issued by official sources (Bank of Italy, Union of Chambers of Commerce, National Statistical Office) have all concluded that Italy's employment performance for the years 2004-05 has been very poor while at the same time Italy's share in international trade collapsed from 4.5 in 1996 to 2.8 in 2005.

The previous points to the fact that the pattern of international specialisation is Italy's core problem, not it's supposed labour market rigidity. Italy is too heavily specialized in medium tech goods where the competition from countries such as China is particularly intense.

Furthermore, Italy's falling rate of unemployment rate is to be attributed to a "discouraging effect". People who lose a job or are about to enter in the labour market realise that the official labour market is incapable of giving them a chance, and they therefore fall back in the unofficial economy, in particular in the South of Italy.

Finally, recent surveys show a growing percentage of people who enter the labour market through temporary instead of stable jobs (around 45% in the last three years), this has serious consequences on the life patterns and choices of people (e.g. postponing the age at which to have a first child, postponing the buying of house properties,...). Also, the financial basis of the welfare state is undermined by these temporary job contracts.

[1] CGIL-Italy

PART 2
Structural reforms: The way ahead

PART 2
Structural reforms:
The way ahead

A TRADE UNION AGENDA FOR STRUCTURAL REFORM IN EUROPEAN LABOUR MARKETS

Ronald Janssen[1]

REDISCOVERING SOCIAL EUROPE AND FAIR WORKING CONIDTIONS AS A SOURCE OF PRODUCTIVITY AND UPWARD FLEXIBILITY

I. Why labour market reforms are necessary and why trade unions should be in the driving seat

Are European labour markets in need of structural reform? The answer to this question is a double 'yes'.

Firs of all, structural reforms are essential in order to complement macro-economic policy. Macro-economic policy is necessary, as seen with the events of recent years. Indeed, following the 2000/2001 slowdown, several European countries found themselves caught in a trap of low confidence and low growth. In the absence of aggregate demand policies to 'kick-start' the economy and to restore confidence, limited growth lingered on for several years. Moreover, the lack of active macro-economic policy to stabilise the economy also drags down the economy's growth potential: if firms face the prospect of insufficient demand and fail to invest, there is less capital available to employ more workers. 'Keynesian' policies are typically thought of as being a short-term affair. But one should not lose sight of the fact that stabilising the demand side of the economy also has a positive impact on growth in the medium and long run by channelling investment and building up capital stock. (Janssen 2006, Janssen/Watt 2005, Schubert 2005).

Nevertheless, a macro-economic policy initiative to renew with higher growth and trigger dynamic investments may not be sufficient. Sooner or later (and one of the problems is that we do not know exactly when), the economy may encounter labour market bottlenecks. A lack of skilled workers may then trigger substantially higher wage growth. If high wage growth is then passed on into prices, price stability may become jeopardized and the economy's high growth trajectory gets derailed. In other words, structural reforms are to be seen as a kind of insurance mechanism against inflation when applying expansionary macro-economic policy. In turn, this also means that more use can be made of growth-supporting macro-economic policies if inflation is no longer a problem.

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1 Economic Advisor at the ETUC

Secondly, Europe needs to adapt to the ongoing process of globalisation. Certainly, the challenge of globalisation should be scaled back to correct proportions. Although the European public fears to a large extent the effects of globalisation on living and working conditions, the fact remains that Europe has done remarkably well in increasing exports and maintaining its export share on world markets over the past 5 to 10 years. Europe is certainly importing more from China and other (emerging) economies in the rest of the world but at the same time is profiting from the expansion of their markets and economies by exporting to them (see ETUI 2006 and Janssen/Watt 2006).

The fact that European exports have been holding their ground on world markets does not mean they will necessarily continue doing so. Indeed, emerging economies (China in particular) are also in the process of upgrading their economy and are seeking to compete with more advanced industrialised countries over a wider range of products and services, including those with higher added value. The challenge for Europe is therefore to 'stay ahead', to move our economies up the ladder of technology and added value by introducing new products and services and new and more efficient ways to produce them. This however again requires a workforce that is skilled and secure enough to engage in such a process of positive change and upward mobility.

Aside from the economic reasons described above, trade unions also have a major strategic interest in driving the process of labour market reform. After all, labour market institutions are part of their 'core business' and trade unions should be wary of the fact of leaving a policy vacuum that may be filled by others. Indeed, the agenda of structural labour market reform is not a neutral one. Reforms can take two completely different directions: either the 'high' road of investing in human capital, raising productivity and promoting upward mobility of workers; or the 'low' road of cutting wages and worsening working conditions by weakening trade unions, downgrading collective bargaining and structures and deregulating. Only the first type of reform agenda constitutes a viable strategy. Indeed, addressing challenges such as competition from low-wage emerging economies by exploiting the European work force is not an option. So, instead of working cheaper and harder, Europe needs to implement labour market reforms that support ways of working smarter and better.

The remainder of this article describes a possible reform agenda which trade unions could seek to promote. This reform agenda has two distinct dimensions. On the one hand, 'high road' approaches promoting investment in workers' skills, workers' mobility between jobs and equal opportunities between men and women need to be promoted. On the other hand, we also need to close down the 'low road': firms that are tempted to take the 'easy way out' by remaining 'competitive' at the expense of their workforce should be prevented from doing so. This implies a strong body of workers' rights so as to ensure fair working conditions in a Europe-wide internal market. The article also strongly argues that both policy dimensions are closely related. The two agendas of investing in labour markets on the one hand and ruling out unfair competition at the expense of workers' rights on the other are highly complementary.

II. Modern labour market institutions to open up the 'high' road

A. Skills, skills, skills!!!

The importance of a skilled workforce for both economic and social success cannot be stressed enough. An economy enjoying then benefit of strong human capital is much better equipped to engage in a policy of innovation and to upgrade its economy. Moreover, this 'human capital' approach also allows a way around the economists' trade-off between equity and efficiency. If skills-biased globalisation and technological change are pushing up wage inequalities, then we need to increase the numbers with skills to reduce their market advantage and to reduce the numbers without skills to reduce their disadvantage. Training policy is the right answer to globalisation, whereas driving workers into precarious jobs that function as bad job 'traps' is a misguided answer.

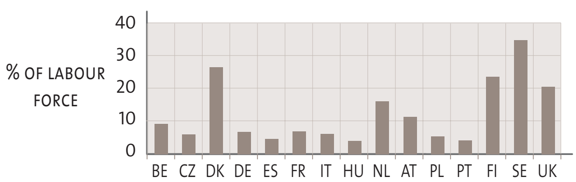
The agenda of investing in skills certainly constitutes a major challenge for Europe. At present, a third of the working–age population (around 80 million people) have no upper secondary education certificate. This may be hampering the process of upgrading the economy (Cedefop, 2005). Although this situation needs to be tackled decisively, progress is not very impressive. A recent Commission report (Commission, 2006) on education and training policies in Europe observes the following:

- There is too little progress on educational benchmarks that are closely related to social inclusion.

Almost 16% of young people in the EU still leave school early, reflecting only slight progress towards meeting the EU 2010 benchmark of 10%. Nearly 20% of 15 year-olds continue to have serious difficulty with reading literacy, reflecting no progress since 2000 against the benchmark of reducing this share by one fifth. All of this means that a certain share of the next generation is at risk of facing social exclusion. To tackle this, the Commission report underlines the paramount importance of pre-school education to prevent educational failure and for laying the foundations for further learning. The broader point to note here is that, as the Commission indeed explicitly acknowledges, social cohesion and education policies are mutually reinforcing. As noted above, broad education policies are essential to keep all workers on board the economic flagship. But the reverse is also true: social exclusion comes where educational progress is absent; it is the worst enemy of the knowledge-based society.

- Although the participation rate of adults aged 25-64 in lifelong learning has been increasing somewhat since 2000, much of this increase is a result of changes in the statistical method of surveys so that overall progress is overstated. Moreover, the average figure of 10% of prime age adults in the EU participating in lifelong learning hides the fact that those who need it the most (low skilled and older workers) have the least access to training.
- There is also much variation in participation in lifelong learning between member states, with some countries actually scoring very high while others still have a long way to go (see graph below).

Participation in lifelong learning



Source: Commission (2006)

How do trade unions fit into this picture? What can trade unions do in their core domain of collective bargaining, apart from urging governments and politicians to increase education budgets and improve training policies?

What they can do is to use the instrument of collective bargaining to force business to break out of the vicious circle of systematic under–investment in training (Kok, 2003). Indeed, when left to operate freely, firms will be the victim of the 'prisoner's dilemma'. Business will tend to refrain from investing in employee training, hoping instead to 'steal' skilled workers by overbidding wages from other employers who do invest in training. But of course, if all employers behave that way, the volume of training offered in the entire economy will be low and bottlenecks for skilled labour will appear rapidly. A market failure exists on training and contributes to structural unemployment. Indeed, a lack of sufficient training possibilities will create bottlenecks on labour markets, triggering accelerated and high wage growth and ultimately a situation where price stability is endangered even when unemployment is still at high levels.

By giving workers the right to regular and sufficient training, collective bargaining can tackle this market failure. This is especially likely when collective bargaining takes place or is coordinated at the sectoral and/or intersectoral level. In that case, trade unions have an overview of the entire sector or economy and 'internalize' the need to include investment in training in their collective bargaining strategies. Through trade unions and collective bargaining, there can be a solution to the problem of collective action by employers for investment in training. In a number of European countries (Belgium, the Netherlands, the Nordic states, France, Italy), this is being done by collective agreements at sector level which oblige all employers to pay into a fund providing training for workers, and in some cases even the unemployed.

The positive effect of collective bargaining on worker training emerges clearly in statistics. According to the Commission report on the quality of work (2003), more than half the workers in firms covered by collective agreements participated in training programmes. In firms not covered by collective bargaining, the share of workers with access to training was much lower ? only one third. And the number of training hours is twice as high in firms which engage in collective bargaining. A further important fact is that collective bargaining provides improved access to training for workers with lower skills, thereby correcting the other market failure of firms tending to provide only limited access to further training to those most in need of it.

To sum up, the message of 'stepping up the pace of structural reform' is certainly true in the area of education and training policies. Much indeed remains to be done in the area of investing in Europe's knowledge base. And one way of doing so is to increase and promote collective bargaining and trade unions' involvement in providing all workers with sufficient access to training and lifelong learning.

B. Supporting upward mobility and career transition for displaced workers

The table below shows what happens to retrenched workers in the EU and the US. It refers to an ongoing policy discussion, with opponents of social welfare and wage protection rules arguing that the US labour market model is superior to the European one since a higher share of retrenched workers return to work in the US. In the US, labour resources that are being 'freed up' by globalisation and technological progress are put back to work to a larger extent than in Europe. The hypothesis is that US workers are more willing to take pay cuts when moving to another job because they have less labour market and social protection to fall back on. In the US for example, one quarter of displaced workers accept a pay cut of more than 30%, whereas this share is much more limited in Europe.

What happens to displaced workers?

Level of industry	European Union	United States
Share of workers back into work two years later	57%	65%
Share of workers without a pay cut	46%	35%
Share of workers with a pay cut of more than 30%	7%	25%

Source: OECD (2005)

There is however another way to interpret these figures. While the rate of transition into a new job is an important criterion, it is not the only one on which to evaluate successful adjustment. Much also depends on what kind of jobs are being taken. If workers who until recently had no difficulty whatsoever functioning in a productive organisation find themselves in lower paid jobs with a substantially lower level of productivity, then this also represents a waste of productive potential and human resources. Globalisation offers the opportunities of enhanced productivity and growth. But these opportunities can only be fully seized if as many retrenched workers as possible move into new and productive jobs.

The danger of human resources going to waste during restructuring processes can be illustrated by what happened to workers laid off by MG Rover (Armstrong K, 2006). Eight months after redundancy, a third of workers laid off were still unemployed. Over half did find new full-time jobs but their new jobs paid them £3,523 a year less and almost half of them think their new jobs are worse.

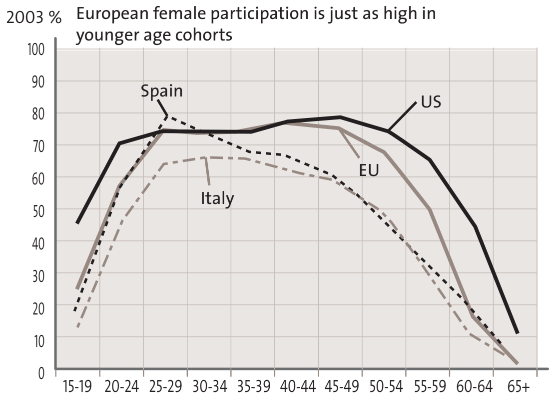
What can labour market policy do? To provide new and fulfilling jobs to a maximum of retrenched workers, there is a need for job transition arrangements offering displaced workers retraining and job search assistance with the aim of developing the skills of retrenched workers and getting them into jobs matching their upgraded skills.

Collective bargaining in several Nordic countries shows a promising way forward. In Sweden and Finland, collective agreements at national and cross-industry level establish the right of productive re-insertion for every retrenched worker. The basic idea is not to have fired workers fall into the 'black hole' of unemployment and leave them there for one year before offering help, but to provide them with active assistance immediately. From the moment notification of lay-off is given, Swedish and Finish workers are offered job counselling, job search assistance, retraining, even (paid) job traineeships in other firms. These rights to productive career transition are supported and organised by social partner funds financed by employer contributions in the form of a percentage of each company's wage sum. In practice, these funds and their activities work in close cooperation with the public employment service and, in case of collective redundancy, they set up offices on the shop floor. If managed successfully, this kind of labour market arrangement helps prevent an increase in structural unemployment. Workers being fired are not left to their fate and are much less exposed to the risk of longer inactivity spells turning into long-term and structural unemployment.

C. Tackling the gender gap to unleash Europe's hidden employment potential

A recent study from Goldman-Sachs (2006) argues that policy makers are too pessimistic on Europe's growth capacity and that they tend to neglect the potential contribution to growth by the female labour force. Goldman-Sachs starts its analysis by observing that female participation rates in young cohorts are just as high in the big five EU countries as they are in the US. Southern countries (Spain, Italy), traditionally countries where male employment and participation dominate, are no exception to this. As shown in the graph below, 2003 female participation rates are even slightly higher in Spain than they are in the US.

This observation may have major implications for future growth of the labour supply. If the younger age cohorts keep their existing high participation rates with age, then the overall participation rate will get a serious boost. As time goes by, a 'composition' effect of younger cohorts with high participation rates replacing older cohorts with lower participation rates would support overall labour supply growth as well as Europe's growth potential.

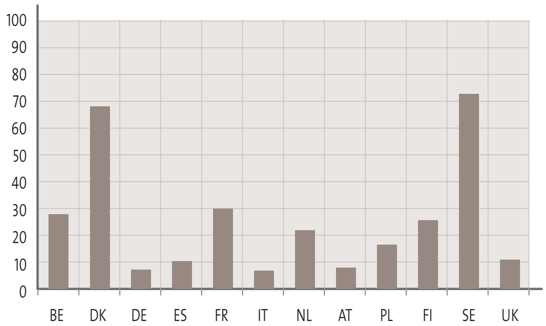


Source: ILO)

There is no doubt that the Goldman-Sachs study is correct in stressing the importance of female labour market participation in improving European growth and employment performance. However, maintaining high participation rates when young female cohorts grow older is anything but automatic. For this to happen, labour market policies focusing on gender issues and gender gaps are necessary. Indeed, gaps between women and men concerning pay, career advancement possibilities and different family responsibilities can act as a strong deterrent for younger women to remain in or re-enter the labour market. Ensuring gender equality is not only worth pursuing as a societal objective, it also strongly contributes to improved economic performance by preventing important labour resources from going to waste.

As the Commission's overview on gender issues (2006) indicates, there is also a substantial need for structural reform in this area. Although the female employment rate has steadily risen over the past years to reach 55.7% in 2004, female employment continues to be concentrated in activities that are already predominantly feminine, with women also facing gender gaps in pay and part-time work. Women earn on average 15% less than men. One third of them (32.6%) take up part-time work against only 7.4% of men. Having a child pushes down the employment rate by as much as 14.3 points for women aged between 20 and 49, whereas the recourse to part-time work increases with the number of children. Half of women with three or more children work on a part-time basis. The latter observations point to the need to step up efforts to invest in qualitative and broadly accessible childcare facilities. As can be seen from the graph below, several member states still have a long way to go before meeting the Barcelona targets of providing childcare for 33% of children aged 0 to 3 years[2].

Childcare coverage rates 0-3 years



III. Labour is not a commodity: fair working standards to close down the 'low road'.

Investing in skills, positive adaptability and gender equality forms part of a so-called 'modern' social policy agenda. All of these policies ensure upward flexibility in labour markets, which is crucial for moving the economy up the technology ladder and keeping Europe ahead of the competition from low-wage economies in the rest of the world. All policy actors, whether trade unions, business organisations or governments, can probably agree on this.

But does this focus on new social policies ensuring upward flexibility imply that we can forget about more 'traditional' workers' rights? Are labour standards guaranteeing fair working standards and protecting workers from abuse by 'bad' employers a thing of the past and an unnecessary rigidity?

The answer to these questions is no. Yes, of course we need to invest and do more in the area of skills, training and positive mobility of workers. But putting good intentions in writing is not enough. If we want business to engage in this new social agenda, then we need labour market institutions to create the

2 The other Barcelona target is to provide 90% of children from 3 years to compulsory school age with childcare facilities.

right framework and to provide business with the right incentives to invest in innovation, productivity and workers' skills. If we all agree that a 'cheap labour' strategy is not the right approach in the global competition with China, then it is important to prevent business from doing exactly that. This is where labour standards come in. By protecting wages and working conditions, labour standards do away with the possibility for firms to 'take the easy way out' and to respond to global competitive pressure by forcing workers to work longer hours with less pay while accepting precarious job contracts. Instead, strong and effective labour standards force firms to face up to global reality and to address global competition by engaging in product and workplace innovation.

The importance of such a policy of fair labour standards cannot be over-emphasized. If, in the absence of a social level playing field, some countries or firms opt for the cheap labour strategy, others will be forced to do the same. Employers will be holding each other to ransom through cut-throat competition on labour standards. In this way, poverty-level jobs and precarious work will spread throughout the European economy. Over a longer term, there is the risk of a two-tier labour market developing with an underclass of workers trapped in 'bad' jobs. But if this happens, the economy's knowledge base, which is key to upgrading the economy, is at risk: a labour market where precarious jobs and unfair working practices are the rule is not in a position to develop the famous knowledge-based society .

So, in choosing the wrong battlefield of cheap/precarious labour strategies, Europe actually risks fundamentally weakening its position in the battle where it should focus its efforts, namely innovation and knowledge.

The following paragraphs further illustrate how fair labour standards on working time, job security and fair and decent wages make an important contribution to the new social agenda of skills, upward adaptability and gender balance by abolishing the forms of labour market competition that are harmful for workers, the economy and society as a whole.

A. Labour standards on working time

One working time standard concerns workers' right to a maximum limit for working hours per week. The European Working Time Directive guarantees such a right by establishing a basic standard of a maximum 48-hour week as an average over a period of three months. At the same time, the directive offers member states a loophole by allowing firms to press their workers to sign an individual 'opt-out', a possibility which has indeed been taken up by the UK government. The result is that the culture of long working hours remains in place in the UK, with some 3.6 million workers (of a total of 25 million) working regularly more than 48 hours a week (TUCa 2005).

The UK experience with long working hours can be used to illustrate the dismal effects of such practices on productivity, human capital and workers' health:

- Long working hours increase the (quantitative) amount of labour resources at the disposal of employers. Although this is certainly convenient for any (individual) employer, it also allows firms to continue inefficient and non-productive workplace practices. It also makes it possible for firms to address global competition by pressing workers to put in longer and unpaid hours instead of raising productivity or investing in new products and services. (In the UK for example, over 2 million workers or six out of 10 of all long-hour workers are not paid for overtime). In this way, business strategies become biased against innovation and high-quality work practices. Long hours also impede labour productivity in an even more direct way: Long-hour workers become tired, which leads to lower output per hour, a decline in the quality of work and more mistakes (TUC 2005b). All in all, the experience for the UK demonstrates that a culture of long working hours discourages productivity and innovation. The following quote from the UK Treasury illustrates this: 'UK workers work 14% longer than German and 29% longer than French workers to produce the same output' (as quoted in TUC 2005b).
- There is ample evidence of long hours affecting workers' health: Those who regularly work more than about 48 hours a week face an increased risk of heart disease, stress-related illness, mental illness, diabetes and bowel problems (TUC2005a).
- Furthermore, those who work more than 48 hours a week have little time left for further education and training. Together with problems such as low pay and hierarchical working conditions which are known to reduce incentives for those at the bottom to upgrade their skills, workers doing long hours simply do not have enough time available to engage in the desired Lisbon agenda of lifelong learning.
- Long working hours also impact on the work-life and gender balance. A striking figure, again from the UK, is that only one in five long-hour workers are

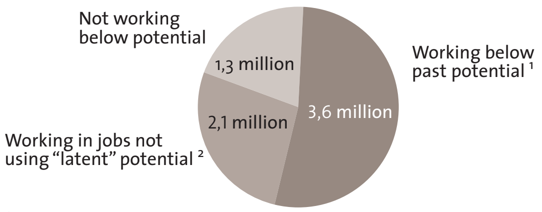
female. In the 'better jobs', this position is even worse. Only 15% of long-hour managers and 3% of skilled manual workers with long hours are female (TUC2005a). These figures point to the fact that long hours implicitly work to discriminate against women. With female workers widely expected to bear the brunt of childcare and domestic work, they are less willing and able to work long hours, which in turn works to block their career advancement opportunities.

The experiences with the culture of long working hours in the UK testifies to the fact that leaving workers unprotected from business pressure to 'opt-out' seriously dwarfs the so-called 'new' social policy agenda of investing in skills, innovation and gender balance. The absence of an essential workers' right to a maximum number of working hours may be seen by short-sighted employers as a means of almost unlimited labour flexibility. But this kind of flexibility is misconceived and comes at a serious price. It works to weaken the economy's potential for growth and upwards adaptability by weakening productivity growth, reducing possibilities for the workforce to engage in further training and putting up barriers to fair treatment for female workers on the labour market.

A further illustration of how the practice of long working hours represents a waste of human resources, in particular of the female human capital base, is described by the Equal Opportunities Commission (EOC, 2006). According to the EOC, long working hours actually produce a 'hidden' but pervasive and enormous brain drain. This is so because many workers, in particular women, react to the overburdening caused by long working hours by leaving full-time employment and opting for part-time jobs. Part–time jobs however, tend to be at lower grades (and are lower paid). This actually means that the practice of long hours together with other stressful work practices is leading to a situation in which the skills of an important part of the labour force are systematically underutilised. The EOC estimates that there is a huge waste of skills and qualifications (see figure below). Half of UK part-time workers previously held jobs using higher qualifications. Another third of all part-timers consider they could easily work at a higher level. All in all, some 5.6 million part-time workers, representing one fifth of the entire UK work force, work below their potential. This is an enormous waste of human resources that no single economy, especially the UK, where the skills level of the work force is not optimal (Ixis,2006), can afford. Besides fighting long working hours as such by setting upper weekly limits, another and complementary approach to tackle this 'hidden brain drain' is to provide workers with the right to flexible work practices so that they can demand measures from employers to improve the work-life balance. But this again involves legislation and rules limiting to some extent the power that employers have over their work force...

The hidden brain drain

Four in five part-time workers are "working below their potential"



Notes:
1 "working below past potential" are people who say they have previously had jobs that used higher qualificatic skills or that involved more management supervision
2 "Working in jobs not using "latent" potential are people who are not "working below past potential" but who they could easily work at a higher level.

Source: Darton Hurrel, 2005.

To complete this chapter on working time standards, we refer to the opposite situation of workers being put in a tight spot by employers offering only a minimum working time. This is the case in Sweden, for example, where employers offer (female) young workers only 'small' part-time job opportunities, combined with 'on-call work'. In this way, an extremely flexible work organisation is being created with employers adjusting labour input according to peaks and troughs in business activity but with workers being extremely uncertain of their income and a work-life balance which is absolutely appealing. This again results in a waste of labour resources. Because part- time workers have to be available at all times, they cannot take up another part-time job to earn a full-time income. Young workers are thus trapped in insecure part-time working arrangements and excluded from participation in the job market on a full-time basis (with further effects on housing decisions and fertility rates). Again, what appears to be 'rational' from an individual employers' point of view is harmful for the economy as a whole. And again, what is needed to remedy this are workers' rights to limit the power employers hold over jobs and workers. In some countries (Belgium for example) this is done by simply outlawing very small part-time contracts so that any work contract needs to start from a basis of 13 hours a week. Other solutions are to limit this excessive employer-friendly flexibility by providing part-timers the right to request a full-time job.

