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**Reforming European Labour Markets:  
The Unfinished Agenda**

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I would first like to say that I am very honoured to participate in this conference here in Vienna. My mission today is to give you an OECD view about labour market reform in Europe. I will try to do that, but you will forgive me if I also draw on my past professional experience as a policymaker in Paris and Brussels. To save time, let me tell you upfront what are the three main messages I want to convey.

- **First, Europe has made substantial progress reforming its labour markets over the last 10 years.** Job creation has been stronger and unemployment has declined – not by accident but through better policies.
- **Second, European countries have made uneven progress.** Some of them have achieved remarkable success, for example the Nordic countries, Ireland and the United Kingdom. Substantial progress has also been achieved along the “Atlantic façade” – Spain, France, Belgium and the Netherlands. In contrast, Germany has only lately started to reform its labour markets.
- **Third and last message: we may have travelled the easiest part of the road toward full employment and a lot remains to be done.** Unemployment remains unacceptably high, in particular among young and low-skilled persons. Long-term joblessness is still a matter of concern and the employment rate of older workers is disappointingly low. Achieving the Lisbon Summit targets will indeed require a lot of ambition and courage.

I'd like now to come back to the past. To draw lessons from experience. In the current context of doom and gloom, it is important to remember that good policies led to substantial progress on labour markets. Through hard work and continued efforts, a large number of European countries managed to generate a “labour deepening process”. Labour deepening simply means using more intensively the most

abundant resource, that is, human resources. These countries mostly situated along the Atlantic façade did their best to price less-skilled workers back into the labour markets. They operated both from the demand side of the market, by cutting for instance non-wage labour costs and promoting wage moderation, and later from the supply side, through in-work benefits and tax credits designed to fight the so-called poverty and unemployment traps.

Governments also allowed a considerable expansion of temporary and part-time employment in those countries where traditional labour contracts were deemed too rigid. These “special” contracts have indeed spread very rapidly in Spain, Portugal, France and Finland. It remains, nonetheless, a question of debate how much they added to overall employment.

The “labour deepening” strategy has produced impressive results. Over the past 10 years (1993-2002), which is the full length of an economic cycle, employment in the business sector has increased by nearly 14 million in the European Union, nearly as much as in the United States (16.4 millions). Altogether, unemployment declined from a peak of 10 per cent in the mid-1990s to about 8 per cent currently. In addition, these gains have withstood rather well the current slowdown. While unemployment has increased, it remains well below the peak reached during the last downturn. All in all, the fall in European unemployment seems to be a lasting one, borne out of better functioning labour markets.

**This brings me to my second point: the uneven speed and spread of labour market reforms among European Union countries.** For various reasons, the pace and scope of reform have differed across Europe in the past 10 years. Germany has been particularly timid until recently. France took useful measures in the mid-1990s but relapsed into Malthusian policies with the 35-hour week. Spain, and more recently Italy, have engaged in a continued effort to adapt labour market regulations and arrangements. Nordic countries, the Netherlands, Ireland and the U.K. have been more comprehensive and persistent in their efforts.

As a result, labour market outcomes are quite uneven across Europe. Unemployment rates vary from the low levels of 4½ per cent in Austria and Ireland to 9 per cent and above in France, Germany and Spain. Employment rates are also highly dispersed. In Italy only slightly more than half (55 per cent) of those of working age are employed. By contrast, three out of four persons are employed in Denmark and the Netherlands.

As the OECD has shown in a recent study of the sources of growth, low utilisation of labour is the main factor behind the gap in GDP per capita between Europe and the US. As you all know, labour utilisation depends on both employment rates and the number of hours worked per employee (Slide 2). Using this measure of labour utilisation European countries look a bit more homogeneous than one might think *prima facie*. To give just one example, it appears for instance that the Netherlands and Germany have managed to keep relatively high employment rates by resorting to short working hours (Slide 3). In truth only a handful of European countries (Austria, Scandinavia, the UK) can meet the test of high labour utilisation (Slide 4).

Well functioning labour markets may not only be useful to reduce mass unemployment and stimulate long-term growth, but also to ensure the resilience of European economies in the short run. I do not have the time today to thoroughly address the interactions between labour markets and economic resilience. Let me just say that in the case of Germany, at least, lack of resilience seems deeply rooted in fragile labour markets.