B. Protecting the job is part of protecting workers

Employment protection legislation (EPL) is another area where the existence of constraints on business behaviour is likely to produce beneficial results for the economy as a whole. Certainly, job protection does impede the ability of firms to fire their work force[4]. However, blocking firms from immediate firing practices also works to promote the kind of business strategies a modern economy needs.

A first indication of the beneficial impact of job protection is seen in the fact that low or moderate labour turnover is associated with higher productivity (Auer and others, 2006). According to this research, an increase of one year of tenure is associated with a 0.4% increase in productivity. This positive relationship holds at medium rates of tenure, starting at 4 years and ending at around 14 years of tenure. On the other hand, low rates of tenure generate a negative impact on productivity with very low rates of tenure (under one year) being quite detrimental to productivity: Workers with less than six months of tenure are found to be only one fourth as productive as workers with two years of tenure. In other words, a stable work force is good for productivity. Europe, with an average tenure of 11 years, is situated in the medium range of tenure and is therefore currently optimising productivity.

What exactly drives this empirical link between job tenure, job protection and the positive record on productivity? The answer is to be found in the fact that job protection confronts firms with a different set of incentives. And these incentives work to alter business strategies and to develop better solutions for facing up to competition than simply getting rid of workers:

- First of all, if firms face costs when firing workers, they will try to avoid the likelihood of incurring such costs. One way to do so is to provide their workforce with training to upgrade their skills. This will enable the company to respond to future competition by engaging in internal and functional flexibility instead of firing workers. Several studies indeed confirm the fact that job protection is an incentive to employers to offer their staff more training. For example, a recent study on the UK, which in 1999 lowered the probation period from two years to one, concluded that workers with low tenure were offered much more training after this reform took place and job protection was strengthened (Marinescu, 2006).
- In general, job protection also prevents business from opting for the 'easy-way out' of job- and cost-cutting strategies which in the longer run are no solution to the threat of competition from low-wage economies. Job protection forces firms to look for other, more innovative solutions. One interesting example here is how Air France and British Airways reacted to the crisis in air passenger traffic in 2001/2002. Whereas British Airways fired a substantial part of its work force, Air France retained them and used the downturn in activity to retrain workers to manage a new ICT-system. When business picked up, Air France was in a perfect position to react to increased activity in a very efficient way. British Airways on the other hand had difficulties responding to strengthened activity and, at one point in time, even faced a worldwide crash in its IT system. In another case from Sweden, Telia was confronted with high notification costs, and opted instead for the cheaper solution of transferring workers into a separate company in which they received training and were offered outplacement services.
- Another link between job protection and innovation is that workers without much job protection will be very reluctant to suggest or agree to innovation. Logically, workers will refuse to 'innovate' themselves out of their jobs if there isn't a minimum guarantee that the employer cannot fire them on the spot. A related argument concerns 'tacit' knowledge, which refers to knowledge which is not transferable through regular training courses but rather through 'learning by doing'. Workers will not be willing to share such knowledge with their colleagues if they can be fired today and replaced by the colleagues they were training and teaching the day before.

As described above, a positive link between job protection and internal flexibility and innovation efforts in existing firms can be established. However, there is also a link between job protection and external upward mobility. A certain level of protection of existing jobs is helpful in promoting workers' mobility from existing but probably outdated jobs

4 International comparisons between countries with strict and loose job protection rules shows that EPL in most cases keeps firms from adjusting their workforce over a time period of a couple of months. However, seen over a slightly longer time period, but still less than one year, firms appear to be able to fire workers despite the existence of EPL. The claim that EPL stands in the way of the process of 'creative destruction' by locking labour into existing but outdated activities should therefore be taken with a big grain of salt (Blanchard, 2003 and Janssen, 2006).

into new sectors and activities that match the comparative advantages of the economy. Key to this is the principle of 'prior notification'. Advance notification gives retrenched workers a 'head start' and thus the possibility of preparing for structural change. Workers enjoying advance notification of dismissal appear to find new jobs more rapidly than workers that are fired on the spot (Torres 2005). This is why even countries with the reputation of having a 'free hire and fire' system have this specific form of job protection. In Denmark, for example, collective bargaining agreements force firms to respect a 4 month notification period in case of collective dismissals for a worker with 4 years of tenure. With 20 years of tenure, the notification period increases to 5 months, and severance pay of one and a half month is added. According to OECD statistics, advance notification in Denmark is one of the highest in Europe[5], with the exception of Sweden (see table below).

Notification period in case of collective dismissal for a worker with 4 years' tenure

Denmark	4 months
Austria	2 months
Belgium	4 months
Finland	2 months
France	2 months 20 days
Germany	2 months
Italy	2,5 months
Sweden	6 months
UK	3 months

Source: OECD Employment Outlook 2004

C. Standards protecting wages and ensuring decent pay

Pleas for 'flexible' wages are very much in fashion these days. These pleas are, once again, based on the idea that 'what is good for one individual firm must be good for the entire economy'. Intense competition from low wage economies, it is argued, makes it necessary for firms to adjust their wages downwards (and/or working hours upward) so that jobs can be saved from the ongoing trend of globalisation and offshore production activity. Sectoral collective bargaining (as is still the practice in many continental European countries), and even collective bargaining itself, is thus considered as a labour market rigidity preventing a flexible response to global competitive pressures. In this view, sectoral collective bargaining should be seriously weakened in favour of enterprise-level bargaining (e.g. through general use of 'opening clauses' allowing deviations from sectoral wage standards) or alternatively, collective bargaining should be replaced altogether by profit participation systems.

However, there is a striking parallel between this view of downward wage flexibility and the argument of state subsidies. For the past decades, economic think thanks and many politicians have been preaching to trade unions and workers that state subsidies to save activities and firms that are condemned to disappear anyway are a waste of money and keep the economy from adjusting to unavoidable change. Admittedly, experience has shown that this view on state subsidies has indeed been correct on too many occasions. But the pressing question is then why should wage formation now step in and take over the role from government subsidies to support ailing firms unable to survive global competition? Isn't this also a waste of money and resources? Isn't this also a policy which is artificially maintaining firms and jobs while missing out on the opportunity to use resources in a more productive way?

In particular, there is indeed the danger that (downward) wage flexibility 'tailor-made' to each individual enterprise will create a moral hazard at the expense of incentives for business to engage in an innovation strategy. If employers, without the constraints of general standards on wages and working conditions, start to realise they can count on workers to bail them out in case of competition problems arise, then they will not be very inclined to go to the trouble of pursuing and investing in innovation. If employers can go for a 'quick and easy fix' by pressing their workforce to cut wages, why should they go the more troublesome road of trying out new products and production techniques?

The argument unfortunately also works the other way around. Even firms that have a tradition of innovation or do see the overall need for the economy to take the innovation route will face serious disincentives. Indeed, for investments in innovation to pay off, a firm must, at least temporarily, enjoy a certain

5 US policy also recognizes the importance of advance notification. In the US, a two month notification period is obligatory in case of collective dismissals. The US also has a system of 'experience rating': firms transferring the costs of adjustment to the state and its unemployment benefit systems do have to pay special contributions, depending to what extent they adjust by retrenching workers. So even in the US, firing is not entirely a 'free lunch' for employers and the burden of adjustment is to a certain extent also carried by business.

'economic rent'. However, if those firms willing to invest in innovation realise that any temporary economic rent coming from their efforts will be immediately neutralised by competitors cutting wages and prices, then the incentive for investing in innovation is seriously weakened (DIW 2004).

So here again, we arrive at the fundamental conclusion that labour standards protecting wages from downward adjustment should not simply be seen as a rigidity blocking change. If wage protection standards block change, it is the sort of change that is detrimental to an economy hoping to improve competitiveness through innovation and productivity. And by preventing this undesirable form of adjustment from occurring, wage protection standards help to focus business strategies on initiatives that upgrade the economy on the ladder of added-value activities.

IV. Conclusions: the way ahead for labour market reform in Europe

In reacting to the argument that Keynesian demand policies are a waste of resources since mass unemployment in Europe is mainly structural, trade unions often get caught in the trap of simply defending more active aggregate demand policies while ignoring the need for structural reforms in the labour market. In doing so, they neglect the important policy area of designing and improving labour market institutions to handle structural change more effectively. Others (employers, liberal minded governments and think thanks) do not hesitate to step into this policy vacuum and advance a one-sided policy of deregulating workers' rights and dismantling social protection to promote the short-term interests of business.

This note has argued that trade unions should reposition themselves on the agenda of structural labour market reform. It has described how certain reforms can bring structural unemployment substantially down by establishing new rights for workers (rights to lifelong learning and skills, on active labour market policies and on gender initiatives). This note has also argued that such a modern labour market can only be built on the basis of fair working conditions. The so-called 'modern' social policy depends heavily on 'traditional' workers' rights such as rights to a limit on working time, the right to advance notification, and the right to wage protection.

The way to reform is not to give up on existing workers' rights. Instead, the way forward is to link these 'traditional' rights even more closely to the new social agenda of supporting skills and upward adaptability, and to strengthen, where necessary, traditional workers' rights, for example, by controlling situations of excessive flexibility.

A final word concerns the interaction between the type of structural reform policies described in this note and macro-economic policies. Indeed, a 'two-handed' approach remains necessary. To eliminate the spectre of mass unemployment in Europe, we need structural as well as macro-economic policy. Structural policy needs aggregate demand management and demand policy needs structural policy. However, exactly how this mutual link can be worked out goes beyond the scope of this article.

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THE OPEN METHOD OF COORDINATION 6 YEARS ON - FROM FLAMBOYANT PROMISES TO UNREALISTIC EXPECTATIONS ? THE CHALLENGE OF REVERSING THE DELIVERY GAP

Niklas Noaksson[1]

Introduction

Six years ago, the Open Method of Coordination (OMC) was introduced in the context of the Lisbon Strategy. It rapidly became the darling of most politicians and scholars. It was a new type of governance, built on trust, learning and participatory democratic principles. The promises of the OMC were countless. The criticism against it was low key. That was in the year 2000. Today the situation is reversed: the promises of the OMC are being questioned, and the criticism is mounting. Can the OMC live up to all the flamboyant promises, or have unrealistic expectations been attached to it? There can be no doubt that the honeymoon period, during which the new method received praise from all sides, is coming to an end. The OMC is being questioned on two accounts: its legitimacy and its efficiency. Is the OMC open to a broad range of actors? Is policy transfer possible without any effective means of sanctioning member states which fail to comply with EU prescriptions? Are member states merely adopting new administrative procedures, without substantially changing polices? Are member states promising more reforms than they are in a position to implement, when they take into account the political and financial price?

The report focuses on the process side, with the intention of closing the gap between commitments at EU level and (the lack of) implementation at national level, and attempting to reverse it. The report argues that we need to learn to expect less in terms of (unrealistically) rapid results, in order to achieve better implementation. And beyond that, the commitment of member states to compliance with EU policies must be further strengthened.

1. The OMC in employment

The employment chapter in the Amsterdam Treaty prescribes that member states shall regard promoting employment as a matter of common concern (Article 126, para 2). This third way between respecting national diversity and European harmonisation is composed of several elements.

The procedure in the Employment Guidelines (EGs) has been cyclical, repeated annually, until its revision in 2005, which we discuss below. The main instru-

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ments are the common European policy guidelines, delivery of National Action Plans (NAPs), recommendations to individual member states, and ways of monitoring and controlling member states. The EU Commission draws up draft guidelines to be discussed and ultimately adopted by the European Council. There is a special employment committee in the Council (EMCO), which is an advisory body for the drafting of guidelines, consisting of two full members from the European Commission and two representatives from each member state. This body is supposed to work in co-operation with the European social partners. On the basis of these guidelines, member states report back in NAPs, describing ways in which the national policies have implemented them.
The NAPs of all member states are submitted to the European Commission for cross-evaluation. The strategic annual report (prior to 2005, the joint employment report) must be approved by both the Commission and the Council. In addition, member states evaluate each other's achievements (peer review in EMCO), and benchmark each other against common indicators. The final step, the supervision of member states' implementation of guidelines, for which the Council is responsible, may, on the basis of a qualified majority vote, lead to the issue of individual country recommendations, the purpose of which is to encourage national policy to follow the European guidelines.

2. OMC governance patterns – an overview
The OMC has its origins in the Broad Economic Policy Guidelines (BEPG) of 1992, and later in the European Employment Strategy (EES) (1997). Not until Lisbon, however, was it given a name and developed into a coherent strategy for soft governance, to be used (more or less extensively) in various policy fields (employment, social inclusion, education, research, health, pensions). The OMC is a form of non-legally binding soft law, in contrast to hard law. This means that there are no legal sanctions against members which fail to comply with its obligations. There is, nonetheless, a commitment to EU objectives, which are of a moral and political nature.

The OMC aims at convergence of policies. EU member states are encouraged to reach the same final goal. Thus, the OMC is sometimes described as a form of 'management by objectives'.
Ultimately, the strategy is supposed to encourage governments to take part in a race to the top (Larsson 2002) or to become the best pupils in the class. The role of the EU has become more ambitious, in that it now seeks to *complement and* go beyond the legislative imposition of minimum social standards (*hard law*)[2] . One important point to realise is that minimum standards alone risk creating negative integration, namely, a race to the bottom in which the lowest common denominator becomes the goal. The OMC is a potentially efficient new governance approach, part of a new policy paradigm (Pochet, in Zeitlin and Pochet 2005). Some authors consider the OMC to be complementary to hard law, yet no more than a second-best choice. Given the diversity of welfare traditions in member states, the OMC is a more flexible response than the traditional transfer of sovereignty from national to EU level. To some extent, therefore, it has the merit of proving acceptable on its own account.

What are the most important characteristics of the OMC? (European Council 2000).
- Common guidelines for the EU, with specific timetables for achieving the goals
- Translating guidelines into national and regional policies
- Periodic monitoring, evaluation and peer review
- Quantitative and qualitative indicators and benchmarks to establish best practices

Setting common EU guidelines which member states are committed to respecting is fundamental in the OMC. The common guidelines are translated into national policies in a National Action Plan (NAP). Progress towards objectives can be measured once common indicators are established. Indicators and targets (other than in pensions and healthcare) allow for periodic comparison of member states' performances. The EU draws up action plans to meet the objectives. The performance of a member state is evaluated by another member state, a peer, in the so-called peer review.

2.1 Policy learning – a key element of the OMC
Policy learning is key to the achievement of policy transfer/convergence. Policy learning, or social learning, is defined as the redefinition of interests on the basis of new knowledge which affects fundamental beliefs and ideas behind policy approaches (Hall 1990).

As mentioned earlier, the OMC is a voluntary process and, as pointed out by Jacobsson (2005), excessive

[2] A second hard law instrument is the European framework agreement which is negotiated by the European social partners.

pressure on members may result in escapist dynamics and lip service. The main procedure within the OMC in which policy learning can take place is the peer review. As there are no binding sanctions in the OMC, it is arguably the single most important procedure in the OMC designed to put adequate pressure on non-compliers. Peer pressure encourages non-compliers to defend their position against criticism by their peers. The peer review is presented as a reflexive process. It fosters co-operation and learning among national administrations. It stimulates actors to review current domestic policies in the light of new empirical evidence and learning from others' experience. It may lead to a voluntary acceptance of norms which, where successful, may be more efficient than coercive sanctions (Jacobsson 2005).

Haas (1992) argues that a network of knowledge-based experts, an epistemic community, helps states to define their interests. The civil servants representing member states in the employment committee (EMCO) form one example of such a network. They are able to constitute an effective social control by a minimum of informal sanctions. The experts provide policy-makers with their interpretations of knowledge, but this is based on their concept of reality, which is mediated by prior assumptions, expectations and experience. Barbier (2004) shows, for example, that the economic and financial actors involved in the OMC for economic policies, the so-called Broad Economic Policy Co-ordination, share a high degree of similar knowledge and belief in the current economic orthodoxy (see also Noaksson and Jacobsson 2003 for an in-depth study of the production of knowledge in the OECD). Therefore, while epistemic communities provide consensual knowledge, they do not necessarily generate truth (ibid).

Where successful, policy learning could yield policy transfer, meaning that the EU as a political actor has an impact on policy affairs in a member state. Yet policy transfer is a debated issue in comparative politics, as will be explained below.

2.2 Policy learning or simply strategic bargaining?

Policy learning which leads to the integration of norms implies slow progress, insofar as it is a question of building up trust between actors. This 'governance by persuasion' also presupposes that actors are sufficiently open-minded to assess knowledge in the light of new experiences and lessons learned from others. Yet the move from mutual learning to policy transfer is a difficult one. Not only must actors be convinced enough of the need to reform their own policy at national level, but there must also be efficient multi-level governance in order to implement the new policies at home.

Policy transfer is particularly complicated, since it involves both agents and structures. To what extent are actors embedded in institutional structures, and to what extent are they free to make independent choices? Are their preferences based on pre-set values and targeted towards strategic bargaining, or are they open to new ideas and policy learning?
The key distinction, critical to our discussion on policy learning, is two dominating institutional approaches (Hall and Taylor 1996). The 'rational choice' approach takes the underlying preferences and identities as given. By contrast, according to the 'sociologist' approach, preferences can be affected by interaction in, for example, a peer review. Clearly, these ideal types described above are not entirely applicable to the real world. Arguably, one can both attempt to maximise one's own preferences, while also sharing common understanding and values with others. Yet, regrettably, most literature fails to go beyond the description of transfers of policies or ideas. There is no explanation or analysis of the processes involved (Dolowitz and Marsh 2000). Some authors consider that policy learning takes place more at a procedural than at a substantive level. According to this view, the OMC is mostly 'window dressing' and not real policy influence. Others, including the author of this paper, find that policy learning is a collective learning process, in which procedural convergence, in turn, leads to a new common language, shaping our beliefs, and with the potential to lead, eventually, to policy convergence. The creation of an 'epistemic community' (Haas 1992) plays a key role in shaping identical normative orientations among actors. These actors adjust their values in accordance with the process of mutual socialisation.

In our view, epistemic communities are channels through which new ideas can flow from the EU to member states, and vice versa. But ideas need carriers, who have the function of gatekeepers, facilitating the entry of new ideas into institutions (Haas 1992). This is a potential obstacle to successful implementation in many countries.

2.3 A game of double standards

There is a lack of real implementation of the OMC with national policy-making structures. This is a major problem in the double standards game whereby governments endorse European guidelines and recommendations at EU level but fail to assume responsibility for carrying them out at home (Jacobsson and Schmid 2002). There seems to be a permanent tension between the search for convergence and respect for national diversity in the OMC. Member states passively resist reform to which they have subscribed in the first place.

In order for the OMC to become effective, it must carefully balance respect for subsidiarity[3] and foster convergence. And yet too much pressure from the EU on member states risks being met with 'defensive' reactions from member states if it is considered to be sidelining the subsidiarity rule. In the assessment section below, we discuss whether this tension can help to explain the delivery gap between policy intentions and actual implementation.

2.4 Lack of effective sanctions

What happens if member states fail to comply with the EU policy orientations? Sanctions on members which do not comply with EU guidelines are generally weak. Some authors take this to mean that the EU guidelines, given their non-compulsory character, are unlikely to be implemented in member states. While it is true that there is no formal system of sanctions, two relevant forms of informal sanction do in fact exist, namely peer pressure and (negative) exposure in the media. Are these effective?

There is virtually no media coverage at all on the OMC in the member states (Meyer 2003). For example, when the European Commission attempted to launch an information campaign about the EES nationally, it met with rejection as the member states found this EU initiative highly unwelcome (Jacobsson and Vifell 2005). It can be concluded that media coverage cannot be considered an effective mechanism to sanction member states.

As we will see in the evaluation later, peer pressure does work. Even though the peer review process could be much refined, it has proved a successful tool for policy learning. Yet policy learning not resulting in policy transfer is not good enough. Can policy learning in the peer review yield policy transfer?

2.5 The (missing) link between the EES and the European Social Fund

The objective of the ESF is to improve employment opportunities for workers in the internal market and to contribute to raising living standards (de la Porte and Pochet 2005). In practice, the ESF is a source for financing the implementation of the EES. In 2004, the European Commission adopted a new programme entitled 'Progress', which will cover areas in employment and the social field. It is to run for 7 years and has been allocated 600 million euros, a sum which is to be administered by the ESF. In brief, the link between the ESF and the EES has always been weak. This is partly explained by the co-financing role of national governments. Even though the ESF has encouraged wide participation of all relevant bodies at national, regional and local level, this process has frequently not been carried out in a qualitative way.

3. Evaluation

Has the OMC led to more jobs in line with the targets contained in the EES? The EU economy did improve considerably during the first five years of the EES, and these improvements were very much in line with the objectives of the EES. Unemployment decreased by 3% and there was considerable employment growth. Yet it is difficult to prove the link with the EES, since these effects might quite easily have taken place even in the absence of the OMC. The twofold nature of the interaction – the relationship between national policies and employment outcomes and between the EES and national policies – makes any causal impact assessment still more complex. On that basis, we will try to assess the OMC in various ways, in a more contextualised manner. The evaluation will draw heavily on the results of Zeitlin and Pochet (2005) and Degryse and Pochet (2005), but other sources will also be used. The kinds of evaluation needed are: (A) substantive policy impact; (B) procedural changes; (C) learning; (D) participation. There will be an overall assessment of the impact of the OMC in EU 15 member states.

Is policy learning working, and is it being transferred on nationally?

A) Substantive policy impact

There is evidence of the incorporation of EU concepts and policy priorities into the national arena. The most central shift is the trend away from reducing unemployment towards raising employment rates. Moreover, passive income support has increasingly

[3] It can also be argued that the OMC bypasses the subsidiarity principle, since it allows co-ordination in areas in which the competence remains national (Jacobsson 2003).

been replaced by Active Labour Market Policies (ALMP). Also, there is an increasing focus on preventing people from becoming unemployed in the first place, rather than on taking action only when they are already unemployed. As Zeitlin (Zeitlin and Pochet 2005) rightly points out, many other concepts have been downloaded nationally: active ageing/avoiding early retirement, lifelong learning, gender mainstreaming, flexicurity (balance between flexibility and security), reconciling work and family life, an inclusive labour market, social exclusion as a multi-dimensional phenomenon beyond income poverty, and an integrated partnership approach to promoting employment, inclusion and local development. It is also possible that a common vocabulary can lead to cognitive harmonisation, for example a shared vision of what causes unemployment (Degryse and Pochet 2005).

Yet some authors, notably Barbier (2004), have criticised the idea of cognitive convergence resulting from a common language on employment. Barbier's research concludes that the meaning of activation policies varies considerably among member states. It should also be noted that the common language is unknown to many key national players (at company level or in sectoral trade union negotiations) or local actors (Pochet and Degryse 2005).

There is some evidence that there has been an actual change in national policies. This is particularly stressed in the EES, which has already had seven rounds of NAPs. In any case, evidence to this effect should be interpreted with caution. Indeed, numerous policy shifts preceded the actual start of the OMC (Zeitlin and Pochet 2005). Governments have chosen to adapt to policies which are in line with their political programmes. Visser (2005) speaks of selective downloading. Yet they have avoided downloading policies which are costly, long-term and opposed to their political aspirations.

One factor which goes some way towards explaining the limited policy impact at national level is the level of importance attached by national governments to the NAPs. In general, the NAP is regarded as a relatively unimportant document in the context of national employment provisions. It is an administrative exercise, repeated annually, yet without strategic focus, since it is backward-looking.

B) Procedural changes

Most studies reach the conclusion that the EES has improved co-ordination within and between national administrations. There is evidence of better cross-sectoral integration between labour market policy, unemployment benefits, social assistance, pensions, taxation and education/training (Zeitlin and Pochet 2005). The compilation of the NAPs requires input from different ministries with specific responsibilities, a situation which opens up new channels for enhanced administrative co-operation.

A second impact is improved statistical and policy monitoring capacities. Even though there are still national differences, the EES and the social inclusion OMC have led to harmonisation of national and European statistics. Visser (2005) argues that the most important impact of OMC processes is the increasingly ambitious level of the targets set. Many countries have introduced special targets for employment, education and training, poverty reduction, etc. This is especially pronounced in the EES. A third effect is improved vertical co-ordination among levels of governance, in particular in federal countries.

C) Learning (among actors in the peer review)

Most studies confirm that peer pressure works. Peer pressure, recommendations and rankings do, in other words, actually influence member states' behaviour. It is the peer review, the exercise of having peers from other countries criticising one member state, which can trigger a reflexive learning process. The learning effect derives from the fact that member states need to reflect upon their own policies, and identify errors as well as achievements.

Degryse and Pochet (2005) conclude that limited learning takes place among an exclusive group of civil servants (who are participating in the EMCO), but is not diffused to a broader group of stakeholders. There is indeed a problem of policy transfer.

The reflexive learning stems from recognising that policies believed to be economically sound may be harmful if regarded from another perspective. Examples of this are early retirement, unemployment created by restructuring, etc. The area in which most learning seems to have taken place is in relation to the importance newly attaching to gender mainstreaming in many countries. Yet there is little evidence of direct learning within the OMC processes.

One key explanation is of course that member states retain, and are not willing to give up, decision-making power over labour market policies. Therefore, the commitment of member states is not always robust. This is proven in the European Commission's five-year evaluation of the EES. The discussion of the revision and redesign of policies was dominated by political bargaining over the new guidelines, even if negotiations subject to deliberative discipline also played a role (Zeitlin and Pochet 2005). Thus, both mutual learning and strategic bargaining have played a role in the development of the EES.

D) Participation

Social partners

The social partners at EU level have an advisory role to play in connection with the employment guidelines, remaining in close contact with DG Employment and participating in the annual tripartite social summit preceding the European Spring summit (annual meeting between heads of state to establish the political orientation of employment and economic policy in the Lisbon Strategy).

As mentioned above, the NAP is not regarded by governments as a strategic document, and this has resulted in no more than lukewarm interest in becoming involved in its production on the part of national trade unions (Degryse and Pochet 2005). Trade unions have found it easier to exert direct pressure on employers than to engage whole-heartedly in the NAP process, where the likelihood of influence is marginal. Even so, in most countries the trade unions and employers' organisations do produce a joint text, which is an appendix to the NAP. At the same time, they often complain of a lack of real influence on policy-making (Zeitlin and Pochet 2005). By contrast, Casey (2005) has criticised the role of social partners in the OMC, arguing that too much social partnership is associated with low employment outcomes, as exemplified by France and Germany, where the social partners' involvement has blocked reform of early retirement programmes.

Local and regional actors

Under the EES, the situation is somewhat different. From the outset, local and regional actors showed that they were keen to become involved. They demanded the right of full participation, a demand later reflected in the employment guidelines by the statement that all actors at regional and local levels should be involved in the implementation of the EES.

In the national context, this resulted in activation of plans at regional and local level, so-called local and regional action plans for employment (LAPs and RAPs). The concern was to raise awareness, at government level, of the importance of implementing a bottom-up approach. Yet to many stakeholders at local and regional level, the OMC in employment is still unknown.

To conclude: the evaluation is that policy learning has had an impact at different levels, first and foremost in the peer review process. On that account, the OMC deserves considerable credit. Also, albeit to a lesser degree, the social partners in particular, but also local and regional actors, have raised their knowledge levels on EU employment policies. Moreover, member states have established new institutional procedures which could facilitate policy transfer. Yet there are still many obstacles on the path from policy learning to policy transfer. Obviously, there is no firm commitment on the part of member states to respect previous engagements. Thus, the literature suggests that the policy transfer that does take place is limited and selective. On that basis, there is a risk that the policy learning in the peer review will be separated from national policy-making. Moreover, there are few examples of upward knowledge transfer from innovative local labour market policies back to the EU level.

4. EU initiatives for better delivery

4.1 Expert group on delivery in November 2004

In 2004 the delivery gap was submitted to harsh criticism by an influential high-level group called the European Employment Task Force, chaired by Wim Kok, a former Prime Minister of the Netherlands. It produced a paper entitled 'Facing the challenge', assessing the Lisbon Strategy and suggesting some detailed reform proposals. The high-level group was composed of national experts, business leaders, labour market experts and a few representatives from trade unions. Although it was supposed to be an independent group, the Kok report was not a purely neutral exercise: it was also a political exercise (Casey 2005). In retrospect, it is perhaps not so surprising that many of its proposals coincided with the wishes of the new Barroso Commission. Subsequently, the core of its reform proposals on improving the process was taken on board in the 'Lisbon new start', presented by the European Commission in spring 2005.

The following recommendations, intended to improve delivery, effectiveness and democratic accountability, were proposed by the Kok group and adopted by the European Commission:

- Member states should set out road maps, including milestones, on how to achieve Lisbon targets
- Each government should designate a Mr or Mrs

Lisbon who would be in charge of carrying forward the day-to-day implementation of Lisbon

- National parliaments should arrange debates on the Lisbon process, opening them up to enable citizen participation
- The European Parliament should establish a standing committee on the Lisbon Strategy for growth and employment.

The Kok report concludes as follows: 'one fact needs to be repeated: much of the Lisbon strategy depends on progress made in national capitals: no European procedure or method can change this simple truth' (European Commission 2004b). This sentence is a reminder that ultimately, commitment depends on member states' willingness to co-operate. Against this background, it is to be noted that one coercive proposal by the Kok group was rejected by the heads of state. The proposal was to announce each year a 'name and shame' list, starting with the worst performer among the member states. This shaming of the worst performers was supposed to be delivered in the most public manner possible, to have an influence via negative publicity nationally. Sweden, one of the countries opposed to this idea, argued that a ranking would not make any sense since countries have very different starting positions (Jacobsson 2005). The lesson learned is that member states are not willing to take any public bashing from Brussels.

4.2 European Commission reform proposals 2005

- National Reform Programme in three-year cycle (forward-looking first year, backward-looking second year, strategic forward- and backward-looking third year) adopted by governments and discussed in national parliaments
- Mr or Mrs Lisbon at government level
- National Lisbon programmes for growth and jobs, thus covering both economy and employment
- Single integrated package of economic and employment co-ordination, to be published annually by the European Commission, entitled 'Strategic Annual report'
- European Parliament to be consulted and to give its opinion on the Strategic Annual report. Yet this must be 'taken into account' by the Council, which means that, in practice, it can be entirely overlooked
- The Commission initiates a partnership with member states, in which it plays the role of the coach. It continues to evaluate the targets and measures adopted by member states. It will 'by use of its power under the Treaty' ensure that member states' commitments are kept
- The social partners' role remains a vital one. As well as the multi-annual Lisbon programme for Growth and Jobs, they also participate in the Tripartite Summit devoted to assessment of progress made, and exchange of best practices
- The European Commission complements its focus on the peer review on individual policy themes, with a bilateral in-depth dialogue between the Commission and member states
- The country-specific recommendations are scrapped for 2006
- The scaling down of the number of indicators from over 100 to about 60 (Pochet 2006)

All these reforms (European Commission 2005a) represent an overhaul of the previous implementation process[4]. The National Reform Programme (NRP) is, in the first year (2006), a forward-looking document based on the new integrated guidelines (a juxtaposition of the old EGs and the BEGL). Thus, the main thrust of the EES is kept unchanged. Moreover, each guideline must be followed by policy actions, and where no action is taken, a justification will be required from member states. The following years, 2007-2008, are devoted to ensuring that the EU guidelines are better respected in national policy-making.

4.3 Effective implementation or just 'new packaging'?

It is premature to evaluate the effectiveness of these reforms before they have actually been tested in action for a few years. However, the European Commission is not reinventing the wheel. Quite the opposite, it is copying more and more parts of a model for multi- and bilateral surveillance well established for at least a decade in the OECD Jobs Study. Since the beginning of the EES, the peer-review in the EU is equal to a light version of the model at work in the OECD (EU devotes shorter time for the actual peer-review session, it performes less extensive preparation of data collection etc). This year the EU has also copied the focus on bilateral contacts. These have turned from being of marginal importance in the old Lisbon into a key component for improved delivery in the new start for Lisbon. Will the enforced bilateral surveillance improve delivery?

4 Another Commission document (European Commission 2005b) goes into further detail as to how the implementation will take place.

At the end of the day, the ownership of the NRPs remains national. Unlike at the OECD, where the OECD secretariat drafts the so-called country reports, EU member states are responsible for delivering the reports and are free to set their own priorities. The new forward-looking approach in the NRP may change the European Commission's influence over national policy-making. In particular, the new three-year cycle would allow for more time to translate EEGs into the national policy-making framework. Yet whether policy advice from the European Commission in the new enhanced bilateral contacts will have substantial effects on the NRP is an open question. The bilan for delivery in OECDs Jobs study, which seems to have been an important source of inspiration for the reforms on implementation, is at best mixed (see Noaksson and Jacobsson (2003) for a detailed comparison between the EES and the OECD Jobs Study). It is also uncertain whether the EU Commission's reforms, if fully implemented, might bring about convergence of outcomes without also (falling into the trap of) converging policy design (which is solely a national responsibility).

Moreover, there is an ongoing discussion in the EU as to whether or not country-specific recommendations should be more or less binding on member states. The 2006 Spring Council decided to scrap the country-specific recommendations to member states[5] . Along the same lines is the decision to reduce the number of indicators. Will this serve the purpose of better implementation?

These reforms are founded on the argument that there is a better chance of effective implementation if the EU guidelines are softened and the monitoring and learning mechanisms are strengthened. Yet the reforms by the EU Commission seem misguided on many counts:
The first round of NRP can be described as a patchwork: there is a reduced use of targets (thus a reduced level of ambition). Few countries have nominated a Mr or Mrs Lisbon, and if they have, these are unknown to the general public. The NRPs are less comparable, in contrast to the old NAPs. The lack of contextual country-specific recommendations would weaken the peer review and, in turn, weaken the EU policy message nationally. National parliaments have barely been consulted: on a scoreboard from 1-12 measuring national ownership in the EU, the average EU 15 score is below 6 (Pisani-Ferry and Sapir 2006). In addition, the national media are unaware of the existence of NRPs (ibid). Moreover, strong reservations have been raised about the watering down of the consultation with the social partners in the process leading up to the NRP (joint declaration by ETUC and others 2006). On the basis of a few provisional evaluations of the first round of NRPs, we conclude that the EU Commission's reforms are likely to prove incapable of reducing the delivery gap.

Our policy stance therefore consists in working towards a better procedure, while also attempting to become more realistic in the expectations we project upon the OMC. In other words, we perhaps need to learn to expect less, in order to obtain, in the long run, better results. This means that we will seek to develop the OMC procedure, which needs to become more transparent and participatory, more democratically accountable, and adequately funded. Another key issue is obviously to improve the peer review process. Some very specialised studies have been conducted on this particular aspect, which falls outside the boundaries of this report. For proposals to that end, see for example Casey (2005).
The issue in question is then how to reconcile the goals of retaining decision-making authority at national level and finding a way of improving delivery of EU guidelines nationally. We will now address this question.

5. Seizing the potential of the OMC for the future
Arguably, the OMC should be developed in the light of its own premises, which advocate voluntary learning, self-correction, innovation, experimentation, broad participation, democratic legitimacy, etc. A necessary condition for learning is a deeper commitment on the part of member states (Zeitlin and Pochet 2005). And the commitment is voluntary, depending all the way on the willingness of national actors (Serrano Pascual 2003).
This will be the starting point for our policy approach[6] .

5 Nikolaus Van der Pas, General Director of the EU Employment directorate, has stated that country-specific recommendations will be reinstalled again in 2007 (ETUC macroeconomic conference, March 2006).

6 Though this report is about process and not content, certainly makes no sense to improve the process of bad policy content. Accordingly, it is critical to refer readers to another report which deals with the imbalance between economic objectives and employment. As long as the Employment Guidelines are subordinated to the dominant economic doctrine, entitled the Broad Economic Policy Guidelines, improving the process will be a small achievement. The rebalancing exercise must include setting the OMC in employment on an equal footing with the BEPG. And more fundamentally, there is a need for substantial reform of the ECB (see Noaksson 2006). See also Goetschy (2005), who concludes that marginal reforms cannot change the economic constraints affecting EU social integration.

5.1 National parliaments to adopt National Reform Programmes

As we have seen, member states are less likely to comply with guidelines that are costly, long-term and opposed to their political aspirations. Governments sometimes act as gatekeepers to deny entrance to policies which they prefer not to transfer to the national level. Today's ALMP are by and large financed at national level. How can the connection between funding and policy implementation be enhanced? One efficient means of increasing political commitment, and of making sure that policies are backed up with funding, would be to have the NRPs adopted in national parliaments. That would resolve the problem of mutual learning at EU level being separated from policy-making at national level. This idea has already gained political support in both the European Parliament and the Committee of the Regions (European Parliament 2003), and the relevance of this proposal is reinforced insofar as the NRP is no longer a backward-looking document but actually a road map for reforms to be implemented nationally. The disadvantage is of course that it would be more difficult to find binding majorities in the Council for the integrated guidelines. Yet once adopted at EU level, and subsequently nationally, policies will indeed be implemented. In a concerted effort to reduce the delivery gap, the importance of this argument must not be neglected.

5.2 Increased transparency and participation

The new bilateral contacts between the European Commission and the member states require openness and transparency and the inclusion of all actors involved. Yet it is not clear from the Commission's documents how the bilateral meetings are supposed to be organised. This paper argues that the meetings in the bilateral contacts between the European Commission and the member states should be open to all stakeholders (government, the social partners, and opposition parties).

Learning via vertical integration is obstructed by government gatekeepers who prevent information from being shared with a broad range of actors. The production of NAPs in employment has so far been a rather closed governmental process, involving the social partners to varying degrees. This could explain some of the limits on the policy learning that has taken place. If sub-national actors are excluded from the process, they will be less committed to implementation. Yet the crucial question remains whether the actors should be policy-makers or only policy-takers? The social partners are indeed the most relevant actors in labour market policy-making. Thus, their active involvement in the NRP is of central importance. However, Jacobsson and Schmid (2002) have exposed a potential paradox: the more open a process becomes to wider stakeholders nationally and sub-nationally, the less open it is likely to be to European convergence ambitions. We are inclined to find a middle way so as not to obstruct the convergence of outcomes at EU level, to which all member states have agreed. There is a need for enhanced consultation with the social partners nationally in drafting the National Reform Programmes in employment. In return, the social partners should be committed to dissemination of the National Reform Programmes and the European Employment Strategy in their branches at regional and local level.

5.3 Financial incentives

The above recommendation of adopting the NRPs in national parliaments will ensure that policy proposals receive adequate funding. But we also aim to explore new innovative forms of ALMP. To that end, more funding from the EU Structural Funds should be reallocated.

The European Social Fund has not been successful in fostering a bottom-up approach in the EES. The ESF projects tend to be temporary in character and with little feedback to the NAP work. Moreover, there is a need for improved organisation between national and sub-national levels in order to learn from successful ESF projects (and in other cases, to learn what not to do) nationally, and for the information to be spread to the European level. Member states need to establish a more co-ordinated organisation with regard to ESF projects, so that the projects at local and/or regional level can feed back into the national and European level, and in the end, increase the mutual bottom-up learning process.

What is more, there is a need to encourage member states to comply with country-specific recommendations. One possible efficient way is to ease the financial burden of undertaking reforms at national level. This could be tested, for example, to reallocate funding from Structural Funds to member states that comply with country-specific recommendations.

Conclusions

The OMC has been challenged with regard to living up to its promises. Yet this should not be taken to mean that the OMC is a failure. On the contrary, the OMC in employment has successfully encouraged policy learning, especially at EU level. Yet only limited and selective transfer has been diffused to national level. Thus, we have identified several obstacles to bridge policy learning and policy transfer. Low willingness on the side of member states to comply with EU guidelines is probably the most important explanation. Another way to put it is that the OMC is not sufficiently capable of encouraging national ownership. There seems to be a trade-off between on the one hand, flamboyant promises and weak implementation, and on the other hand, realistic commitments consonant with domestic politics and real implementation. Any proposals for reform of the OMC must try to reconcile the goals of retaining decision-making authority at national level and finding a way of improving delivery of EU guidelines nationally. Some of the EU Commission's proposals – for example consulting national parliaments on the NRPs – represent movement in the right direction. But many further actions need to be taken to substantially reinforce national ownership.

Arguably, member states are promising more at EU level than they are willing to implement nationally, considering the potentially high political and financial price. Against this background, we are proposing several reforms to reverse the delivery gap. Firstly, there is need for real national ownership of the NRPs: a broad range of national stakeholders should participate in the preparation of the NRPs. Secondly, national parliaments should adopt the NRPs. And thirdly, the member countries that comply with EU guidelines could receive a financial incentive, taken for example from the Structural Funds. These reforms would constitute a concerted reform package of the OMC. This would possibly lead to more willingness on the side of member states to comply with the EU Commission's proposals. As we all know, but sometimes tend to forget, it takes two to tango.

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LABOUR MARKET REFORMS: A PERSPECTIVE FORM SWEDEN

Åke Zettermark[1]

The Swedish economy is an open economy and has traditionally been heavily dependent on foreign trade of goods and services. To benefit from foreign trade, it is necessary to face changes in production patterns. Trade unions have been rather positive to structural change – as long as lost jobs have been replaced by new jobs at higher wages.

A corner stone in the Swedish model is the system of general social benefits. Benefits are at a relatively high level of compensation and can be supplemented by collective agreements.

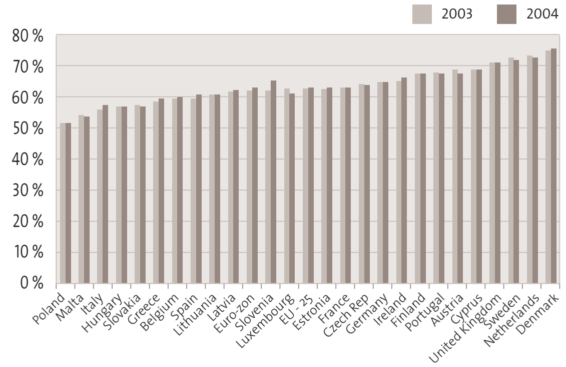
Since 1938, the social partners have had a tradition of co-operating without intervention from the government. Many issues have been solved through voluntary agreements instead of through legislation, including how to increase and cut the work force. Traditionally, a high percentage of the working population in Sweden belongs to trade unions, today it is about 80 per cent.
During the 1950´s the Swedish model developed with the characteristics of collective and central wage bargaining, full employment and a wage policy based on solidarity. This wage policy meant that companies, independent of their ability to pay for wage increases, had to pay the same wage for the same type of job. That fuelled structural change as less profitable firms closed down and the more profitable expanded their work force. The Public Employment Service received resources to support the redundant workers with relocation costs and training for their new jobs at expanding firms or elsewhere.

I would claim that the focus on security for the individual is to make him or her employable – not to focus on keeping the job in question. The flexibility is a responsibility of the social partners while security is a joint responsibility of the government and the partners. During the 1970´s one might argue that security was more emphasized. We got several new laws on security for the workers. One of the most debated laws was, and still is, the Employment Protection Act (LAS) with the "last hired, first fired"-principle.
People became more reluctant to move to a new job because they would lose their seniority protection – and also because they would have to find two new

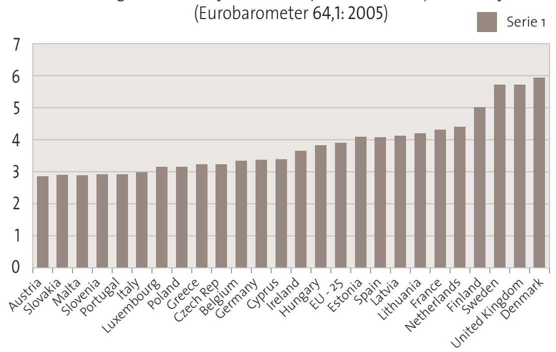
1 International Secretary, SACO-Sweden

jobs, for both spouses. Notably, the female participation rate in the labour force has increased substantially since the 1970´s and is today very close to the male rate. We still debate whether the Act tends to hamper a productive turn-over because workers stay too long on a job.

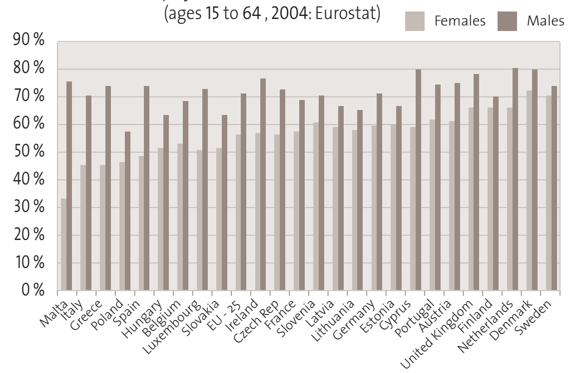
Total employment rate, ages 15 to 64 (2003 and 2004: Eurostat)



Average number of jobs to date, per worker and per country (Eurobarometer 64,1: 2005)

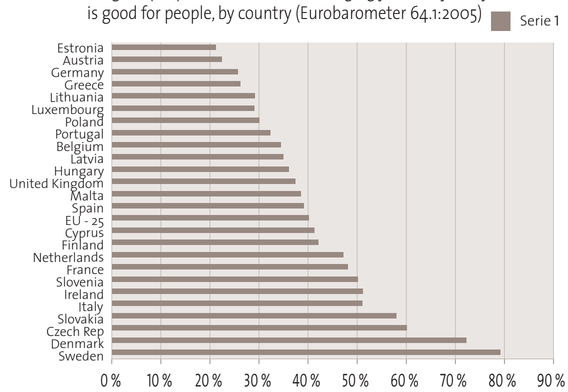


Employment rate, females and males (ages 15 to 64 , 2004: Eurostat)



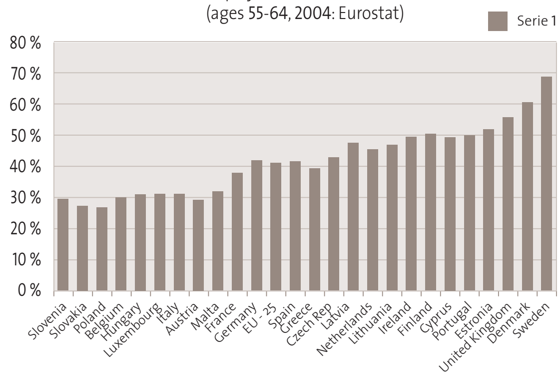
Given a work life length of approximately 40 years, the average number of years spent on each job in Sweden is around 7 years according to the Eurobarometer 2005. However, various studies use different ways to measure average job tenure. A report from the Centre for European Policy Studies and the European Club for Human Resourses 2004 on labour mobility shows the average job tenure as 11 years in Sweden and about 8 in Denmark, while it is less than 7 years in the United States and an average of 9 years in an OECD.

Percentage of people who think that changing jobs every few years is good for people, by country (Eurobarometer 64.1:2005)



We can also see from the Eurobarometer that in both Sweden and in Denmark changing jobs every few years is considered a good thing for the people and for the country. Between 70-80 per cent of the persons in these two countries think that is a good thing to do. The Czech Republic ranks third with 60 per cent.

Total employment rate of older workers (ages 55-64, 2004: Eurostat)



However, the Employment Protection Act has discretionary rules which give the social partners the right to draw up a collectively agreed redundancy list. In these cases, exceptions are made to the seniority principle due to many reasons. For instance, individuals with specific qualifications can be considered so essential that they must stay with the company. Or in other cases, older workers may agree to leave if they receive reasonable compensation.

In spite of this the employment rate is close to 70 percent for the older workers – "the most experienced work force", as Allan Larsson, former director general of DG Employment put it.

One reason for a relatively high employment rate for older workers may be that the adult population is participating in education and training. According to Eurostat, 35 per cent of persons aged 25 to 64 stated that they received education or training in the four weeks preceding the survey. The information collected relates to all education or training whether or not relevant to the respondent's current or possible future job

If we look at workers´ training provided by their employers, a little over half of all workers received some training in 2003, according to Statistics Sweden. The average length was about seven days. And there was no difference between young and old workers; the older had the same amount of training. Women had a little more than men. Public sector more than the private sector. A number of collective agreements have been concluded, including provisions on competence (skills?) development. Whether the "Frame-work of Actions on Life Long Learning", concluded some years ago on the European level has had any influence so far is difficult to say. But from the unions' side, we are of course pushing for it.