Let's turn to **my third point: the most difficult challenges are still ahead of us**. We first need to remember that past improvements started from a very low base. Europe had very poor employment prospects in the early 90s so that even today the situation remains unsatisfactory with low employment rates, high unemployment and severe labour market exclusion for the most vulnerable groups.

In addition, the pace of progress has obviously receded in the recent past. At present trends, it will indeed be very difficult to meet our Lisbon objectives for 2010. I don't need to remind you of the key figures. At 64%, the rate of employment in Europe is well below the 70% Lisbon target. For older workers, the situation is even worse. We aim for 50% in 2010 but the employment rate is still hovering at 39% today. This is a very large planning gap.

The problem is not only that a lot remains to be done, it is also that the easiest remedies have already been used up. So far, governments have often reformed by stealth, or in other words, by turning a blind eye when markets were bypassing burdensome regulations. In countries such as France, Spain or Italy, for instance, hiring workers under "special" labour contracts has become *de facto* the norm while the highly protected sort of contract is reserved for long-standing employees. More temporary contracts make it easier for firms to adjust to cyclical fluctuations. But it also contributes, negatively, to create a dual labour market.

Reforms have also been relatively “painless” because governments have chosen to alter workers’ and businesses’ behaviour the “soft way”, i.e. through lower taxes or higher public transfers. The deteriorated state of public finances in most European countries will make it very difficult to accentuate these policies in the future. Budgetary scope to expand further earned income tax credit kinds of schemes or lower taxes on labour will be much more limited.

These “painless reforms” have made important contributions. But they will be more difficult to mobilise to address the remaining problems I already mentioned. The next steps toward full employment will imply tackling labour market institutions and mechanisms more squarely than in the past. Entailing at times a high “political cost” for the authorities in the face of strong resistance to change.

In this challenging context, I would like to mention five possible priorities for future reforms.

**First priority: putting the employment rates of older workers on a rising track.** Encouraging older workers to stay longer in the labour force is not an easy task. Obstacles will have to be removed from both the demand and supply sides of labour markets.

We have been working hard at the OECD on some of the supply-side issues. And we found that in most European countries the opportunity cost for older workers of staying in the labour force is often prohibitive.

This applies to people in their mid-fifties faced with the possibility of entering pre-retirement or similar schemes. It also applies to people in their sixties willing to stay beyond the legal working age. As a general rule, working extra years beyond the legal age does not bring you any increase in your future pensions.

According to a forthcoming OECD study, this very skewed set of incentives has had quite a negative impact on employment. Why did this absurd situation emerge? Because pension policies have often been subverted and used as auxiliary instruments for misguided labour market policies. It was often believed that by removing ageing workers from the labour force you would reduce unemployment.

This, of course, did not happen. Unemployment remained high in those countries which indulged in Malthusian policies while the long-term sustainability of pension systems was badly affected. It is now

time for governments to roll back all these disincentives. This means dismantling preretirement and other similar schemes and allowing those people who want to work past the legal retirement age to do so.

On the demand side it will be important to make sure businesses adjust rapidly to the new policy set up and manage to retain ageing workers in the labour force.

All these changes on the pension side are of course needed to stimulate potential growth and buttress the sustainability of public finances. But they should also be seen as a first step toward more flexible systems, à la suédoise, where people will be able to choose when to withdraw in the full knowledge of the consequences on their pension incomes.

**Second priority: adapting employment protection legislation to meet the present needs of our societies.** Here we need to provide adequate protection to all employees without penalising employment nor interfering with the good functioning of labour markets. Ideally, we should strive for shared flexibility and job security, or to put it differently full employment without dualism in labour markets.

As you all know, special contracts, such as part-time or short-term contracts owe their current popularity to good and bad reasons. On the positive side, they provide employers and employees with flexibility in some special circumstances. They may help employers cope, for instance, with highly seasonal or uncertain activity. And they provide some employees with better opportunities to combine work and other activities such as care giving, education or leisure.

On the less positive side, however, it may be suspected that the current spread of special contracts is reflecting excess regulation in the rest of the economy. In countries with strict employment protection, special contracts may indeed remain the only option to retain flexibility. This is probably why, in France, two-thirds of new hirings have taken the form of special contracts in the past few years. And why also, in Germany, during the same period, permanent jobs sharply contracted, while temporary employment increased (Slide 5).