To what extent did privately owned companies provide staff training? In the latest survey published in 1999 we can see that at least nine out of ten companies in Denmark and in Sweden provided training. This survey is made every fifth year.

Initiatives by the partners to handle structural change

Let me mention two initiatives by the social partners which both have been of great importance and can serve as good examples on partnerships and in line with the Lisbon Strategy.

First, the Agreements on Transition, often known as Relocation Agreements. Today, these agreements cover many sectors of the labor market. The purpose is to help redundant employees find new careers by providing them with various educational and retraining schemes which are supplementary to the schemes at the public employment service. These agreements are signed by the social partners, and are administrated by foundations called "job security councils. The councils' activities are financed by the employers, who pay a calculated share of wages to council funds.

In 1974, the first council was established covering salaried employees in industry and services. Government sector employees, bank employees and employees in municipal companies where included in agreements during the 1990's, and in the most recent agreement, which was signed last year, workers from the predominately blue-collar organization in the private sector were also included. All employees working with employers covered by the agreements are included under the activities, regardless of whether they are trade union members or not. Eight to nine out of ten of those who were looking for a new job succeeded to find one.

Being jointly run by the social partners gives a stronger cooperation between the employers' organizations and the trade unions as they take a responsibility for necessary changes.

Second, the Industrial Agreement. This is referred to in the Swedish Reform Program submitted last fall to the Commission.

In 1997, this agreement was made between twelve employers' associations and eight trade union organizations, representing effectively all industrial sectors in Sweden. The agreement is unique in its scope: it covers essentially the entire sector of the Swedish economy that is exposed to competition, it bridges old boundaries between blue collar and white collar employees on the union side, and it introduces an entirely new model for collective bargaining and conflict resolution.

The parties take joint responsibility for wage determination in their area of the labour market and contribute to more effective wage determination, which makes it possible to combine low unemployment and stable prices.

In the agreement, the parties set out their joint assessments of the prospects for industrial activities including international competition, economic conditions, competitiveness and energy availability. The importance of research and development as well as education and skills development for industry is studied in more detail and reported to an Industry Committee.

A framework for a wage negotiations procedure is outlined in the bargaining part of the agreement. It intends not to resort to industrial action. The parties are required, under the agreement, to start negotiations three months before the previous agreement is due to expire and to complete them before it expires.

The Industrial Agreement has set a standard for the other bargaining parties. The government has been impressed by it and is referring to it both in the National Reform Programme and in its Research Bill to the Parliament.

'GETTING TRAPPED IN LOW WAGE JOBS: THE FRENCH EXPERIENCE'

Emmanuel Mermet[1]

The current situation in France prompts two severe observations in terms of links between macroeconomic policy and reform strategy: at the moment, France represents the counter-example for Europe of what NOT to do!

Firstly, its macroeconomic policy is not consistent with either the European objectives or the objective of improving growth.

The government's major strategy has been to reduce the State's tax take and social security revenue by lowering income tax and introducing relief for social security contributions on low wages (up to 1.6 times the minimum wage).

The result of this policy has been to drive up public deficits, which for several years have been breaching the objectives of the Stability and Growth Pact (a ceiling of 3%) and the Maastricht criteria in terms of public debt. Debt today is in excess of 65% of GDP, standing at over 1000 billion euros! This puts it well over the 60% in the Maastricht criteria!

The point is that the drop in the tax take, without a reduction in spending, has encumbered the State's accounts: for it is difficult, during a serious economic slow-down, to cut spending as well, particularly in the social field.

Moreover, the drop in income tax, already implemented in 2002, 2003 and 2004 and scheduled for 2007, has not supported household consumption. On the contrary: it has had the effect of increasing inequalities, since it has been of greater benefit to the better-off. The lower social security contributions have not significantly supported job creation or have meant specialist job creation in terms of low wages, trapping the workers concerned in low-paid work and deskilling. There is no incentive for businesses to raise wages above a certain threshold because they will lose the relief. Neither is it worth their while to invest in employee training or innovation, for this will also mean losing the relief if wages start moving above the ceiling of 1.6 times the minimum wage.
Secondly, regarding the reforms and the Lisbon Agenda, the government has opted to force its way through, as witness the recent news about the First Employment Contract (Contrat Première Embauche or CPE). The CPE, which allows young workers aged under 26 to be sacked during the first two years of work with no reason given, stigmatises young people who already find it difficult to get into the labour market.

By refusing to use the path of social dialogue, the government has deprived itself of another labour market reform which might have secured a consensus. By not applying the 2004 law on the priority of the social dialogue over the law in the field of the labour code, it even broke its own political commitments. On top of that, the CPE project runs counter to the spirit of Lisbon, because it does not make it possible to offer the flexicurity promoted at the European level: it allows flexibility, but not security.

In addition, the CPE did not appear in the National Reform Programme (NRP) recently presented to Europe (nor was this NRP prefaced by any consultation with the trade unions). This should be emphasized by the European Commission!

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PART 3 Structural reforms and the european macro-economic policy regime

PART 3

PART 3
Structural reforms and the european macro-economic policy regime

MONETARY POLICY AND STRUCTURAL REFORMS IN THE EURO AREA

Ad van Riet[1]

1. Introduction and overview

The Governing Council of the European Central Bank (ECB) set out its monetary policy strategy for maintaining price stability in the euro area in October 1998, just before the inception of the single currency on 1 January 1999. This stability-oriented monetary policy strategy, which was reviewed and confirmed in May 2003, provides a medium-term framework for analysing and assessing how changes in the economic and monetary environment affect the outlook for price developments and the risks for price stability in the euro area[2].

The ECB naturally takes account of the structural characteristics of the euro area economy (notably in terms of the functioning of its labour, product and capital markets, the efficiency of its institutions and the effectiveness of its adjustment mechanisms), as well as the authorities' structural policy measures in these fields. More precisely, it examines how changes in these structural features alter the economy's response to shocks and to what extent structural reforms are likely to affect the euro area's current and expected economic and financial conditions, its longer-term economic performance and, in particular, the medium-term outlook and risks for inflation in the euro area.

In this context, the ECB also considers how changes in the structural characteristics of the euro area economy – including those resulting from structural policy measures – may affect the conduct of monetary policy via their impact on the operation of the monetary transmission mechanism. The focus in this respect is on the efficiency and effectiveness of its interest rate actions in achieving the desired impact on the euro area economy in general and price developments in particular (see ECB, 2000).

Overall, this comprehensive analysis of the inflation prospects and the optimal interest rate response provides the basis for the ECB's monetary policy decisions, which are geared in an unambiguous manner towards the maintenance of price stability over the medium term. This credible anchor for longer-term inflation expectations is an indispensable contribution to a stable economic environment in which the decisions of other policy-makers – also in the field of

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[2] See ECB (2004a) for a general overview of the characteristics of the monetary policy of the ECB.

structural policies – and the actions of individual firms and households can be most welfare-enhancing. Maintaining price stability in a lasting manner should therefore be seen as the best way for the ECB to support the standard of living of the euro area's citizens and, thereby, the realisation of the strategic objective for the European Union (EU) set by the Lisbon European Council in March 2000 (see European Council, 2000; and Trichet, 2004a).

Following this introductory overview of the main mechanisms at work, the purpose of this contribution is to give a broad-based account of the possible interactions between the ECB's monetary policy, on the one hand, and structural policies in the euro area, on the other. While it does not provide a model-based framework, the aim is to present in a qualitative manner the most relevant channels. Two questions will be addressed in this context. Section 2 will deal with the question of how structural reforms may affect the conduct of monetary policy in the euro area. Section 3 discusses how, in turn, the euro area's monetary policy through its consistent focus on maintaining price stability supports the reform process and, thereby, the realisation of the Lisbon agenda. Finally, Section 4 emphasises the urgency of further structural reforms in Europe.

2. How do structural reforms affect the conduct of monetary policy in the euro area?

Starting with this first question, the key point to observe is that structural reforms change the economic and financial environment which is relevant for monetary policy decisions. In particular, effective reform measures affect the structure, institutions, flexibility, potential and performance of the economy through various channels, depending on the composition of reform packages. A few examples may illustrate this point[3].

- Completing the EU internal capital market and deepening the degree of financial integration in Europe would offer further scope for exploiting economies of scale and increasing competition in financial markets. This would relax liquidity constraints, cut transaction costs, reduce the cost of capital, and make it easier for investors to diversify risks and hedge against the consequences of unforeseen economic developments. The resulting more efficient allocation of capital, in turn, should be expected to raise the productivity of financial investments.
- Measures aimed at opening up goods and services markets to domestic and foreign competition would also offer more scope for exploiting economies of scale, allow for a more productive (re)allocation of resources and stimulate market entry. A higher level of competition would reduce excessive rents of firms, which translates into lower prices, facilitates wage moderation and raises output and employment. More competition also creates stronger incentives for firms to have a flexible production capacity and a less rigid price-setting mechanism in place and to be as efficient as possible. This drive towards greater flexibility and efficiency is likely to stimulate technological innovation and promote new investments, supporting both productivity growth and job creation.
- A free mobility of workers in the EU internal market, less regulations which unduly protect the jobs of 'insiders' at the expense of 'outsiders', and adequate training facilities to support occupational mobility and a better 'matching' between jobs and workers should be expected to improve the functioning of labour markets. Together with wage differentiation in line with regional, sector-specific and local labour market conditions and productivity developments, this will help to avoid excessive wage increases and reduce structural unemployment. In this context, a more forward-looking and flexible wage formation process increases the capacity to absorb negative shocks, thereby avoiding prolonged output and employment losses.
- Well-focused fiscal reforms undertaken by the government would complement and enhance the above benefits. A 'high-quality' public sector would offer stronger incentives to work, save, invest and innovate. In particular, reducing distortions caused by tax and benefit systems, relaxing excessive regulations to ensure a business-friendly environment and providing adequate facilities for education and research would contribute to increasing the effective supply of resources. In addition, fiscal consolidation and lower government debt ratios would support the public's confidence in the longer-term sustainability of public finances, thus fostering economic stability and output growth.

Overall, appropriately designed structural reforms aimed at well-functioning labour, product and capital markets characterised by efficient institutions and effective adjustment mechanisms will

3 For a more detailed overview, see e.g. European Commission (2005).

translate into a more dynamic and resilient economy with a stronger economic performance, more employment, lower prices and higher real incomes.
For the conduct of monetary policy in the euro area, the possible effects of structural reforms such as those mentioned above are highly relevant. Two aspects need to be considered in this context, namely:
1) The impact of reforms on the medium-term outlook for inflation and the risks for price stability in the euro area; and
2) The impact of reforms on the operation of the monetary transmission mechanism and the optimal interest rate adjustment.
As regards *the first aspect*, following its EU Treaty mandate to maintain price stability in the euro area, the monetary policy strategy of the ECB requires a comprehensive examination of all factors of relevance for the cyclical and the longer-term components of the inflation process. The favourable impact of well-designed EU-wide or aggregated national structural reforms should be expected to show up in two ways (see e.g. Duisenberg, 2003; and Trichet, 2004b). Assuming successful implementation, the effects of such reforms would arise at the euro area level firstly in the form of a positive supply shock (which in some cases may be accompanied by a negative demand shock) with possible consequences for the inflation prospects. Secondly, they change the structural characteristics of the euro area economy. As these determine how shocks which threaten price stability pass through the economy, they are of key interest when analysing the inflation dynamics and prospects. Several channels may be considered in this respect.

From a longer-run perspective, effective reform measures should be expected to increase the structural efficiency and flexibility of the euro area economy and thereby its growth potential. In particular, stronger potential output growth would raise the benchmark for desirable medium-term money growth and raise the level at which the economy can sustain output growth without inflationary pressures arising. The outlook for inflation is also likely to be affected by the associated reduction of structural unemployment, which should delay the emergence of wage pressures during a recovery. Measures allowing for free market entry and more effective competition should reduce excessive mark-ups of firms, which in turn would allow for lower relative prices in the affected sectors. This also implies that during the period of transition to the new equilibrium the rate of price increases in these sectors, and possibly also in the economy at large, would fall. A more flexible economy, allowing for a faster reallocation of available labour and capital resources would help to avoid bottlenecks and excessive wage and price rises. Furthermore, a greater flexibility of wages and prices in absorbing rather than accommodating shocks threatening price stability and a more forward-looking behaviour of economic actors more generally may reduce the risk of second-round effects of such shocks appearing in the form of wage and price increases. The implementation of supply-enhancing reforms (especially when associated with an initial contraction of demand) may in the short run change the balance between aggregate supply and demand, temporarily raising the degree of slack in the economy. However, an offsetting factor in this case could be that convincing structural reforms are conducive to supporting consumer and business confidence, thereby improving demand conditions and the short-term economic outlook. Overall, if there is firm evidence that structural reforms – taking all other economic and monetary factors into account – contribute to reducing wage and price pressures at the euro area level, a central bank with a mandate and strategy like the ECB will normally react in order to maintain price stability over the medium term.

Moving on to the second aspect, structural reforms may also affect the conduct of monetary policy via their impact on the operation of the monetary transmission mechanism and the most appropriate interest rate adjustment (see ECB, 2000; and Trichet, 2004a, 2004b). In particular, measures which improve the functioning of markets (notably by removing barriers to competition and breaking down rigidities which constrain the adjustment of wages, prices or supply) will tend to make it easier for monetary policy-makers to deal with temporary shocks to inflation. This derives from the fact that, as noted above, in more flexible labour and product markets, workers and firms have more room for manoeuvre to absorb such shocks without protracted inflationary pressures unfolding. Under such favourable circumstances, a smaller interest rate response than would otherwise be necessary may be sufficient to maintain price stability. Moreover, in less rigid economies a period of interest rate adjustments may be shorter than otherwise, as their impact would pass through the economy more quickly. Accordingly, successful structural reforms leading to better-functioning markets and a more resilient economy also tend to reduce the volatility of output and employment associated with shocks to

inflation and the necessary monetary policy reaction. Overall, structural reforms enhance the efficiency and effectiveness of monetary policy actions and thus facilitate the task of the central bank to maintain price stability.
To the extent that structural reforms generate a stronger dynamic efficiency and permanently raise the level of potential output and productivity growth, and thus the return on capital, economic theory argues that the level of the 'natural' real interest rate must rise, in order to generate sufficient savings to meet the higher investment demand. Arguably, from a conceptual point of view, this 'natural' real interest rate is an important benchmark for monetary policy, providing guidance for the central bank's optimal real short-term interest rate in the long run. However, as the 'natural' real interest rate is unobservable and can only be estimated with a large degree of uncertainty, the ECB has clarified that it does not use this concept in the actual conduct of its monetary policy (see ECB, 2004b).

While all the aforementioned effects of structural reforms on the euro area economy would in principle be taken account of in the conduct of monetary policy, a careful evaluation is always needed, since considerable uncertainty exists about the quantification and persistence of their impact. A relevant question is, for example, whether favourable reform measures should be expected to just raise the level of economic potential as a one-off, in which case the economy will temporarily enjoy stronger output growth in the period of adjustment to the new equilibrium; or, alternatively, the economy may be seen as moving to a permanently higher potential growth path as a result of a greater dynamic efficiency. A similar question is whether effective reforms reduce the rate of relative price changes in the affected sector(s) only temporarily, or for a prolonged period of time, for example by generating a more anti-inflationary attitude among economic actors[4].

A further complication in assessing the impact of structural reforms is that some measures may entail short-term implementation costs, which could trigger opposition from interest groups, even when over time these costs would be far outweighed by the longer-term gains for the whole society. The occurrence and persistence of such opposition critically depend on the credibility of the political reform process. Sometimes, reforms are not implemented in the way they are announced, they comprise piecemeal rather than comprehensive measures, their design or sequencing may be questioned, their long-run benefits are communicated poorly, or there is no instrument in place to facilitate the adjustment process for those affected. Under such circumstances, the general public might be doubtful about the (net) positive effect of reforms. This makes it more difficult to gain approval for new reform measures and/or complicate their successful implementation in practice (especially when this depends on a change of behaviour by households or firms). Given this complex reality, in which the 'actual results' of structural reforms may deviate substantially from the initial 'expectations', monetary policy-makers have no alternative than to take a cautious approach when conducting a 'real-time' assessment of how the whole range of structural policies will affect the economic and financial structure and the outlook for inflation.
Another important point to note is that there is no mechanical link from structural reforms to the monetary policy stance, as a decision to change interest rates must always take account of the full range of factors – including those unrelated to structural reforms – which determine the outlook and risks for price stability at the euro area level. Accordingly, accommodating a priori the positive effects of structural reform measures, irrespective of the prevailing uncertainties and inflation risks, would undermine the credibility of monetary policy in the euro area and conflict with the EU Treaty mandate of the ECB to maintain price stability as an independent institution[5]. As discussed in Section 3, such a result would be the exact opposite of how monetary policy-makers could best support the political reform process in Europe.

3. How does the euro area's monetary policy contribute to supporting structural reforms and the Lisbon agenda?

The second question to address is how the euro area's monetary policy helps to increase the incentives for implementing structural reforms and thus

4 For a discussion of these two questions, see ECB (2006b).
5 In a similar vein, the OECD (2006, p. 17 and 54) stresses four key conditions for a monetary policy reaction to supply-enhancing structural reforms: 1) a prevailing low and stable inflation environment; 2) a credible commitment to implement a series of reforms; 3) a prudent estimation of the positive impact of reforms on potential output, and 4) clear signs of downward pressure on inflation in case demand does not autonomously expand in line with the increased output potential.

contributes to the implementation of the Lisbon agenda. The key point to note with this question is that the ECB's credible commitment to maintaining price stability over the medium term, as well as its contribution to safeguarding financial stability, have a favourable influence on the economic and financial environment in which the reform process takes place. Again, two aspects may be considered, namely:
1) How price stability helps to identify where reforms are needed; and
2) The way price stability facilitates the implementation of reforms and the achievement of the Lisbon objectives.
As regards *the first aspect*, in an environment characterised by price stability it is much easier to distinguish changes in relative prices from changes in the general price level. Even in an environment of stable average prices, some prices for individual goods and services will still be rising and prices for other goods and services falling. This diversity in price developments reflects specific demand patterns for individual products due to changing preferences, as well as specific supply developments in individual industries such as those related to the pace of technological progress. In this respect, the distribution of price changes for individual goods and services around the average for all products provides signals for economic actors on the basis of which they can take well-informed consumption and investment decisions, adequately assess market developments, and if necessary adjust their demand or supply. However, they will not be able to recognise the signals provided by relative prices when these are obscured by overall inflationary tendencies.

Accordingly, an environment characterised by price stability facilitates very much the identification of those sectors in the economy where reforms may be most necessary. In particular, it would be easier to isolate excessive cost and price increases in a specific sector when there is not at the same time a more general tendency for prices to rise in the economy. For example, 'underperforming' industries may be faced with a lower productivity growth than other, comparable industries, causing relatively high unit labour cost and price increases and damaging their competitiveness. This signals a need for efficiency-enhancing measures to improve performance. Also, rent-seeking behaviour associated with lacking competition in a particular market will normally show up in relatively strong price rises. As in an environment of overall price stability such excessive relative price developments will be transparent to everybody, they provide a clear signal for the competent authorities to take corrective action aimed at opening up the market concerned and ensuring more effective competition. By contrast, a significant decline in relative prices in a particular market arising from free entry of new competitors clearly shows the benefits of such actions for consumers and producers[6]. In a similar way, the micro-studies of price-setting behaviour in the euro area countries undertaken by the Eurosystem's Inflation Persistence Network have provided indications of the (lack of) price responsiveness for individual product categories in the consumption basket as well as in specific industries. These results are very useful for identifying the sectors where reform measures should aim at increasing competition and flexibility (see ECB, 2005b).

Regarding the *second aspect*, it is important to recognise the substantial benefits of price stability for society (for an overview, see ECB, 2004a, pp. 42-43). As already noted above, a stable general price level makes it easier for everybody to rely on the signals provided by relative price changes. Since the euro area's monetary policy via its consistent focus on price stability provides a credible anchor for longer-term inflation expectations, there is also no reason for creditors to demand inflation risk premia in real interest rates, for workers and firms to let their wage and price formation be influenced by inflationary tendencies, or more generally for individuals to engage in costly hedging activities against future inflation (or deflation) risks. Furthermore, price stability avoids that the distortions to economic behaviour caused by tax and social security systems are further exacerbated by inflation (or deflation). An environment of price stability – in conjunction with financial stability – is therefore a vital contribution to a stable economic and financial environment. As inflation (or deflation) also often causes an arbitrary and unpredictable redistribution of incomes and wealth and typically hits the weakest members of society most, price stability also helps to maintain social stability.

Such an overall stable environment promotes more forward-looking behaviour and allows for individual decisions of workers, savers and investors about the supply and allocation of labour, capital and other

6 See e.g. ECB (2001) and Martin et al. (2005), which take a closer look at the case of network industries.

resources to be taken in the most efficient and productive way. In the euro area, these benefits are further enhanced by the many opportunities offered by a large single currency area in which internal cost and price transparency is not clouded by exchange rate uncertainty. This favourable constellation, in turn, will foster non-inflationary and sustainable economic growth, enhance employment and support social cohesion, in line with the Lisbon objectives.

Moreover, as noted above, in such a stable environment the benefits of structural reforms are both more obvious and less diffuse. They are more obvious, because the welfare-enhancing effects would surface faster and would be more substantial. And they are more visible, as they are not masked by overall inflationary dynamics or surrounded by major uncertainties about whether they are for real. Overall, this should be expected to underpin the credibility of the political reform process and the Lisbon agenda. As a consequence, it will be easier for structural policy-makers in Europe to persuade the general public of the advantages of reforms in the longer run and remove scepticism regarding any short-term costs. This should facilitate the political decision-making process in support of such reforms as well as their implementation.

4. The urgency of structural reforms in Europe

As argued by Issing (2004), the ambitious Lisbon agenda agreed in the year 2000 has been crucial for raising Europe's awareness of the need for structural reforms. However, in the first few years the implementation of this agenda was disappointing. Following the mid-term evaluation of the progress made, the European Council (2005) therefore decided to relaunch the Lisbon strategy and to refocus its priorities on growth and employment – also as a way to reach those related to the environment and social cohesion (see ECB, 2005a). In addition, more convincing fiscal consolidation should improve the conditions for stronger output growth and job creation. The introduction of a Community Lisbon Programme and the stronger commitment of EU Member States through the submission of National Reform Programmes (after consultation with national stakeholders and national parliaments) are welcome improvements in order to pursue the implementation of the Lisbon agenda in a more determined manner. This determination is all the more important, as since the year 2000 the challenges from accelerating globalisation, rapid technological progress and ageing populations have not abated, but only become more pressing.

To address these challenges, a comprehensive and consistent reform strategy would have the best chances of success[7]. Completing the EU internal market should be a key ingredient of this strategy in order to foster an efficient allocation of resources, larger economies of scale and an attractive business environment in which competition is the driving force behind ongoing investment, innovation and the creation of new firms and jobs. The necessary labour market measures are wide-ranging. They should comprise reform of tax and benefit systems to increase labour supply, both in terms of the number of workers and the hours worked on a life-time basis[8]; address labour market rigidities and promote wage flexibility to increase labour demand; and create better life-long education and training systems as a way to improve human capital and prepare workers for the future[9]. Last, but not least, governments need to contribute their share by providing sustainable and high-quality public finances (see e.g. ECB, 2006a). In line with the original strategic goal of the Lisbon agenda, such a comprehensive and consistent reform package would be conducive to a more dynamic and 'shock-resistant' European economy, which features well-functioning labour, product and capital markets and stronger incentives to work, save, invest and innovate.

As noted by the European Council (2006), enhanced structural reforms and further fiscal consolidation are of special importance for the euro area countries. A more critical assessment of

7 Evidence presented by Hauptmeier et al. (2006) suggests that public expenditure reforms in industrialised countries in the 1980s and 1990s were most successful in terms of raising economic growth and improving fiscal performance if they were part of a comprehensive package rather than a piecemeal approach. Annett (2006) stresses the consistency of structural policies, both internally and over time, as a keylesson from successful reform cases, i.e. the selected product market, labour market and fiscal reforms should complement and reinforce each other and be continued over a longer period.

8 For an analysis of the causes and consequences of the trend decline in average hours worked in euro area countries over the past decades, see Leiner-Killinger et al. (2005).

9 See ECB (2002) for a discussion on the efficiency of the matching process on the euro area labour market.

the progress made by these countries would therefore be in order. Three arguments may be offered which support this view. In the first place, well-functioning markets and stronger supply incentives would offer scope to better exploit the substantial welfare-enhancing benefits of the euro associated with the implied internal cost and price transparency and low transaction costs. Given these benefits, the adoption of the single currency should in principle have created strong incentives for euro area countries to undertake reforms – even if a supporting monetary policy reaction, as explained above, cannot be taken for granted (compare Duval and Elmeskov, 2006; and OECD, 2006, p. 54). Secondly, in an integrated single currency area the advantages of moving to flexible euro area economies are more obvious, as this would increase the capacity to cope with asymmetric shocks. For example, in several euro area countries structural reforms should promote more rapid wage and price adjustments and more effective adjustment mechanisms in general in order to deal with deviating trends in intra-euro area competitiveness. Thirdly, moving to sound public finances would create scope to let automatic stabilisers work in case of asymmetric shocks in the euro area. Moreover, fiscal discipline and the long-term sustainability of public finances in the member countries are essential to underpin confidence in the internal and external stability of the euro. Overall, realisation of the Lisbon agenda would improve the performance of the euro area economy, increase its resilience to shocks, and also strengthen its cohesion. This is vital for the long-term credibility of the euro.

While there is a political consensus about the urgency of further structural reforms in Europe, there is still some resistance to taking the necessary steps. Some observers have raised the question of 'the right time' for implementing structural reforms. As observed by Blanchard (2006, p. 47), reforms encounter less opposition in an economic upswing, when unemployment is falling. However, he also notes that a cyclical upturn in fact also alleviates the political need for reforms and thus tends to delay rather than encourage them. This suggests that the underlying economic challenges facing a society must rather be addressed as and when they arise, irrespective of the stage of the business cycle[10]. Postponing unavoidable measures would not increase the chances of their implementation, but only raise the burden of adjustment and prolong the period needed to offset any initial output and employment losses.

The challenge is to explain in a convincing manner the need to rejuvenate the European economy and the longer-run welfare-enhancing benefits of reforms to the general public, while facilitating to the extent possible the adjustment process for those affected. For its part, the ECB will continue to support the reform process in Europe, in the first place by maintaining price stability for the euro area; secondly, by contributing to safeguarding financial stability; and, finally, by explaining the necessity of structural reforms for safeguarding the standard of living of Europe's citizens.

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10 Case studies presented by Hauptmeier et al. (2006) and Annett (2006) find that the most successful reform programmes have been initiated in 'bad times' and tended to continue in 'good times', i.e. the countries concerned did not wait for the 'good times' before taking action.

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POTENTIAL OUTPUT - A QUESTIONABLE CONCEPT [1]

Gustav Horn [2] - September 2006

1. Introduction

Potential output measures a country's sustainable aggregate living standard and is thus one of the most important categories of economics. It is also a key indicator for monetary and fiscal policy. The ECB, for example, uses the output gap – the relative difference between potential output and GDP – as a leading indicator of inflation and requires a precise growth rate of potential output to determine its reference value for M3. Potential output is also relevant for fiscal policy and medium-term fiscal planning, for example to determine the structural budget deficit. Despite its importance, however, potential output is a difficult concept to pinpoint both theoretically and even more so empirically.

In this article results are presented that highlight the theoretical difficulties of defining potential output in an unambiguous way. We then discuss the causes of the marked revisions of potential output estimates by major international research institutions. In the final section policy conclusions are drawn from the fact that estimates of potential output are rather inexact and even unreliable.

2. Potential output in a theoretical perspective

Potential output is the sustainable level of real (inflation-adjusted) GDP. It is constrained due to limited natural resources (population, raw materials), institutional factors (e.g. on labor markets) and the factor

1 This article is an abbreviated version of Horn/Tober /Logeay (2006).

2 Gustav Horn, IMK-Düsseldorf

endowment (especially the capital stock and human capital). A given level of output is sustainable if it does not generate inflationary or deflationary tendencies.
Arthur M. Okun, who coined the term potential output in 1962, defined it as the level production at full employment, the latter according to Okun referring to the degree of utilization of the factors of production that does not cause inflationary pressure. The concept of potential output necessarily implies an unemployment rate greater than zero in a free society and in peaceful times. Therefore its analysis also requires analysis of this "equilibrium" unemployment rate, the non-accelerating inflation rate of unemployment (NAIRU). Okun's aim was to quantify the material loss resulting from an increase in unemployment and to provide a measure for full capacity utilization indicating whether economic policy action is required. In this vein the Okun coefficient quantifies the negative relation between changes in the unemployment rate and GDP. For Germany the Okun coefficient calculated on the basis of the period 1995–2005 is 1.1[3]. An increase in the unemployment rate by 1 percentage point therefore implies by and large a reduction in GDP by 1 %.

The concept of a sustainable level of output devoid of inflationary and deflationary tendencies is much older than the terms „sustainable", potential output" and „Nairu". More than a century ago Wicksell (1936 [1898]) in his analysis of the "natural" rate of interest asserts that the ratio of output to potential output affects the price level and that inflation theory must analyze the development of aggregate demand and supply. Although Wicksell did not use the term potential output or the term "natural" output level, the concept is obviously implicit in his analysis. Full employment in this context does not mean zero unemployment. Okun, for example, calculated potential GDP on the basis of an unemployment rate of 4 % (Okun 1962: 98) and Joan Robinson (1962: 88f.) emphasized that "if we ever reached and maintained a low level of employment, with the same institutions of free wage bargaining and the same code of trade union behaviour, a vicious spiral of rising prices and rising wages would become chronic."

The NAIRU[4] implied in these quotes may not only be affected by institutional factors, but also by macroeconomic policy as indicated by the quotes below.
"In some countries, such as the United States, the rise in unemployment was transitory; in others, including many European countries, the Nairu rose and has remained high ever since. I argue that the reaction of policymakers to the early 1980s recessions largely explain these differences. ... In countries where unemployment rose permanently, it did so because policy remained tight in the face of the 1980s recessions." (Ball 1999: 190)
"... the long-run aggregate supply curve may be vertical, but its location is endogenous to macroeconomic policy." (Solow 1998: 11)

The theoretical difficulties of unambiguously defining potential output are due to divergent opinions about the persistency of output gaps and the possible endogeneity of potential output, both of which arise from different assumptions about the inherent stability of the economy. From a Keynesian perspective the effectiveness of endogenous mechanisms that return the economy to equilibrium is uncertain at best. Long-lasting negative output gaps are thus a likely occurrence and entail the danger of hysteretic effects causing potential output to adjust to the GDP rather than vice versa. In contrast, monetarists and proponents of new classical theory hold the view that the rational behaviour of economic agents rapidly corrects disequilibria and that potential output is unaffected by economic downswings and upswings. New Keynesians occupy a position somewhere in between. Economic policy advice differs in accordance with these divergent views. Whereas Keynesians tend to favour active macroeconomic stabilization policies and regard macroeconomic policy as a necessary adjunct to structural reform, monetarists and new classical theorists view macro policy as more or less superfluous, argue strongly for rule-based policies, and consider structural reforms to be the key to higher economic growth.

From the viewpoint of neoclassical theory and most New Keynesian approaches, the endogenous adjustment towards a full utilization of potential output is

3 For the United States Okun had calculated a coefficient of 3.3. However, his estimation is flawed because he estimated the coefficient on the basis of the unemployment rate as the dependent variable and GDP as the independent variable and then used the reciprocal of the calculated coefficient to quantify the dependency of GDP on the unemployment rate. When estimated directly (and thus correctly) the coefficient is 2.

4 The NAIRU concept was developed by Modigliani and Papademos (1975), who, however, called it NIRU (noninflationary rate of unemployment). The term NAIRU was first used by Tobin (1980). Unlike the term "natural rate of unemployment" introduced by Friedman in his Presidential Address to the American Economic Association in 1968, the NAIRU is not a purely neoclassical concept; see Carlin / Soskice (1990: 166).

relatively simple[5]. Assume for example that potential output rises due to an unperceived increase in technological progress. The resulting excess supply will cause prices and wages to fall until the real demand at given nominal demand increases sufficiently to match it. Say's law is valid in all variations of neoclassical theory: supply creates its own demand. The adjustment mechanism is analogous in case of an increased labor supply resulting, for example from a higher participation rate. At the outset with a given capital stock, competition between workers causes real wages to fall to a level compatible with full employment[6]. The increase in employment implies an increase in the marginal productivity of capital which generates higher investment and a corresponding increase in the capital stock[7]. When adjustment is completed both employment and the capital stock are higher than before and real wages have returned to their initial level[8]. Certain strands of Keynesian theory[9] question whether aggregate demand remains unchanged in face of falling wages:

"For, whilst no one would wish to deny the proposition that a reduction in money-wages accompanied by the same aggregate effective demand as before will be associated with an increase in employment, the precise question at issue is whether the reduction in money-wages will or will not be accompanied by the same aggregate effective demand as before measured in money, or, at any rate, by an aggregate effective demand which is not reduced in full proportion to the reduction in money-wages."
(Keynes [1936] 1964: 259 - 260)

If price adjustments are not instantaneous and perfect as assumed in the neoclassical model, quantities will adjust which in turn affects production, employment and income (Tobin 1993: 46). If new hiring is not immediate, aggregate demand will fall as a result of lower nominal income.

„The relevant labor demand curves are the nominal values of marginal products. These values will fall, the demand curves will shift down, if and as product prices fall. Product prices will fall because nominal labor incomes decline along with wage rates; as a result workers' money demand for the products they produce will decline too. Here, then, is a case in which demand and supply schedules do not stay put while the price adjustment to excess supply takes place. It is illegitimate to appeal to the intuition that seems so credible for single markets."
(Tobin 1993: 58)

The main point of theoretical contention is the question of what happens when the price level or the rate of inflation falls unexpectedly. Does the relative decline in the price level raise real aggregate demand thus providing for an endogenous stabilization, as argued by neoclassical theory? Or is it likely, as put forth by Keynesians, that endogenous expansionary forces fail to take hold in which case the restrictive effects of the relative decline in the price level may even dominate and cause a recession or cumulative destabilization?

„(T)he question is whether proportionate deflation of all nominal prices will or will not increase aggregate effective real demand."
(Tobin 1993: 58)

The two potential expansionary effects are the Keynes effect and the real balance effect, both of which assume a constant (expansion of the) money supply. The decline of interest rates postulated by the Keynes effect may be thwarted by a liquidity trap or else their effectiveness hindered by a low interest elasticity of investment. Furthermore, if disinflation is expected to continue the marginal efficiency of capital may decline thus lowering investment[10].
According to the real balance effect economic agents consume and invest more as the real value of their cash balances and financial assets increases as a result of falling prices (Patinkin 1992, Tobin 1993). This wealth effect, which is central to neoclassical theory, may be countered by the Fisher effect. According to the Fisher effect, a falling price level or a falling rate of inflation (relative to expected values) increases the debt burden of enterprises thus negatively affecting production and investment[11].

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5 King (2000: 49) calls the New Keynesian Model the „New Neoclassical Synthesis" because of the similarities between New Keynesian theory and neoclassical-monetarist theory.

6 The underlying assumptions in the following are perfect markets, a substitutional production function, constant returns to scale and a given international level of interest rates.

7 Cf. Bean (1997: 100), Burda/Wyplosz (1994: 204) and Gordon (1997: 439/441).

8 Real wages reach their original level if interest rates remain unchanged despite the higher level of investment; see, for example, Burda/Wyplosz (1994: 203ff.).

9 See, for example, Spahn (1997), Tobin (1993), Greenwald/Stiglitz (1993), Leijonhufvud (1990), Riese (1986).

10 This Mundell-Tobin effect is also mentioned by Keynes (1936). Post-Keynesians furthermore stress the income-distribution effect: The lack of aggregate demand is aggravated by the fact that in the process of falling wages and prices income is redistributed at the expense of wage earners, who have a higher propensity to consume (Kalecki 1939 und 1942).

11 Creditors and debtors exist also in the case of base money since base money primarily enters circulation when firm stake loans from commercial banks which in turn borrow money from the central bank.

The decrease in activity of firms and banks as a result of negative liquidity and wealth effects is, for example, analyzed by Greenwald/Stiglitz (1993). In the words of Patinkin (1992: 297):

„... the question remains whether it [the real-balance effect] is strong enough to offset the adverse expectations generated by a price decline, including those generated by the wave of bankruptcies that might well be caused by a severe decline. In brief, the question remains whether the real-balance effect is strong enough to assure the stability of the system: that is, to ensure that automatic market forces will restore the economy to a full-employment equilibrium position ...“

What are the consequences for potential output of a lack of endogenous stabilizing mechanisms, in particular the real balance effect? Initially there is none, only the emergence of a negative output gap, i.e. a deviation of production from its potential. The destabilising process of falling wages and falling aggregate demand will eventually come to an end in the face of nominal wage rigidity, but there is no endogenous tendency that brings output back to its potential. This output gap either persists or it closes as a result of diminished potential output. The former case is the one Keynes focused on in the General Theory and led him to conclude that *"an increase in the quantity of money will have no effect whatever on prices, so long as there is any unemployment"* (Keynes [1936] 1964: 295).

Similarly Blanchard/Summers (1986) analyse the case of unemployment equilibrium in the insider-outsider model. In this case expansionary macro policy or some other exogenous macroeconomic impulse is necessary and sufficient to close the gap. In the absence of disinflation policy makers, however, may falsely conclude that potential output has diminished and overlook the unemployment equilibrium.

An output gap that persists over a long period is unlikely from a theoretical perspective. Eventually capital stock adjustments (Bean 1997: 93; Gordon 1997: 439) and hysteresis on the labor markets[12] will lower potential output until the gap disappears. Underutilization of capital is small if it exists at all and the long-term unemployed may not be hired at the going wage even if aggregate demand picks up. Since monetary policy is generally believed to be powerful enough to cause output gaps in the short and medium run, the implication for monetary policy is apparent: if output gaps close as a result of labour market hysteresis and capital stock adjustments, then macro policy is not neutral in the long run but rather affects the real economy.

"...If monetary policy can affect real economic activity by means other than money illusion then it may be possible for money to be nonsuperneutral in the long run."

Espinosa-Vega (1998: 13)

In addition to the NAIRU, endogenous technological progress is a second channel through which macro policy may affect the level of potential output.

3. Revisions of Germany's potential output

From an empirical perspective it is also the NAIRU and endogenous technological progress that make it difficult to estimate and forecast potential output with certainty. Volatile outcomes resulting from small changes in the specification or the estimation period pose a problem for policy makers because estimation errors can have dire consequences for unemployment and inflation.

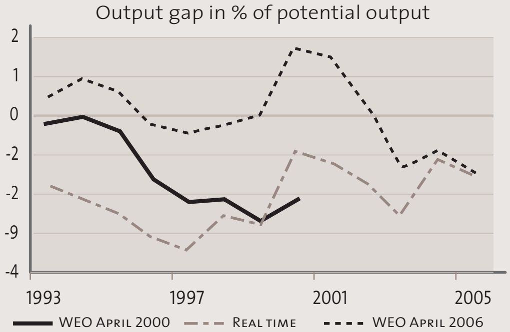
Methods to estimate potential output can be categorised into three groups: first, purely statistical methods (eg. Hodrik-Prescott filter and Rotemberg filter); second, methods that determine potential output primarily on statistical grounds but make use of the interaction between certain economic variables (semi-structural methods, eg. multivariate Hodrick-Prescott filter and multivariate Kalman filter); and third, methods that determine potential output on the basis of economic factors (structural methods, eg. production function approach). Only structural methods make possible a distinction between different theoretical approaches. They are also better suited for projections and simulations exercises, especially in the case of changes in the structural or macroeconomic environment at the end of the observation period. They are superior to univariate methods because they provide an economic explanation of movements in potential output.

In practice, however, estimates based on production functions are to a large extent based on univariate methods, especially the Hodrick-Prescott filter, to estimate the potential values of the individual components of the production function. It is there-

12 See Logeay/Tober (2006) for an overview of causes of labor market hysteresis.

IMF estimates at different points in time[1]

Output gap in % of potential output



[1] Real time is the output gap estimate for the year preceding the production year

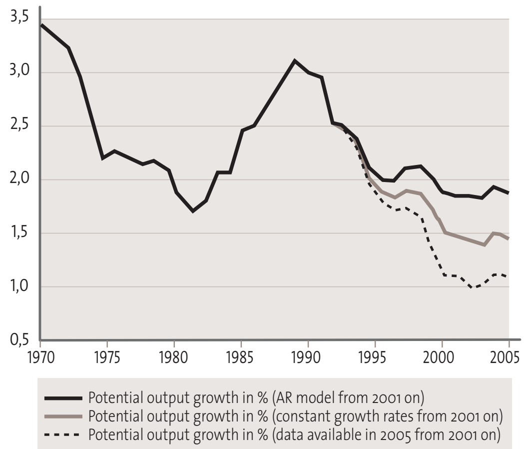
Source: International Monetary Fund, World Economic Outlook, spring issues 1994 to 2006

fore not surprising that the estimates of potential output of different institutions are quite similar and actually more similar than are the estimates of each organization for a specific year at different points in time. In the case of the International Monetary Fund (IMF) this difference can be exemplified best using the years 1999 and 2001. In the spring 2000 the IMF estimated Germany's output gap in 1999 to be -2.8 %; in the spring of 2006 the IMF puts the output gap in 1999 at +0.1 %: this is not only a difference of almost 3 percentage points but also a change from negative to positive. The real-time estimate of Germany's output gap in 2001, i.e. the estimate in the spring of 2001, was -1.2 %; from today's perspective (spring 2006) the IMF estimates the output gap in 2001 to have been 1.5 % and thus markedly positive. An equally stark picture emerges when looking at the figures provided by the EU Commission and the OECD. Revisions in this magnitude invalidate the use of measures of output gaps and potential output growth as indicators for economic policy. To illustrate the problem we calculate Germany's output gap for 2005 on the basis of the rate of potential growth that the IMF estimated in spring 2000 for period from 1992 to 2001, that is 2.1 %[13]. According to this calculation the output gap in 2005 would have exceeded 8 %.

The frequent and large potential output revisions are largely due to the econometric methods used for estimating potential output, in particular the endpoint problem and forecast mistakes, rather than a changing view about the structural factors of the German economy. To illustrate this point we use the following time series of the AMECO database for the period 1970-2007: real GDP, net capital stock, labor force, standardized unemployment rate, wage share and NAIRU. The time series for West Germany and unified Germany are linked using growth rates. We then calculate the average wage share (62 %) and – by rearranging the production function equation – a time series for total factor productivity (TFP).

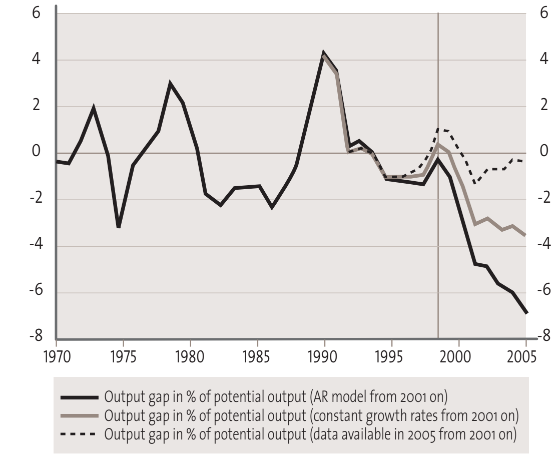
How revisions come about is shown using the potential labor force, potential TFP and the NAIRU. First, we use an HP filter on the labor force and TFP to produce their respective potential values and, subsequently, a series for potential output. Focusing again on the year 2000 we calculate an output gap of +1 %. Second, we go back in time to 2001, a time when the time series above included data up to only 2000. To extend the series until 2007 we apply the two methods most commonly used by international organizations: simple ARIMA models and ad-hoc extensions. In the ARIMA version TFP and labor force are estimated in log levels, more specifically with an AR(2) model with trend and a simple AR(2) model respectively. The new data points thus generated exceed the trend observed in 1995-2000. In contrast, the ad-hoc method extrapolates this trend. The NAIRU is in both cases generated according to the method used by the EU Commission, i.e. we increase (decrease) the NAIRU by half of the change in the preceding year. We now recalculate potential output based on these data. The time series generated by the AR model yields an output gap of 0.4 % in 2000, the trend-based approach one of -0.3 %.

Output gaps and potential growth in artificial real time



It is apparent that potential output estimates greatly depend on the expected values of its components which, in turn, largely depend on the respective previous development in the estimation models used (see chart above). It follows that current estimates of Germany's potential output may prove to be far too

[13] The potential growth rate deviates from 2.1 % in only two years, namely in 1995 (2.0 %) and in 1998 (2.2 %). This is probably due to rounding errors.

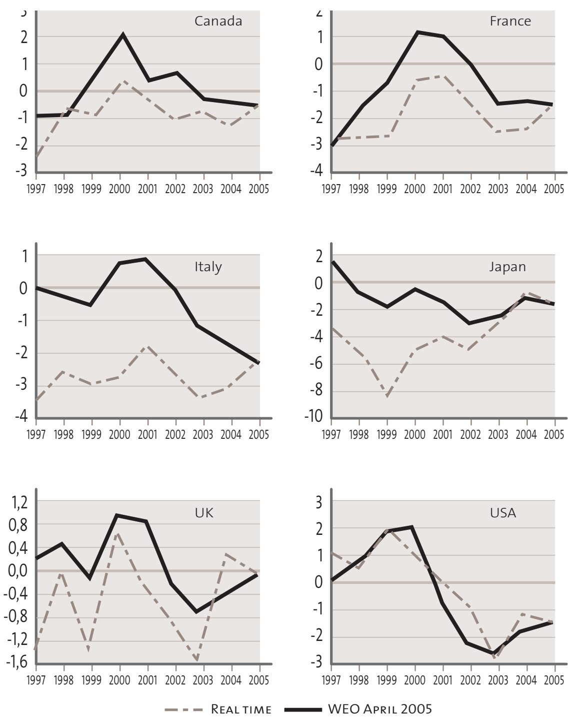


pessimistic if the economic weakness of the past years proves to be a temporary phenomenon and that they do rather reflect than explain the lower growth path of the recent years.

4. Revisions of other countries potential output

-The same problems basically occur for other countries. Taking the IMF and OECD estimates it turns out that for Italy the difference between real time potential output and latest figure is particularly high. As in the case of Germany Italy is a country with a lengthy spell of economic weakness. The relatively long duration of slow economic activity is the reason why the usual estimation procedures show a decreasing potential output that changes the interpretation of

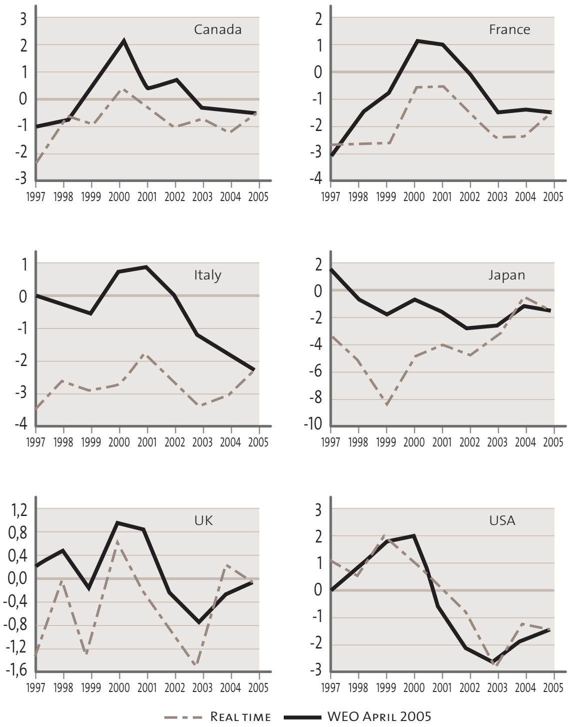
IWF estimates of the output gap in different countries at different points in time in % of potential output



1) Real time is the estimate of output gap for the appropriate year.

Sources: International Monetary Fond, World Economic Outlook, spring edition, 1997 to 2005.

OECD estimates of the output gap in different countries at different points in time in % of potential output



1) Real time is the estimate of output gap for the appropriate year.

Sources: International Monetary Fond, World Economic Outlook, spring edition, 1997 to 2005.

past output gaps with every additional period of time. What was a deeply negative output gap from the perspective of 2001 data turns out to be only slightly negative if not positive by hindsight. Japan with its long period deflation showed a similar pattern for the beginning of the century. Since its slight recovery the difference shrank significantly .

In other countries where the cyclical pattern of economic activity was far more regularly the differences between real time potential output data and actual data far less pronounced. This applies for Canada, US and to some extent also for France. In all these countries the downturn in 2001 was followed by a more or less speedy recovery.

5. Conclusion

The ultimate lack of knowledge about the precise values of the NAIRU and potential total factor productivity allow for the estimation of many different levels of potential output. Most macroeconometric models explicitly assume a long-run neutrality of money. If this assumption is false, as contended both from a theoretical and empirical perspective in the literature (Solow 2006; DeGrauwe 2006), then low potential growth may become a self-fulfilling prophecy. Labor market hysteresis is one channel of long-run monetary non-neutrality, a lower investment ratio and thus lower TFP growth another. The OECD further notes that long-lasting periods of economic expansion give rise to increasing participation rates (OECD 2006: 49), i.e. an increasing labor supply.

It is extremely problematic to use this theoretically compelling concept as a basis for economic policy advice. It is possible to identify factors that positively affect potential output, as for example, the investment ratio. But no estimate of potential output can be claimed to be accurate or precise, so that several different estimates have to be used as policy indicators. But even that does not solve the fundamental problems given the fact that the estimates for a given period vary significantly over time. This, however, vastly complicates fiscal planning and the use of monetary policy rules, such as the Taylor rule. Policy makers cannot rely on actual figures presented since they may change the following period. The bottom line is that potential output as measured by the methods presently available cannot be considered as a yardstick for economic policy theory. Given the difficulties involved in robustly estimating potential output to this variable. Pragmatism should prevail. In the face of a benign inflation outlook and high unemployment economic policy should strive to test the limits of potential output and to set in motion a virtuous cycle of a decreasing NAIRU, a rising participation rate, higher productivity growth and an improvement in fiscal balances.

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THE STABILITY AND GROWTH PACT: STABILITY WITH(OUT) GROWTH?

Catherine Mathieu[1] and Henri Sterdyniak[2]

1. Introduction

With the launch of economic and monetary union (EMU), a new frame-work for the conduct of economic policies in Europe has been implemented. The ECB's independence, the Stability and Growth Pact (SGP) and the focus on structural reforms show that 'liberal' views have won over 'Keynesian' ones. The weaknesses of this framework soon emerged, however. The euro area remains a low growth area. Rigid rules lacking economic rationale have induced persistent tensions in Europe.

2. An inappropriate framework

From a Keynesian perspective, independent national fiscal policies are necessary in EMU because monetary and exchange rate policies are run at the euro area level and become ineffective in the event of asymmetric shocks. Moreover, fiscal policy gains strength in a monetary union since it will not be counteracted by interest rate rises or an appreciating ex-change rate.

Taking the monetarist view, EMU needs binding rules to constrain fiscal policies. Otherwise, governments will run over-expansionary policies exactly because they do not need to be concerned about interest rates, external balance or speculation on the exchange rate. This view, supported by central bankers and the German government, has prevailed and the SGP focuses on public finance objectives rather than on economic growth. Hence, the SGP is not a coordination process, but rather a forced convergence towards *a priori* norms.

The SGP can also be seen as a way to impose a new conduct of fiscal policy, in line with what we call the federal, technocratic and liberal ide-ology (FTLI). This ideology aims at depriving governments of all lee-way. It gives them incentives to cut public expenditure and implement liberal structural reforms, while preventing expansionary macroeconomic policies. Governments have signed this Pact because they and their national technocrats share this dominant ideology. Instead of active economic policies, European dominant classes favour structural reforms that increase labour market flexibility, cut taxes and public expenditure, and increase company profits.

The monitoring of euro area fiscal discipline is based on three elements: two criteria are inherited from the Maastricht Treaty (the 3% of GDP deficit threshold and the 60% reference value for the ratio of debt to GDP). The third element is the institutional frame-work for the implemen-tation of fiscal surveillance (the SGP).

The 3% deficit ceiling is the absolute reference. However, it has no economic rationale. Why 3%? The reasons given are awkward. A deficit of 3% of GDP would stabilise the debt level at 60% of GDP under nominal GDP growth of 5%. But, apart from the fact that the reference should then apply to the cyclically-adjusted balance or to average borrowing over an economic cycle, why the 60% figure for the debt-to-GDP ratio?

Moreover, a country hit by a specific fall in domestic demand may very well need a deficit higher than 3% of GDP. *A priori*, such a deficit will not raise inflation. It also benefits partner countries by avoiding the negative impact that would otherwise result from falling domestic de-mand. In 2003, the public deficit reached 4.1% of GDP in Germany, but inflation was low (1.0%) and the current account showed a surplus (2.1% of GDP). It is difficult to claim that the German public deficit generated negative spillover effects. Moreover, the budgetary procedures of the SGP do not prevent the emergence of excessive inflation. For example, inflation reached 5.1% in the Netherlands in 2001 while government borrowing was balanced.

In the past, deficits have been higher than 3% of GDP quite often in many OECD countries. At that time, they were seen as necessary to support output. In theory, the discipline the SGP is imposing would not be so much of a problem if monetary policy were

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more growth-oriented, but this is not the ECB's remit. Moreover, a single monetary policy cannot fit different national cyclical positions. GDP growth and inflation differ significantly among euro area economies (see Table 1). With an inflation target set at 2% by the ECB, the interest rate given by a Taylor rule ranged from 1.5 in the Netherlands to 7.3 in Ireland at the end of 2005. So the 2% interest rate set by the ECB was too high for the Netherlands and Germany whereas it was, although at varying degrees, too low for the rest of the monetary union.

With a single interest rate, a single public deficit-to-GDP ratio existing independently of the level of domestic demand cannot be optimal for each country.

Table 1: Interest rate, GDP growth and inflation forecasts, October 2005

	GDP growth%	Consumer prices, %	Differential (1)	Output gap	Interest rate target (2)
Germany	0.9	1.9	-0.8	-2.7	1.9
France	1.6	1.8	-1.4	-2.1	2.9
Italy	0.3	2.1	-0.4	-2.0	2.5
Spain	3.3	3.3	-4.5	-0.8	6.4
Netherlands	0.9	1.5	-0.4	-4.0	1.5
Belgium	1.6	2.5	-2.1	-1.5	4.0
Austria	2.0	2.2	-2.2	-2.2	3.6
Finland	2.1	1.3	-1.3	0.1	3.2
Portugal	0.9	2.3	-1.2	-4.4	2.7
Greece	3.3	3.3	-4.6	0.5	7.1
Ireland	4.9	2.4	-5.3	-0.6	7.3
Euro area	1.4	2.1	-1.5	-2.3	3.0

(1) Differential between the short-term interest rate (2%) and consumer price inflation plus real GDP growth forecasts 1 year ahead (as of October 2005).

(2) Defined as [π= g + P + 0,5 (P-2) + 0,5 (output gap)] where g: potential output growth, P, inflation rate and :(x-y) OECD's output gap.

Sources: Consensus Economics, OECD (2005), authors' calculations.

The Treaty states the obligation for countries to keep their public debts below 60% of GDP or otherwise to bring debt below this ceiling. But as countries with public debts well above 60% of GDP were allowed to join the euro area (Italy, Belgium and Greece), this constraint has been 'forgotten' since 1997.

Thirdly, the SGP requires euro area countries to submit annual stability programmes. The latter must have macroeconomic and budgetary projections for the current and three following years, targeting a budgetary position 'close to balance or in surplus' in the medium-run. However, such a target has no economic justification. A country in which private savings are spontaneously too low (high) may need some budget surplus (deficit). Moreover, it is reasonable to finance public investment through borrowing and therefore some public deficit may be justified. And keeping deficits permanently at 0% of GDP will result in a nominal public debt in continuing decline as a percentage of GDP. Here, it needs to be pointed out that there is a demand for public debt from financial markets, especially from pension funds that need to invest in long-term, liquid and safe assets. Finally, eliminating public deficits and debts may result in very low interest rates, which would limit the room to act if the country were to be hit by a negative demand shock.

At the Ecofin Council of July 2001, Member States accepted the Commission proposal to set a target of balanced (as measured by the Commission) structural budgetary positions. Once this target is reached, only automatic stabilisers will be allowed to work, while discretionary policy will be excluded. Thus, fiscal policies will become automatic and Member States will lose all fiscal autonomy. The justification for the proposal was that discretionary fiscal policy is dangerous because governments can misjudge the economic situation or permanently run expansionary policies. Furthermore, the Commission, pointing to the disincentives on work caused by taxes, was insisting that public deficits be reduced through spending cuts and not through increased taxation.

Ultimately, the SGP does not offer a framework for coordination of macroeconomic policies. The SGP does not set a strategy and a target for economic growth in Europe. Monetary authorities do not take part in the process. The cyclical position of the European economy, whether global or country-specific, is not really taken into consideration. National programmes are evaluated separately, without analysing their impact on partner countries. A satisfactory coordination process would do the opposite. It would examine precisely the economic situation of the area as a whole in order to set the appropriate level of interest rate, and then switch to the analysis of domestic situations in order to decide which fiscal policies need to be implemented at the national level.

3. From 1997 to 2005: the SGP undergoes reform

3.1. Eight years, twelve sinners

From 1997 to 2000 robust growth and declining interest rates, together with a small positive fiscal impulse (0.3% of GDP per year according to the OECD, see Table 2), allowed public deficits to fall in the euro area. Public deficits started to rise again in 2001-2002 because of decelerating economic activity and because the fiscal impulse still remained slightly positive. Despite the repeated requests of the Commission, the euro area's primary structural surplus decreased over the 1997-2002 period.

Table 2: General government balances in the euro area
Percentage of GDP

	Government balance	Cyclical component	Interest payments	Cyclically-adjusted primary balance
1997	-2.6	-0.7	4.5	2.5
1998	-2.3	-0.3	4.2	2.2
1999	-1.3	-0.0	3.6	2.3
2000	-1.0	0.7	3.6	1.7
2001	-1.9	0.6	3.5	0.8
2002	-2.5	0.0	3.3	0.5
2003	-3.0	-0.6	3.1	0.4
2004	-2.7	-0.7	2.9	0.5
2005	-2.9	-1.0	2.8	0.5

(1) Excluding proceeds from the sale of UMTS licences.
Source: OECD (2005).

Since the economic slowdown of 2001, the SGP has generated permanent tensions in Europe. The Commission has been asking for cuts in public deficits even as Member States try to support growth in a situation of high unemployment and weak inflation. The crisis erupted in November 2003 when the Council refused to adopt the Commission recommendations calling on France and Germany to strongly reduce their structural deficits in 2004 and 2005. The Council then adopted a less stringent conclusion which was accepted by the French and German governments. The Commission however was of the opinion that the Council did not have the right to refuse its recommendation; procedures and fines should be automatic. So the Commission put the case before the European Court of Justice. According to its verdict, Member States retain the right of appreciation in the excessive deficit procedure (EDP), but recommendations on excessive deficits can be modified by the Council only on the initiative of the Commission. So the Commission and a qualified majority of the Council must reach agreement.

In September 2004, it came to light that the public deficit figures provided by Greece had been false since 1997 and that the Greek deficit had never fallen below 3% of GDP. In 2005, deficit figures for Italy and Portugal were also raised. In December 2005, 12 EU countries were su-jected to an Excessive Deficit Procedure: five in the euro area, the UK and six new Member States. In most new Member States, public deficits are higher than 3% of GDP, but public debt remains below 60% of GDP, while these countries also have significant public infrastructure needs. From 1998 to 2005, the 3% ceiling has been breached for eight years by Greece, five years by Italy, four years by France and Germany, two years by Portugal and one year by the Netherlands.

3.2. On national views

Some countries, like Spain, oppose any change in the Pact. Spain benefits from robust growth thanks to low nominal interest rates as compared to domestic inflation and GDP growth, and does not need any expansionary fiscal policy. However, with inflation at 3.6% and a current account deficit at 7.4% of GDP for 2005, Spain is less virtuous than Germany, where inflation is 2.0% and the current surplus 3.8% of GDP. Some small countries like the Netherlands, Belgium and Austria use the European disciplinary framework to cut their public debts and are also opposed to a reform of the Pact.

The larger countries have called for a reform of the Pact. In November 2004, Silvio Berlusconi called for a Pact oriented towards growth rather than stability. He suggested the exclusion of public capital and R&D expenditures from the deficit figures. Gerhard Schröder claimed that the judgement on excessive deficits should take account of several criteria, e.g.: the introduction of reforms that are costly in the short run but boost growth in the long term; the country's contribution to price stability in Europe; the economic situation; the net contribution to the EU budget and, as concerns Germany, transfers to new Länder. The French government suggested the exclusion of military spending and aid for developing countries.

Ultimately, European cohesion was at stake in this discussion. On the one hand, the three largest countries represent 75% of the euro area population and might have vetoed a reform. On the other, several smaller countries accused Germany and France of not complying with European rules. But some of these smaller countries receive Community funds, benefited from falling interest rates when joining the EU and are less in need of independent fiscal policies than bigger states because they can more easily implement tax competition or competitiveness policies, both of which are harmful strategies at Community level.

3.3. The new Pact

At the March 2005 Council, Member States agreed on a text prepared by the Commission. The Council stated that the economic rationale of budgetary rules had to be enhanced but also that the 3% of GDP value for the deficit ratio had to remain the centrepiece of multilateral surveillance.

Part II, **'Strengthening the preventive arm'**, agrees to the definition of medium-term objectives (MTO) that are differentiated for each Mem-ber State. *But the range goes only from -1% of GDP for low debt/high potential growth countries to balance or surplus for high debt/low potential growth countries. Why wasn't the golden rule for public finance considered, or a deficit stabilising public debt at a reasonable level (i.e. a structural deficit objective of around 2% for a country with nominal growth of 4% and a target of 50% for the debt ratio; and around 3% for a country with nominal growth of 7.5 % and a target of 40% for the debt ratio)?*

The implicit liabilities from ageing populations will be taken into account. *However then why not take the social contributions that people will pay to have a satisfying level of pension and health insurance into account as well? Countries with generous public pensions systems may decide to have a higher tax burden than countries where employees need to save on an individual basis in view of retirement or health spending.*

Member States not having reached their MTO should make a budget-ary effort of 0.5% of GDP per year (cyclically adjusted and excluding one-off measures). The effort should be higher in periods when the out-put gap is positive, smaller in bad times. *However potential output and the economic cycle are difficult to assess. For example, the Commission's estimates point to small output gaps. If this is the case, and despite a high unemployment rate, even a short period of growth would then lead to an overheating economy.*

Structural reforms, in particular pension reforms introducing a manda-tory, fully funded pillar, will be taken into account if they raise potential growth and induce long-term savings in the long run. *However shouldn't the design of the social security system be a national choice? There is no justification for a European rule providing incentives for a fully funded system.*

Part III is entitled **'Improving the implementation of the excessive deficit procedure'**. The Commission will prepare a report if the deficit exceeds 3%. A small and temporary breach of the rule will be allowed if it is due to negative growth or a strong negative output gap. The proposal tabled by France, Germany and Italy to withdraw certain categories of expenditure from the deficit has not been accepted. However, will be taken account of 'all relevant factors' such as policies implemented in the framework of the Lisbon agenda, R&D spending, public investments, economic situation or debt sustainability. These elements may prevent triggering of the excessive deficit procedure (EDP) but only if the excess is limited and temporary. They could also allow for longer adjustment paths to bring deficits below 3%. Then again, for countries with debts in excess of 60% of GDP, the Council will take account of the speed of reduction in the debt-to-GDP ratio.

The Commission maintains the right to prepare a report for each country surpassing the ceiling and will be entitled to send an early warning directly. But the state concerned will be entitled to justify its policy by referring to a number of relevant factors. In other words, implementation of the EDP will not be automatic. It will require judgements on the policy choices of the state concerned. One intriguing question is here how peer countries can condemn a policy conducted by an elected government, if this policy generates no negative externalities?

This agreement may be viewed as a serious weakening of the Pact. On the other hand, there is no reflection on the objectives of fiscal policy or on measurement of the output gap; the easing of the medium term objective is very limited; the requested annual 0.5% decrease in structural deficits to GDP ratios remains. Governments will continue to have to justify domestic fiscal developments before the Commission and other member states. The Pact will remain a factor of permanent tensions in Europe.

The ECB, in particular Otmar Issing, has expressed strong concerns about the reform, saying that 'the conflicts between lax public finances and a monetary policy centred on price stability would endanger the construction of monetary union'. But it is difficult to see how a country with a public deficit, low inflation and an external surplus, with all of these being the consequence of weak domestic demand, can threaten euro area price stability.

4. How to improve the fiscal framework?

The need for reform of the SGP has generated significant literature.

4.1 Fiscal Policy Committees

Wyplosz (2002) has proposed the creation of a fiscal policy committee of independent experts in each Member State. These committees would have the mandate of ensuring debt sustainability and would set the level of government borrowing, while public spending and receipts would remain under the control of national governments and parliaments. Fatás et al. (2003) have made a more moderate proposal: a European Sustainability Council, an independent panel of experts, would assess national fiscal policies according to sustainability criteria. Their judgment would be made public, to enforce fiscal discipline through public opinion and financial markets. But debt sustainability is a vague concept that makes sense as a long-term constraint only and would be difficult to consider for the conduct of fiscal policy in the short term.

In economic downturns, what trade-off would the Committee make between output and debt stabilisation? Could these experts' judgments replace governments' responsibilities? For instance, in 2004, some European countries chose to run high deficits rather than depress output further. Could these experts claim that such policies were not sustainable? Following on from the ECB's independence, this would be a further step towards leaving economic policy under the responsibility of a technoc-racy.

4.2 Public debt surveillance

Pisani-Ferry (2002), Gros (2003) or Calmfors et al. (2003) have pointed out that fiscal discipline should focus on debt rather than deficits, since it is excessively high debt that may threaten the sustainability of public finances. Without considering the cyclical effects on debt-to-GDP ratios deteriorating automatically in times of subdued activity, they suggest that the limit for deficits should depend on public debt levels. This would be an incentive for member states to cut public debt in order to get more cyclical leeway. The proposal puts constraints on highly indebted countries: Italy, Belgium and Greece. But the constraint is questionable for Italy and Belgium where public debt has a counterpart in a high households' savings ratio. The constraint comes in addition to the objective of a medium-term balanced budget, which already implies a continuing decrease in the public debt-to-GDP ratio.

Old-age-related public spending – pensions and health – will increase under the effects of ageing populations in the EU in the near future. Some economists (among them Pisani-Ferry 2002 and Oksanen 2004) suggest that each country should evaluate and make public the implicit debt level of its public pension and health systems, in addition to financial debt. What should the implicit debt include? Why not include also public education spending entitled to newborn children? In any case, anticipated receipts should be considered too, like taxes and social contributions. The proposal paves the way to a never-ending process of complicated calculations surrounded with a high degree of uncertainty. Indeed, the estimated level of implicit debt relies on many assumptions concerning future retirement age and pensions levels. The implicit debt level may be greatly reduced, effectively or fictively, if the country announces in advance that the level of pensions will be lowered or that the retirement age will be postponed (as France did in 2003). Ultimately, the real question is not to aggregate financial public debt and implicit social debt but to determine whether fiscal policy is sustainable and optimal. If house-holds benefit from a high, well managed and useful level of social spending, they may accept a high level of contributions. The burden could even be less heavy than having to pay insurance premiums to inefficient or unreliable private companies.

Many economists (among them Delbecque 2003, Oksanen 2004) and the Commission think that the SGP rules are justified by the future rise in pension spending. Their view is that public debt needs to be significantly reduced now to ensure the future pensions. This is necessary for inter-generational equity reasons (all generations sharing the tax burden) as well as economic efficiency (avoiding imposing too heavy a tax burden on future generations). However, the fundamental rationale and objective of the Pact is to facilitate fiscal policy coordination and to avoid negative externalities inside monetary union, and not to give technocrats the power to set what they think are optimal fiscal policies for each country.

4.3 The golden rule for public finances

Public investment has positive return effects over a longer time period and it is therefore logical for it to be financed over a similar period of time. Independently of short-term stabilisation concerns, government budgets should be split into a current budget - including spending related to public capital stock depreciation - which should be balanced, and an investment budget, financed through borrowing. The British government adopted such a rule, the so-called 'golden rule for public finances', in 1998. Several economists (Modigliani et al. 1998, Creel et al. 2002, among others) have suggested importing this rule into the euro area. The structural current government balance, i.e. excluding public investment, should be permanently balanced or in surplus. If the objective is to keep public debt at the level of public capital stock, which may be judged de-sirable from an intergenerational equity point of view, the golden rule must be that the cyclically-adjusted borrowing should be in balance with net public investment (Mathieu/Sterdyniak 2004).

The golden rule allows governments to borrow to invest, which is of paramount importance for countries with significant investment needs like the new Member States. According to endogenous growth theory, cuts in public investment negatively affect potential output growth. However, the golden rule approach opens a Pandora's box on the definition of public investment: should the national accounts definition be the reference, or should all expenditure preparing the economy for the future, like education or research, be also taken into account, as proposed by Fitoussi (2002)?

The golden rule defines fiscal policy neutrality, cyclical neutrality (only automatic stabilisers are allowed to work) and structural neutrality (public savings equal public investment). However, a government may decide not to be neutral. It may wish to implement an expansionary fiscal policy in times of slow growth or to run a contractionary policy in a period of high inflation. It may wish to implement structural measures if it thinks that savings are too high ex ante (which would necessitate an excessively low interest rate) or too low (in the light of demographic changes). As with the existing rule, there is no certainty that application of the golden rule results in a fiscal policy stance which, given the level of interest rates at the level of monetary union, delivers a satisfying level of output in the member state.

4.4. Reforming European economic governance and improving policy mix

The European fiscal and monetary framework is a highly political issue. What powers should be in national or community hands? It is also a technical issue: a single monetary policy and different fiscal policies need to be consistent with one another.

An elected economic government of Europe, making fiscal decisions for all, is currently a utopia. The democratic debate has remained at the national level while at the same time business cycles as well as institu-tions still differ from one country to another.

Given the current level of European political integration, governments must keep their prerogative on national fiscal policy. The European surveillance of member states' economic policies should be limited to preventing any national fiscal policy from negatively affecting the rest of the area. That is why binding rules should bear directly on externalities. Thus, the rule should be that countries are allowed to implement the fiscal policy of their choice, as long as it does not affect the macroeconomic equilibrium of the area, in other words as long as domestic inflation stays in line with the inflation target of the area. For example, one could think of an inflation target being set between 1.5% and 3.5% in the area. 'Northern' countries could then choose a target within 1 and 3%, while lagging countries would target an inflation rate between 3 and 5%. In such a framework, a country hit by a negative demand shock would be able to counterbalance it through an expansionary fiscal policy. Conversely, a country hit by inflationary pressures would have to implement restrictive measures.

The European authorities – the Commission and the Ecofin Council of the euro area – would be responsible for checking that inflation remains at the level set in each country, and possibly accepting some deviations and adjustment periods in the event of specific or common shocks. The European authorities could also be responsible for checking that domestic public debts do not put the sustainability of public finances at risk, or that no country runs an excessively large current account deficit relative to the area current account balance.

However, this framework does not set the respective roles of monetary policy and fiscal policies. A satisfying level of global demand may be obtained through a combination of high interest rates and public deficits, or of low interest rates and public deficits. The second combination will lead to higher private investment and therefore will be preferable in terms of medium-term output growth. In other words, the compatibility between monetary policy and fiscal policies has to be organised. In our view, the best rule is the following: monetary and fiscal policies should set a common objective aiming at the convergence of real interest rates and output growth. For example, if long-term real interest rates are higher than output growth, this implies that investment is too weak. In that case, monetary policy should cut interest rates and should be accompanied by restrictive fiscal policies in those countries where the interest rate cut would raise inflation excessively. National fiscal policies should be responsible for managing the inflation-production trade-off in each country while monetary policy should target the interest rate.

In addition, it would be desirable to set up economic policy coordina-tion in the framework of the Eurogroup, which would maintain a dialogue with the ECB. This coordination should not focus only on public finance balances, but should aim at supporting economic activity and achieving the 3% growth target of the Lisbon strategy. It should be kept in mind that improving the European fiscal framework is not merely a technical issue, but requires a new alliance between social classes concerned about full employment and social cohesion.

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THE EURO AREA DRIFTING APART – DOES REFORM OF LABOUR MARKETS DELIVER COMPETITIVE STABILITY OR COMPETITIVE DIVERGENCE?

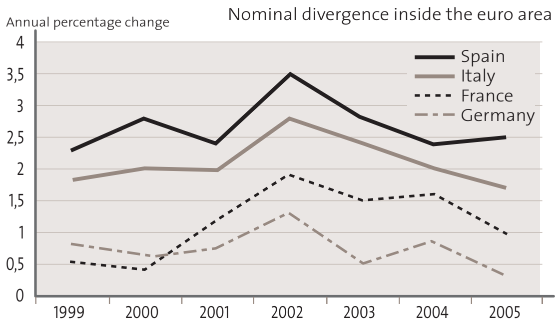
Jörg Bibow[1]

Persistent cyclical divergences in inflation and economic activity have been observed across the euro area in recent years. At the same time, the current account positions of member states have gone through marked swings in opposite directions. Imbalances are growing rapidly while overall growth has remained subdued since 2001. These trends have led to some public debate. But key policy-makers do not appear to be seriously alarmed as yet.

Complacency may be misplaced, though. Or can we be sure that these developments are signs of economic health, signs that market forces are working in their supposedly equilibrating fashion? Alternatively, are they signs that necessary adjustments perhaps are being hampered by those allegedly all-pervasive structural rigidities, a situation which therefore calls for urgent structural reform, to enable EMU then to function more successfully in future? Or do these trends reflect that the euro area is drifting apart in a rather serious manner?
The latter is indeed to be feared. And according to the analysis offered here, structural rigidities are not to blame for these dangerous trends. Instead, divergences have been caused by the ill-conceived Maastricht regime in conjunction with the working of market forces. The evidence does not suggest that more flexibility through structural reform would deliver competitive stability. Rather, reform of macro-economic policy-making is called for to rein in the risk of competitive divergence.

Persistent cyclical divergences and mounting imbalances inside the euro area

A brief look at some key stylized facts will prepare the ground. Starting with inflation, the primary or even sole concern of the euro area's stability-oriented policy-makers, conspicuously persistent inflation differentials have been observed under EMU. Focusing on the four largest countries and a core inflation measure that excludes the 'tax-push' phenomenon[2], so as to provide a clearer picture of underlying *market* forces, Germany has been at the low end of the spectrum throughout these years. Thanks to Bundesbank over-ambitiousness in its final days of hegemony under Hans Tietmeyer and Otmar Issing, Germany started out from an extremely low level of below one per cent in 1999. After a mild and temporary rise due to the productivity slump in 2001-02, (market-determined) core inflation then even declined towards zero by 2005. At the other end of the spectrum is Spain, with a core inflation trend of around 2.5 per cent. Inflation in Italy has shown a similar evolution to that in Spain, although at a slightly lower trend level of two per cent. France started from an even lower level than Germany in 1999, but experienced a more marked increase in 2001-02, with core inflation staying well above German levels ever since.



Source, Eurostat, Destatis, IM
Note, Core consumer prices (excuding energy, food, alcohol, administered service prices)

Turning to domestic demand growth, which provides a better summary measure of internal dynamics in economic activity than GDP growth, a similar pattern may be observed. Germany is consistently to be found at the low end, and Spain at the high end of the spectrum, with France and Italy somewhere in-

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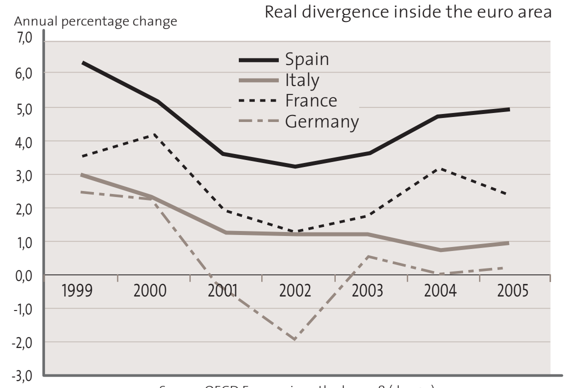
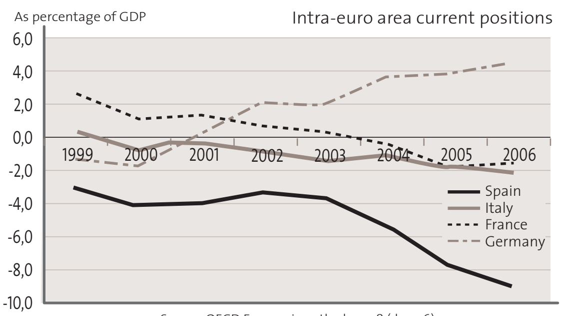
[2] A recent extensive study by the author has shown that a series of increases in indirect taxes and administered prices, undertaken largely under pressure from the Stability and Growth Pact's three per cent deficit limit, have caused a significant upward distortion in HICP headline inflation since 2001. At its peak, in 2004, 'tax-push inflation' contributed 0.7 of a percentage point (or roughly one third) to overall inflation. See Bibow 2006a.

between. Notice also that the slowdown in 2001-02 was common to all four countries. Yet while growth fully rebounded in Spain in due course, recovery was more moderate in France and Italy, and Germany actually failed to recover at all until 2006.



Source, OECD Economic outlook no. 78 (dec 05)
Note. Real total domestic demand

In line with these persistent inflation and growth differentials, a build-up of current account imbalances has occurred since the euro replaced national currencies in 1999. While Germany has experienced a striking improvement in its current account position, the other three countries' positions have deteriorated markedly. Since 1999, Germany's current account position has improved by some five per cent of GDP. By contrast, Italy's, France's and Spain's current account positions have deteriorated by three, four and five per cent of GDP respectively, with the latter's deficit forecast to reach double-digit territory by next year.



Source, OECD Economic outlookno. 78 (dec 06)

Let me quickly concede here that 'catching up' may be part of the story in Spain's case, though only a minor one in the general view[3]. How, then, can such *persistent cyclical divergences* be explained? And do they pose any threat to EMU?

Asymmetric shocks as the prime suspect

Surely 'asymmetric shocks' must be seen as the prime suspect. These are shocks that do not affect all currency union countries – thus by their very nature causing divergence within the union. Asymmetric shocks have been at the heart of optimum currency area research right from the beginning. Optimum currency area (OCA) theory was always regarded as providing the right kind of framework for assessing the chances and risks of EMU in Europe throughout the decades of debate that accompanied this ambitious project until its realisation and beyond. In view of the above evidence, and in the light of OCA, one would thus investigate the hypothesis that Germany in particular may have been subject to a series of adverse shocks, shocks that have had much less of a negative impact on Germany's EMU partners.

Before applying OCA wisdom to the divergence phenomenon as seen in the euro area since 1999, let me clarify three points here at the outset. First, to the extent that the 'global slowdown of 2001' represented a negative external shock to the euro area, arguably this shock was essentially a common one, symmetric rather than asymmetric in nature. Whether related to this common external shock or not, as noted above, the slowdown in domestic demand seen in 2001-02 was common to all four countries under investigation here too. Second, if anything, the global recovery since 2002 has featured asymmetry in Germany's favour. Arguably, Germany has been the greatest beneficiary of the strong global growth environment since 2003. Its export structure (capital goods) and its exposure to fast-growing economies in central and eastern Europe, developing Asia and among oil producers have both worked to Germany's advantage. Third, focusing on the global economy and external shocks is liable to distract from the real issue. The real issue in the euro area concerns domestic demand, both its persistent overall weakness and persistent divergences. The euro area is a very large economy, second in size and global weight only to the US. Blaming protracted domestic demand stagnation on conditions 'elsewhere in the world economy' is a poor excuse – especially when the global economy has enjoyed a four-year boom.

In coping with asymmetric shocks, the related key policy matter is whether any emerging cyclical divergences are either counterbalanced or amplified by market mechanisms, or whether deliberate policies have to be designed with a view to stabilising – and holding together the various parts of! – the currency union.

3 Catching up is far more of an issue when it comes to the new EU members in central and eastern Europe.

Revisiting optimum currency area theory and reasonable expectations before EMU

A key issue in joining a currency union is that it means giving up control over national monetary and exchange rate policies. For within currency unions, these key macroeconomic policy instruments can no longer be used for stabilisation purposes in cases of asymmetric shocks. Obviously this would not matter if the currency union were not subject to asymmetric shocks, which require country or region-specific treatment. Symmetric shocks, on the other hand, require a common union-wide stabilising response. And, in principle, monetary, exchange rate, and fiscal policies can all be used to address common shocks. Also, giving up national control over these tools would not matter much if alternative adjustment mechanisms, either markets or policies, could do the job instead. At least this was the logic behind Bob Mundell's original reasoning about optimum currency areas.

Interestingly, Mundell started out from the premise that real-world economies generally feature significant nominal rigidities, so that wage-price flexibility could not be relied upon as the key adjustment mechanism in response to asymmetric shocks. Therefore, Mundell thought about potential alternatives. The key alternative mechanism for which he became famous is factor mobility. Even if wages and prices do not adjust sufficiently, Mundell reckoned, international movement of factors could bring about a mutually beneficial rebalancing just as well. Factors would move from the depressed region hit by a negative demand shock to the booming region, so that an overall balance could be restored. Labour mobility was judged to be the key stabilizing factor, while capital mobility was always seen as being of subordinate importance.

Subsequent contributors to optimum currency theory identified a number of other factors that could potentially prove important in forming a currency union. Chief among them were fiscal policy and the degree of fiscal integration on the one hand, and financial integration on the other. The former represents the key remaining macroeconomic policy instrument once monetary and exchange rate policies are surrendered. The latter channel features private access to integrated financial markets as a means to diversify risks.

Numerous studies were undertaken to assess how well or poorly EMU in Europe might fare on the basis of optimality conditions (or criteria) as derived from OCA. Typically, the US, supposedly a well-functioning currency union, was used as the most relevant benchmark.

The general tenor of findings was that labour mobility is significantly lower in Europe than in the US. Therefore, not too much should be expected along Mundellian lines on this front. That said, it has always been somewhat doubtful anyway whether labour mobility could play much of a role as far as short-run or cyclical divergences rather than permanent shocks were concerned. And in view of the fact that the EU features cohesion among its goals, doubts even arise as to whether large-scale migration flows are really even desired in case of longer-run divergences, given that the EU seems to favour the use of regional and cohesion policies instead.

With regard to fiscal integration, too, it was clear that a degree of integration comparable to that achieved in the US's federal budget was a long way off. The current EU budget is not only small (little more than one per cent of GDP), but also not applicable for stabilisation purposes. A balanced-budget rule is in place and the EU budget's structure does not lend itself to that purpose either. Hence it was clear that national fiscal policies alone had to be relied upon instead. In principle, it seems possible to coordinate national fiscal policies in such a way as to ensure an appropriate aggregate fiscal stance while at the same time allowing member states sufficient flexibility so as to use their only remaining stabilisation instrument to deal with country-specific shocks. In actual fact, this kind of reasoning was absent from the design of the Maastricht regime, with its sole focus on disciplining policy-makers. Coordination was judged unnecessary, flexibility undesirable, but discipline all-important (Bibow 2001).

Hence national fiscal policies had to be constrained, first by the fiscal convergence criteria preventing the entry of profligate countries, and then by the Stability and Growth Pact deterring or punishing misbehaving governments once a country had joined the club of like-minded, stability-oriented members. The upshot is that fiscal policies became deliberately circumscribed so as to ensure balanced budgets, judged as a prerequisite for stable money, to be secured by a central bank mandated to focus primarily on price stability rather than growth and employment. Again using the US as the relevant benchmark, a stark contrast in macroeconomic policy regime has to be reported here.

That leaves financial integration as the final candidate of key mechanisms that could hold the currency union together and prevent countries and regions from drifting apart. The reasoning here runs somewhat counter to the original OCA idea of a homogeneous group of members since, in principle, more (not less!) heterogeneity opens additional scope for diversification of risks through financial markets. In practice, Europe fares quite well on this count. While probably still below the degree of financial integration prevalent in the US, more and more market segments in Europe too have become deep and integrated. The crucial question is how much in terms of self-correcting and stabilising forces can realistically be expected to arise through this market channel.

Be that as it may, the most surprising fact is that the official view in Europe today holds that wage-price flexibility alone could and should balance the system anyhow.

The official flexibility doctrine: a real surprise and serious flaws

The official view today is either that there is nothing wrong with inflation and growth divergences, since they are simply the reflection of equilibrating market adjustment processes, or else that they must be the result of those allegedly all-pervasive structural rigidities and thus call for thorough structural reform, so as to no longer prevent the equilibrating market adjustments from doing their natural work (see ECB 2005, for instance). The idea is essentially that wage-price flexibility is all that it takes to guarantee smooth readjustment in response to any kinds of shocks in the euro area, thereby holding the currency union together and preventing members from drifting apart.

The unfettered working of the forces of competition is thus supposed to secure overall stability. In particular, wages and prices should fall in the depressed economy but rise in the booming economy, thereby restoring overall equilibrium in the currency union. Note that this implies that adjustment is supposed to work through changes in competitiveness alone, featuring net exports as a pull or drag factor on GDP growth. No matter what kind of shock might hit, the competitiveness channel is king – as is explicitly stated by the relevant authorities and key propagators of the official flexibility doctrine.

For instance, the OECD (2004) observes in its euro area survey that 'in the absence of monetary policy instruments and with the leeway for fiscal policy also limited, adjustment will have to rely on changes in external competitiveness operating through wages and prices'. Note that this statement is made with particular reference to the Maastricht regime: in the absence of the relevant macroeconomic instruments, the competitiveness channel alone will have to do the trick. The ECB seems similarly optimistic on the supposed equilibrating role of the competitiveness channel, when it asserts that the 'competitiveness ('real exchange rate') channel, although slow to build up, eventually becomes the dominating adjustment factor' (ECB 2005, p. 77)

That the official view should stake everything on the competitiveness channel is truly surprising, given that Mundell started out from the presumption that wage-price flexibility could not primarily be relied upon to ensure competitive stability in real-world economies. But the official view is also seriously fallacious on a number of counts. The analysis will focus on five key flaws in the argument.

1. Far from being ineffective, as some seem to think in view of the fact that a number of countries have been running budget deficits well in excess of three per cent of GDP over a number of years, the working of the Stability and Growth Pact is also inherently asymmetric – thereby amplifying divergence.
2. Apart from driving the competitiveness channel, the sole focus in the official view, wage-price flexibility also has an important internal dimension, which is actually key to persistent real divergences across larger economies in particular.
3. Rather than offsetting subdued wage income growth through overall easy credit conditions, as was observed in the US between 2002 and 2005, the financial system too can further amplify divergences in a monetary union, given that the common monetary policy responds only to the euro area aggregate situation; at best one has to add in the ECB's case.
4. If the shock in question is symmetric rather than asymmetric in nature, reliance on the competitiveness channel is ill-founded and does not lead to stability in the first place, but is bound to cause divergences together with permanent, cumulative imbalances within the currency union instead.

5. Rather than freeing and supporting the market forces that will then ensure competitive stability, structural reform too can foster and amplify competitive divergences. Worst of all, structural reform makes it even more likely that the above processes and mechanisms may trigger competitive deflation.

These five key flaws in the official flexibility doctrine will now be discussed in turn, starting with the ill-named Stability and Growth Pact.

How the Instability and Stagnation Pact amplifies divergences too

To begin with, it is clearly wrong to suppose that the Stability and Growth Pact may have proved ineffective. True, a number of countries have failed to stay within the three per cent deficit constraint. But this merely reflects the impact of the 2001 slowdown and prolonged stagnation that ensued. In fact, given the prolonged period of subdued growth that the euro area has gone through since 2001, it is quite remarkable that the budget deficit (excluding the one-off revenues from the sale of mobile phone licences in 2000) has increased by roughly one and a half per cent of GDP only [4].

It is of course generally understood by serious economists that the Pact is not based on any sound economic theory, but is in fact a sad product of muddled thinking (De Grauwe 2005). The budget balance, let alone the deficit ratio, is not directly controllable by policy, but endogenous. These are endogenous variables, moreover, that may fail to comply with tales of 'expansionary fiscal contractions'; fairytales that seem to haunt the euro area's policy-makers.

The Maastricht parameters of three and 60 per cent, respectively, for the deficit and debt ratios implicitly assume annual nominal GDP growth of five per cent. No wonder the euro area's public finances have come under renewed stress as nominal GDP growth has persistently fallen well short of that requirement since 2001. Protracted stagnation, together with nominal interest rates that persistently exceed nominal GDP growth, are the opposite of what is needed to maintain sound public finances. Policies which blindly focus on deficit reduction 'no matter what' do not solve this problem at all, but effectively depress GDP growth instead. The Pact's prescription that governments should keep their budgets 'close to balance or in surplus' has made matters worse. High and persistent unemployment as well as adverse debt dynamics – the two principal causes of Europe's fiscal troubles – are then bound to prevail. The euro area is trapped in a senseless fiscal regime with an inherent anti-growth bias.

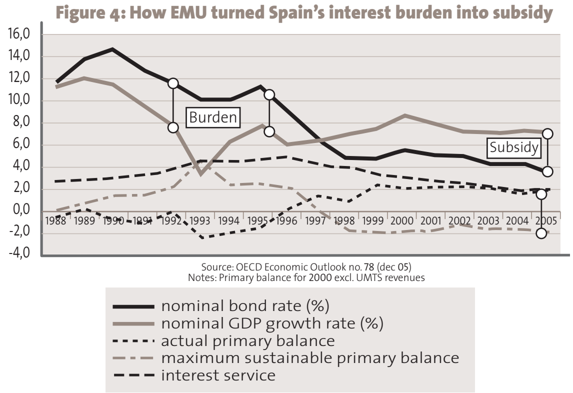
Apart from causing stagnation, the Pact also amplifies divergence. This stems from the Pact's inherent asymmetry. The 'excessive deficit' limit of three per cent effectively disciplines countries which are already in trouble, while there is no corresponding discipline imposed on booming ones. For instance, stagnant Germany has been under persistent pressure to impose tight budgets while booming Spain enjoys the freedom to cut taxes and reinforce its boom.

In this context, it is worth briefly tracing back today's divergences to their origin in the 1990s. The arrival of EMU delivered a decisive change in Europe's monetary order. Traditionally, due to its key currency bonus, Germany had enjoyed the lowest interest rates in Europe (pace Switzerland), significantly below those in EMS satellite countries. By 1998-99, nominal interest rates across the euro area were converging. That is, former EMS satellite countries experienced a market decline in nominal interest rates towards the German floor, with many cases providing a benign boost to domestic demand. In Spain, for instance, unemployment has halved since the mid-1990s. Of course, such a drastic decline in unemployment itself presents an enormous budgetary boon. In addition, debt dynamics have also become far more favourable.

In fact, Figure 4 shows that EMU has turned Spain's traditional interest burden into a subsidy. Today, Spain could even afford to run a primary budget deficit and still keep its debt ratio stable. As the employment boom has balanced the budget, however, Spain's debt ratio is on a sharp decline (down from 68.8% in 1995 to 46.5% in 2006). Spain further boosts domestic demand through tax cuts, for instance.

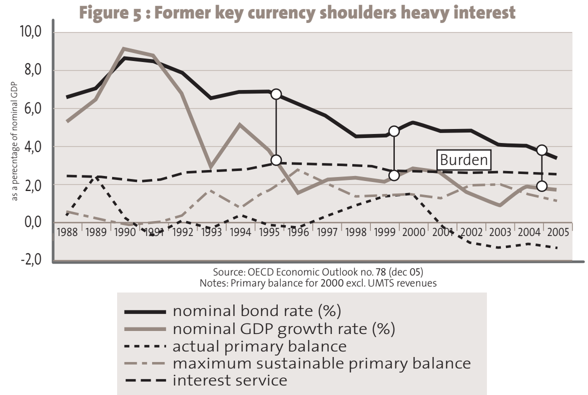
4 Recent estimates of the structural balance imply that whatever little fiscal stimulus may have occurred in 2001-02 has meanwhile been fully reversed (see OECD Economic Outlook no. 78). However, this result has to be taken with a pinch of salt. After years of subdued actual growth, the euro area's potential growth rate has been cut to 2 per cent, while what seemed to be a negative output gap in 2000 is presented in today's estimates as a sizeable positive gap. If this is taken into account, it seems rather questionable whether at least the euro area's automatic stabilizers were allowed to operate in full. See Horn (2006) and Aghion and Howitt 2005.

Figure 4: How EMU turned Spain's interest burden into subsidy



By contrast, Germany has not received any boost from interest rate convergence, enjoying 'stability orientation' à la Buba until the end. Confronted with the historical challenge of unification, the Bundesbank decided that it was best for Germany to suffocate domestic demand and squeeze German inflation below one per cent by the time of the euro's launch. Unemployment soared and debt dynamics became highly adverse as nominal GDP growth was depressed to a rate of two per cent rate (Bibow 2005a). Despite extensive privatisation initiatives, Germany's debt ratio is on a sharp rise (up from 55.8% in 1995 to 71.4% in 2006). Struggling with a sizeable interest burden and the SGP's limit of three per cent, Germany is about to inflict more budgetary tightening on domestic demand. For instance, the VAT rate will go up by three percentage points in January 2007, the greatest tax increase in German history.

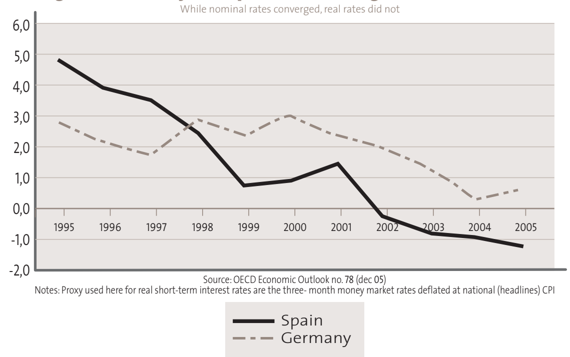
Figure 5 : Former key currency shoulders heavy interest



While these examples illustrate how the Pact amplifies divergence, note also how the Pact interacts with the common monetary policy in manifestly adverse ways in this context[5]. For to the extent that the SGP depresses growth and inflation in stagnant Germany, it raises German real interest rates relative to developments in Spain. In fact, as Figure 6 shows, as nominal interest rates converged at the start of EMU, real interest rates did not. Real rates show a striking trend of divergence, with booming Spain enjoying negative real interest rates. Diverging real interest rates are related to the supposed working of the competitiveness channel through wage-price flexibility (on which more below).

Figure 6: Germany's competitive advantage turned on its head

While nominal rates converged, real rates did not

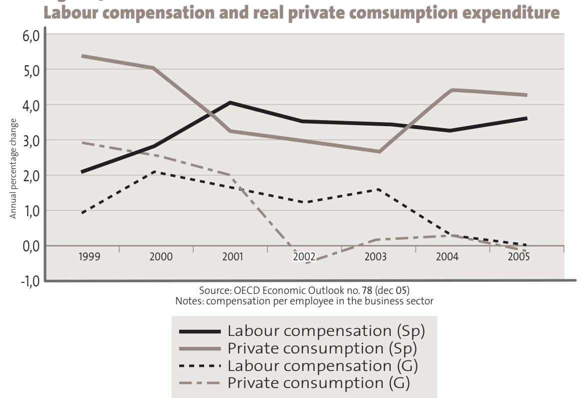


The internal dimension of wage-price flexibility

According to the official flexibility view stressing the competitiveness channel, wages and prices in Germany should decline or at least rise at a sufficiently lower rate than in booming Spain. Following this prescription leads to an improvement in Germany's external competitiveness and boosts (net) exports, which should contribute to GDP growth. The opposite happens in booming Spain, which sees its external competitiveness deteriorate due to relatively higher wage-price inflation, with net exports acting as a drag on GDP growth. Actual wage-price inflation and competitiveness trends have been fully in line with these prescriptions.

But we must not overlook the internal dimension to this supposed equilibrating adjustment mechanism.

Figure 7:
Labour compensation and real private comsumption expenditure



5 Recall also the 'tax-push' phenomenon which results from the highly counterproductive interaction of monetary and fiscal policies in the euro area (see Bibow 2006a).

The internal dimension of wage-price flexibility stems from the fact that wages are not just costs, but also incomes. As a result of 'wage moderation', wage-income earners in Germany are confronted with moderate disposable income growth, which comes on top of general job market uncertainties and SGP-imposed budget cuts. While there are few better ways to depress private consumption growth, as Figure 7 shows, the opposite has been true in Spain, where on top of a booming job market, private consumption also found support from less moderate wage rises. The point is that private consumption tends to be the most important GDP component. Especially in larger economies, private consumption typically has much greater weight in GDP than exports. Even as the external dimension of wage-price flexibility may boost net exports and GDP, its internal dimension can provide an overwhelming drag on growth.

How divergences are amplified by financial propagation mechanisms

It is highly doubtful whether a large economy (such as the euro area) should run a growth strategy that relies on external competitiveness gains, especially in today's environment of global imbalances. It is true, though, that wage moderation can also boost employment other than through external competitiveness gains, namely by forcing expansionary monetary policy upon the central bank. It is through its disinflationary effects that wage moderation provides an avenue to employment growth through domestic demand, at least if the monetary policy-maker complies and boosts domestic demand accordingly.

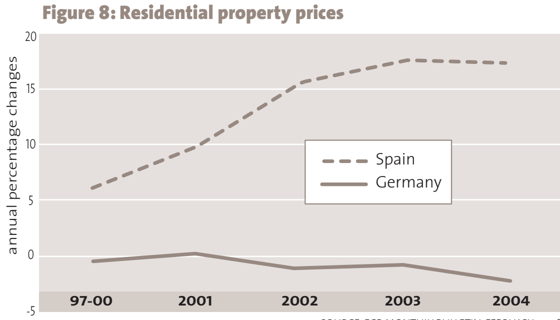
In the case of the US, this channel is quasi-automatic. Let us recall that the US Fed has a clear double mandate: maximum employment and price stability. As the economy slumps, the Fed is therefore bound to ease policy, so as to support employment. But even in the case of an inflation targeter like the Bank of England, for instance, a growth slowdown elicits monetary easing, namely through its impact on wage dynamics and the inflation forecast.

Although the ECB, too, is mandated to support economic growth and employment, 'without prejudice' to its primary goal of price stability, important complications arise here due to the ECB's idiosyncratic interpretation of its role. One key problem is that, in the ECB's view, price stability *by itself* is always the best contribution that monetary policy can make to any other goal. Another key problem is that it is not so much forecast inflation but past inflation which seems to guide the ECB. The ECB's rear-view mirror approach has had a vastly detrimental effect on economic performance: after choking growth through its aggressive interest rate hikes back in 2000, the ECB then failed to ease in time as the productivity slump (2001-02) and tax-push inflation (2002-05) kept inflation above its self-declared two per cent tolerance level (Bibow 2005b).

While no one else but the ECB is responsible for these serious policy blunders, monetary policy is not to blame for the following complication, which is, however, intimately related to wage and inflation divergences within the euro area. Instead, individual member states have to be aware that the quasi-automatic route between wage moderation and monetary easing is blocked in a currency union. In fact, wage moderation in any one member country relative to the average can even backfire. The point is that the disinflationary impact of national wage moderation on national price inflation only reduces euro area inflation by the respective country's weight in the overall HICP. Thus, at best a partial reward from the ECB may be triggered in this way. If inflation increased elsewhere in the currency union at the same time, not even a partial reward would be forthcoming. This is because the monetary policy domain and the domain of wage moderation are not the same – unlike the situation in Germany under Bundesbank rule. Making things worse still, today, as German inflation declines relative to inflation elsewhere in the euro area, German real interest rates rise both absolutely and relative to the euro area average.

But this is not where the story ends. Diverging real interest rates – driven by wage-price flexibility and inflation divergences – will be likely to trigger important propagation mechanisms in the financial system. In particular, while negative real interest rates are likely to ignite a lending boom in Spain, with rising asset prices and improving creditworthiness of borrowers leading to more credit ease, quite the

Figure 8: Residential property prices



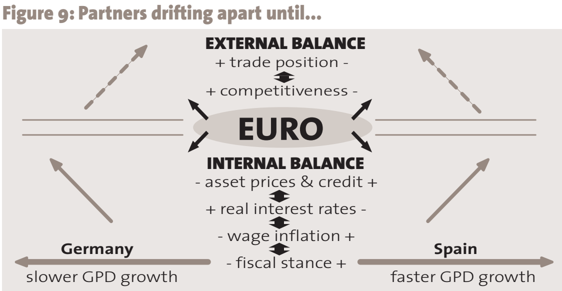
SOURCE: ECB MONTHLY BULLETIN, FEBRUARY 2006 opposite can arise in Germany – even risking a credit crunch. Essentially, this is the well-known endogeny of credit growth and asset prices, which, by working in opposite directions on either side of the wage-price flexibility divide, can further amplify divergences. Figure 8 shows diverging residential property price inflation trends in Germany and Spain.

Of course, this is neither to deny that financial integration offers opportunities of risk diversification nor to suggest that international investors may not at some point start to adjust their exposures in ways that should limit the decoupling of asset price trends. The point is that wage-price flexibility can transform a common monetary stance into rather divergent financial conditions, which thereby act as an amplifier of economic divergences for quite some time. All along, an integrated financial system may smoothly finance the related build-up of financial imbalances within the monetary union to be discussed shortly.

Most fundamentally: the powerful forces of divergence analysed so far are not really separate, but actually reinforce each other. As an SGP-imposed fiscal tightening weakens an already weak economy, a decline in wage-price inflation relative to the average will tend to depress domestic demand directly, both through its impact on incomes and through a relative tightening of financial conditions. In turn, prolonged economic weakness is bound to backfire on the budget, perhaps prompting further budgetary cuts. The opposite occurs in the strong economy.

The bottom part in Figure 9 summarizes how these various forces of divergence, which reinforce each other, tend to undermine the achievement of internal balance in individual member states while at the same time, instead of holding things together, also driving the members of the monetary union further and further apart. This is not the result of structural rigidities. It is the result of the ill-conceived Maastricht macroeconomic policy regime in conjunction with the working of supposedly equilibrating market adjustment forces.

Figure 9: Partners drifting apart until...



Reliance on the competitiveness channel may disturb overall balance rather than restoring it

Turning now to the upper part in Figure 9, it is true that all along wage-price flexibility is indeed driving the competitiveness channel in the supposed way. Relatively lower wage-price inflation boosts Germany's external competitiveness, and the country's trade position improves. By contrast, Spain's external position deteriorates together with its external competitiveness due to relatively higher wage-price inflation reflecting Spain's ongoing boom.

In Mundell's analysis, changes in relative competitiveness, achieved either through wage-price flexibility or through nominal exchange rate adjustments, simultaneously help to restore external and internal balance in both countries affected, and in a mutually beneficial way. Importantly, Mundell assumed that the currency union is being hit by an *asymmetric* shock while overall effective demand in the common currency area is sufficient. However, these conditions do not at all describe developments in the euro area since 2001.

In particular, Germany was not hit by any adverse asymmetric shock in 2001 that required the country to 'restore' its competitiveness and regain external balance through competitive disinflation. Instead, with the usual time lag following the aggressive monetary tightening engineered by the ECB in 2000, the euro area experienced a severe but common slump in domestic demand, whilst external demand, too, took a dive. Quite the opposite of what Mundell's analysis assumes, the actual situation in the euro area was one of insufficient overall domestic demand, while Germany subsequently benefited from a benevolent asymmetric shock as recovery took hold 'everywhere else in the world economy'.

Arguably, among EMU members, Germany has benefited the most from the global boom since 2003. Yet, despite its favourable positioning in global export markets, and on top of its disproportionate benefits in terms of external demand stimuli received thereby, Germany has performed worse than much of the rest of the euro area. In particular, domestic demand in Germany has yet to recover from the 2001 slump. Of course there is the standard structural waffling, but why do these alleged rigidities affect domestic demand only, while the world export champion Germany can flexibly handle any export boom with no problem whatever?

The above analysis has shown how the Maastricht regime in conjunction with the working of market forces in line with wage-price flexibility has suffocated domestic demand in Germany. While this explains the German domestic demand malaise, it is not where the problem ends for the euro area as a whole. The point is that through relative wage disinflation and for no good reason, Germany has achieved a sizeable real devaluation at the expense of its European partners. Essentially, Germany has pursued a beggar-thy-neighbour strategy. Reflecting the inappropriateness of Germany's reliance on the competitiveness channel, intra-euro area current account imbalances are mounting as a consequence (see Figure 3 above). Rather than restoring individual members' external balance while helping to achieve internal balance in the union as a whole, growth in the euro area has become seriously unbalanced and competitiveness trends have diverged as the supposed partners are drifting apart.

Figure 10: Cumulative GDP growth and its composition (2001-2005)

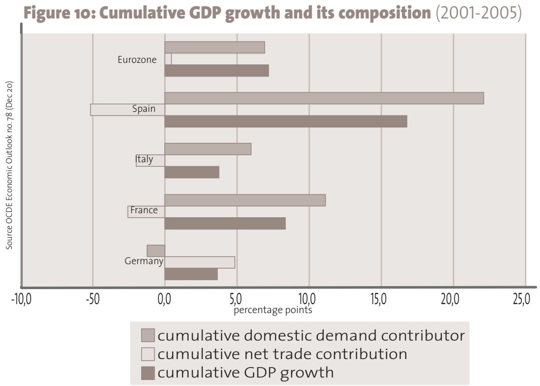


Figure 10 underscores that subdued GDP growth in the euro area between 2001 and 2005 was due to *domestic demand* growing barely more than one per cent per year while net exports – despite euro appreciation and the oil price shock, etc – made on balance a small positive contribution. Figure 10 also highlights that stark disparities in growth composition have occurred. In Germany's case, meagre GDP growth was more than exclusively driven by net exports while domestic demand shrank! In Spain's case, net exports on average subtracted one per cent from GDP growth per year – a situation not too dissimilar to the US.

Similar to occurrences at the global level, current account imbalances imply a corresponding build-up of financial imbalances within the euro area too. In particular, given that Spain's public sector is in balance, Spain's private sector is running down foreign assets and/or selling assets and debts to foreigners at a rate corresponding to the country's current account deficit (which is forecast to reach 10 per cent of GDP next year). A good part of the changes in net foreign investment positions is related to Spain's ongoing property market boom, a market which some observers consider to be seriously overheated. Financial integration in the euro area means that a property market bust in Spain is likely to have negative wealth effects beyond Spain – the stabilizing role of risk diversification. Of greater interest are potential problems in financial intermediaries in this context, as the risk of financial contagion relates to the apparently unresolved lender-of-last-resort issue in the euro area.

No doubt, up to this point the integrated financial system has smoothly financed the build-up of current account and financial imbalances related to persistent inflation and growth divergences as reliance on the competitiveness channel has not restored but disturbed overall balance in the euro area. Importantly, the intra-euro area changes in relative competitiveness, as driven by supposedly equilibrating wage-price flexibility, are *cumulative and permanent*.

It is, of course, not the first time that developments like these have occurred in Europe. Traditionally, balance has eventually been restored through adjustments in nominal exchange rates, or ERM 'realignments'. For instance, in the second half of the 1980s similar trends were observed which in 1992-93 then proved believers in the 'hard EMS' wrong. The big question is how the unwinding of intra-euro area imbalances can be accomplished today, now that nominal exchange rates are gone for good.

Structural propaganda incorrect

According to the official flexibility doctrine, everything would be just fine if only structural reforms were carried through more whole-heartedly. This is a great myth indeed. Essentially, the official view is pushing for microeconomic reform as a replacement for sound macroeconomic management. While Mundell thought of nominal exchange rate adjustments and wage-price flexibility as alternatives specifically in the case of asymmetric shocks, the official flexibility doctrine regards structural reform as a panacea that would bring about wage-price flexibility sufficient to compensate for the missing macroeconomic tools that adherents to the Maastricht regime have deliberately foregone. However, not even flexible economies like the US and UK can do without proper demand management. Arguably, these economies perform much better than the euro area precisely because they benefit from the flexible use of macroeconomic instruments.

But the structural propaganda is incorrect in other respects too. For one thing, notorious claims that positive confidence effects would come along with structural reform have been revealed as nothing but wishful thinking. If anything, Germany has proved the opposite to be true. As a result of the creation of job uncertainty, structural reform has undermined confidence. By implication, for structural reform to be successful there is a need for accompanying macroeconomic policies that boost incomes and demand – rather than the opposite as is current practice.

For another, suggesting that structural reform is also the answer to Spain's competitiveness problem and external imbalance exposes seriously flawed thinking. No doubt structural reforms (intertwined with SGP-imposed public thrift campaigns) have played their part in weakening workers' bargaining position in Germany, thereby nourishing Germany's competitive wage disinflation. And of course, certain interest groups continue to push for still more of the same medicine for Germany. To restore its lost competitiveness, Spain would thus need to embark on even faster wage disinflation and even more ambitious structural reform. And yet Spain's cumulative competitiveness loss is not the result of rigidities. Market forces have played out according to the script. Booming Spain has experienced higher wage-price inflation than stagnating Germany – just as the competitiveness channel would seem to require in its supposed role as dampener of cyclical divergences. To avoid the accompanying permanent and cumulative changes in competitiveness, market forces would at the same time need to bring about relatively lower wage-price inflation in booming Spain compared to stagnating Germany. Even if this were possible with unfettered market forces doing their natural work in an integrated currency union, which is hard enough to imagine, the competitiveness channel could then obviously not function as a dampener of cyclical divergences through net exports as a pull or drag factor on GDP growth as well. Proponents of the official flexibility doctrine appear to be keen to spoil whatever little credibility they may have left[6].

Competitive divergence is a serious threat to EMU

The bottom line is that we are clearly asking too much of the competitiveness channel. In Mundell's analysis, wage-price flexibility and nominal exchange rate adjustments are alternative expenditure-shifting instruments, applicable to restore external balance in the case of asymmetric shocks. In the case of common shocks, union-wide wage-price flexibility can be stabilizing when combined with a flexible common monetary policy – but only then. The official flexibility doctrine assumes wage-price flexibility to look after both external and internal balance as long as we abstain from proper use of macroeconomic policy and no matter what kind of shock might derail the euro area. There is no theory to back up these confused beliefs. Persistent divergences and mounting imbalances are the consequence.

In a recent interview upon retiring from the ECB Board, Otmar Issing once again confirmed how seriously muddled the euro area's key policymakers are about developments in the economy under their stewardship. Issing (2006) expresses concerns about diverging unit-labour cost trends, which, he justifiably fears, may give rise to tensions. He suggests that by allowing their external competitiveness to deteriorate, certain EMU members have manoeuvred *themselves* into a difficult position which requires *them* to change course. The fact is that even in booming Spain, wage inflation has been very low by any standard. Another fact is that diverging unit-labour costs trends are due to Germany's resorting to a beggar-thy-neighbour strategy. Inviting others to follow Germany's example and engage in competitive wage wars is a recipe for disaster (Bibow 2006b). And it should also be remembered here that one key motivation for EMU in Europe was to ban competitive devaluations forever. With the guardians of stability themselves now calling for that very kind of warfare between EMU partners, the euro may not be blessed with a long life.

Mr Issing's prescriptions provide yet another example of serious and systematic misdiagnosis, characterizing policy-making in the euro area. When the euro area was hit by a largely symmetric

6 For instance, referring to persistent divergences in measures of competitiveness between member countries, Papademos (2005, p. 3) asserts that the 'persistence of these developments suggests that adjustment mechanisms are functioning slowly and that self-equilibrating forces are not sufficiently strong'. The notorious call for structural reform follows.

negative demand shock in 2001, which was at least partly caused by the previous monetary tightening in 2000 in the first place, the Maastricht regime failed dismally to offer a cure and re-ignite domestic demand. As stagnation was allowed to set in, the Maastricht regime in conjunction with supposedly equilibrating market forces then nurtured and amplified persistent divergences and the corresponding build-up of imbalances.

And yet there is currently much excitement about a supposed recovery apparently underway at last. Pre-emptive cheers may be unfounded. In the context of the four-year global boom that started in 2003, the euro area has been the only world region that has managed to stagnate throughout. Of course, potential growth estimates have been adjusted downwards, which conveniently helped to close the negative output gap through statistical fudging rather than policy. Today, the global environment can hardly get any better, it seems almost bound to get worse. The ECB embarked on what it considers a 'normalisation' of interest rates (i.e. tightening) even before any compelling signs of a revival in domestic demand had emerged. With stagnation-oriented monetary policies set to continue and fiscal tightening 'no matter what' in the pipeline as well, the results will be just that: stagnation.

Meanwhile, Germany's beggar-thy-neighbour strategy poses another serious threat to the viability of EMU in Europe. Proponents of EMU should realize that it is first of all the Maastricht regime that requires structural reform. Structural reform to unleash market forces in full while failing to reform the ill-conceived Maastricht regime will lead not to competitive stability, but to competitive divergence instead.

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LABOUR MARKET REFORMS AND MACRO-ECONOMIC POLICIES IN THE LISBON AGENDA

Richard Exell[1]

This is an important moment. We need to look at the structural reforms that have happened so far, and decide what reforms we can and cannot support.

The first point I would want to make is that the trade union movement needs to argue intelligently, but that we also need to stand out against the developing consensus when that consensus is pointing in the wrong direction.

There is a tendency among some economists to see employment regulation, strong labour market institutions and high standards of social protection only as a problem.

But, of course, the laws, institutions and practices that make up employment regulation do more than simply affect the degree of labour market flexibility in the economy. They were all introduced to promote a desirable social purpose. Some may do so ineffectively or inefficiently; and that is worth knowing; but a policy that saw them only as 'rigidities' to be got rid of would be neither desirable nor feasible.

Despite the reputation of our government, what we have actually seen since 1997 has been the partial re-regulation of the labour market.

Take the minimum wage. I know that minimum wages are controversial for unions in some countries, but here I want to just consider the neo-liberal politicians and economists who bitterly opposed it because it would reduce wage flexibility; it would, we were told, increase unemployment and inflation.

In fact, price rises in 1999 (the year the minimum wage was introduced) were *lower* than in the previous year. Employment rose by 250,000 in that year, and it has continued to rise alongside the minimum wage, so that there are now more than a million more jobs than there were 7 years ago.

Contrary to some predictions, the minimum wage has raised productivity and output. When it was increased in 2001, nearly a fifth of firms responded by increasing their use of new technology, and it has also been responsible for modest increases in training and improvements in retention and motivation in the low-paying sectors.

The minimum wage has made life better for many low paid workers. 1.2 million received a pay increase, with black and minority ethnic workers and disabled people gaining disproportionately; and over a million people have gained from each subsequent increase. It has reduced the gender pay gap by about 1.5%.

Or consider the rights introduced by the Working Time Directive. These rights *enhance* efficiency through improved health and safety, a better climate for gender equality, promoting better work-life balance. Indirectly it reduces labour turnover, leads to increased innovation and more innovation.

In the UK, despite the severe limitations resulting from our opt-out, 6 million people got an increase in their holiday entitlement, *including 2 million who had previously had no holidays at all*. This is a large increase in the total of human happiness, and it is shocking how many politicians and commentators pay it no attention at all.

We need these rights to have the force of law because there are far too many employers who will do nothing, even when better conditions would be in their interests, helping them to maximise the contribution their workforce can make to the organisation. A major survey, known as Working in Britain, found that *"managers are pragmatic enough to adapt to change in the way they treat their employees when it is required of them but few seem willing to take any positive initiative to introduce workplace reform to meet worker demands or aspirations."*

Getting rid of employment legislation would not make the problems it addresses go away. Remove rights and workers will try to defend themselves through their unions, weaken the unions and they will turn to the courts. Businesses hate the 'compensation culture' that has long been a feature

[1] TUC - UK

of US employment, where unions have been weak and regulation set at a low level for many years. Its rise in the UK has uncannily followed the move to deregulation and attacks on unions.
So, some level of regulation is a good thing. And I could (and, in British debates, often have) make a similar case for social protection and collective bargaining.

But it's important not to get carried away by this argument and live down to the stereotype of the trade union dinosaur, opposed to any labour market flexibility.

Because we shouldn't forget that what unions do, day in-day out, is to *promote* flexibility. Let us take numerical flexibility, because it is normally the most controversial – as the current French experience illustrates.

Numerical flexibility is usually taken to have two aspects: internal and external. Internal numerical flexibility is actually much more easily regulated by collective bargaining than by legislation. Unions have long experience of negotiating on overtime, shift premia and annual hours contracts. Business people who resent the intervention of outside regulators in these matters might care to consider the advantages of working with a union to agree mutual gains solutions.

In ideological terms, what unions do is to help make clear that promoting reform, flexibility and higher growth is not the same as re-ordering the workplace on one-sided terms. Innovation, new technology, training and re-organisation of work (especially the introduction of high performance working practices) are all more likely in unionised firms. This is certainly true in the UK, and I would guess is so in other European countries as well.

We make it *easier* to introduce these reforms because we make sure that all the human aspects – what causes 90% of failures in reform programmes – are addressed. But we won't let it happen in a one-sided way. We make sure that reforms are introduced on a win-win basis – there's something for our members in it.

Now, if what you want to do is promote reform, flexibility, higher growth and employment, that isn't a problem. It's only a problem if what you want to do is to use the reform process as a vehicle for re-ordering industry on employers' terms. We have a lot of experience of that in the UK, and we know that a key task for unions is to distinguish between reform programmes that are genuine, which can be a basis for negotiation, and those which are part of a rhetorical exercise, facilitating an attack on working people.

One of the key questions in this intellectual battle ground is around external numerical flexibility – employers' freedom to hire and fire.

This has become something of a totem for the free-market right. Employment protection legislation and strong unions, they believe, hamper productivity, because firms are unable to respond to changes signalled by the market. Lower productivity eventually feeds through to lower total employment, which also results from employers' reluctance to take on extra workers for fear that they will be unable to dismiss them, should the need arise. Unemployment will therefore, it is argued, be higher in economies with tougher employment protection standards.

Contrary to what newspapers across Europe write, and contrary to what the UK government itself sometimes says, British experience since 1997 actually weakens this case.

Most anti-regulation arguments from international evidence rely on comparisons between the USA and the EU. This is interesting – between 1979 and 1997 the UK went as far down the de-regulationist route as the US, but is much less frequently quoted. There is a good reason for this: UK jobs growth in the 80s and 90s was consistently at around the same level as the rest of W. Europe or slightly worse. Our foray into de-regulation had *no* effect on this pattern.

It is a similar story when it comes to unemployment. In the 1960s and 1970s UK unemployment was lower than in the economies than went on to form the current Eurozone, but between 1980 and 1995 the average annual unemployment rate was higher in the UK than in the Eurozone. Only in the second half of the 1990s has the gap widened significantly between UK and average Eurozone unemployment rates, a period when labour market regulation in the UK was increasing.

Of course, none of this stops the neo-liberals substituting what they believe for what anyone can observe. After the 1997 election the right-wing economist Patrick Minford predicted that, together with the minimum wage, the new Government's (very moderate) plans for strengthened employment would cost more than half a million jobs in the first year, and a million by the end of the second. Recalling this prediction highlights the fact that this is not the best time to argue that labour market efficiency depends on less secure employment.

Far from being a threat to jobs, re-regulation has been accompanied by a significant increase in employment - by about 1.5 million since 1997. We have the highest employment levels and lowest unemployment for a generation, with new records being set every month, and most of this growth has come from permanent employee jobs, not temporary work and self-employment.

There is no evidence that labour market regulation reduces productivity growth, and the impact on overall unemployment levels is small. A better way of thinking about the links between institutions that restrict employers' freedom to hire and fire (notably strong unions and employment legislation) is that lower protection increases insecurity but also increases the rate at which people are hired, and thus reduces long-term unemployment. But it also increases firing, and thus increases short-term unemployment. In practice, the two effects nearly cancel each other out, so the overall impact of weakening unions or lowering legislated standards is slight. This was certainly the conclusion reached by the OECD in a 1996 study, and it has repeatedly been confirmed by international empirical studies.

In any case, the motor of job creation isn't labour market regulation, it's the level of demand. Inefficient labour market institutions could, in theory impair the ability of a country to respond to favourable macro-economic circumstances, but they can't create demand when it doesn't already exist. Trying to increase employment through structural reform is, to use a metaphor coined by Keynes in other circumstances, like pushing a piece of string.

It's strange that, at a time when commentators insist that Britain shows the importance of labour market reforms, we have actually seen unemployment falling because of effective macro-economic policies that the UK government rarely boasts about. It has been a unique achievement – alienating progressives across the continent by boasting about the reforms that *haven't* raised employment, whilst keeping quiet about the overall economic management which *has*.

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