Temporary jobs are now a significant reality of our labour markets. They have probably contributed to alleviate Europe's unemployment problem. But as a result labour turnover and job insecurity are now highly concentrated on vulnerable groups living at the fringes of labour markets. This kind of two-tiered labour market comes with additional drawbacks too. Because they are less regulated

than traditional labour contracts, temporary work is often less remunerated. They also provide a lower access to key fringe benefits, such as paid vacations, paid sick leave, unemployment insurance and pensions. From a broader macroeconomic perspective, it could even be argued that the increasing number of people on short-term contracts may shelter long-standing employees who may be tempted to push up wage demands further.

It is now time to move from second bests and palliatives to first best options. We need to give more balance to the currently polarised arrangements. It could mean reforming head-on permanent contracts with a view to minimising separation costs. A less encompassing solution may involve the introduction of a benchmark fixed-term labour contract, characterised by a reasonable but not excessively long duration and moderate separation costs. Whatever the options, labour contract reform is certainly needed to reduce dualism and social exclusion.

**Third priority: activating the fight against unemployment and poverty traps.** Here we should aim at removing the strongest disincentives to take up low-paid jobs. Financial disincentives can be for instance very strong if high replacement incomes, relative to wages, are cut off abruptly when getting a job.

How to alleviate these unemployment traps is of course a matter of political choice and budgetary circumstances. Some countries might choose to boost in-work benefits while maintaining high replacement incomes. Others may choose to reduce them.

Most countries would be well advised, in addition, to review and tighten the management of unemployment schemes. A variety of parameters such as eligibility conditions, job searching requirements, time-degressivity of replacement incomes may have to be adjusted according to circumstances.

To be a bit more concrete, it would be good if practice matched principle, so that unemployment compensation is really withdrawn when job offers are systematically refused. One has to recognise, however, that regrettably enough unemployment compensation is very often paid regardless of job searching activities. Hence job placement agencies have an essential role to play to remedy these obvious deficiencies. Indeed, some countries have had remarkable success with so-called activation policies where replacement income is conditional on availability to various work-like or training activities.

To put it in a nutshell, we are still far off the mark when it comes to fighting unemployment traps. In this field, there is still a lot of unfinished business and more worryingly much unstarted business.

**Fourth priority: reducing further labour costs for low-skilled workers.** In most countries, there is no budgetary room for additional cuts in labour taxes should they be needed. In this context, the tough issue of reforming minimum wage formation cannot be bypassed any more. In France, the cost of unskilled labour is still relatively high with detrimental consequences for employment. In my home country, indexing minimum wages on consumer prices rather than average wages will help. More generally, adapting minimum wages to sectoral and regional specificities should also be advised. Here it needs to be borne in mind that poverty, which we all want to avoid, is first and foremost a phenomenon linked with the absence of work.

**Fifth and final objective: pruning active labour market policies.** Active labour market policies have a tendency to proliferate and to detract policy makers' attention from more substantial labour market reforms. As such, they can easily reach the zone of negative returns.

To avoid such an overstretching they should be targeted to areas of proven value. A number of training and subsidised employment schemes directed to the youth and long-term unemployed seem indeed valuable. These programmes should of course be designed in cost-effective ways. All in all, European governments spend between 1 and 2 per cent of GDP on active labour market policies. From past personal experience, I have the strong feeling that here lies a source of solid budgetary savings.

To wrap up my thoughts, this afternoon, I would say that 10 years ago European labour markets were indeed in very bad shape. At the time and following the lead of pioneering countries such as the Netherlands and the UK, other countries launched difficult reforms. These attempts were often met with suspicion, derision or hostility, in wide segments of the population. With hindsight and contrary to naysayers' predictions they produced good results.

Now is the time to launch a second wave of reforms. If anything, this second wave may be more difficult to steer through than its predecessor. But it is no less needed. As you well know from newspapers, labour market reforms are back in the headlines. Meeting again with stiff resistance. To those embattled reformers, I would say: some Europeans made it a while ago, others can make it now. Let us go forward.

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## **Reforming European Labour Markets:**

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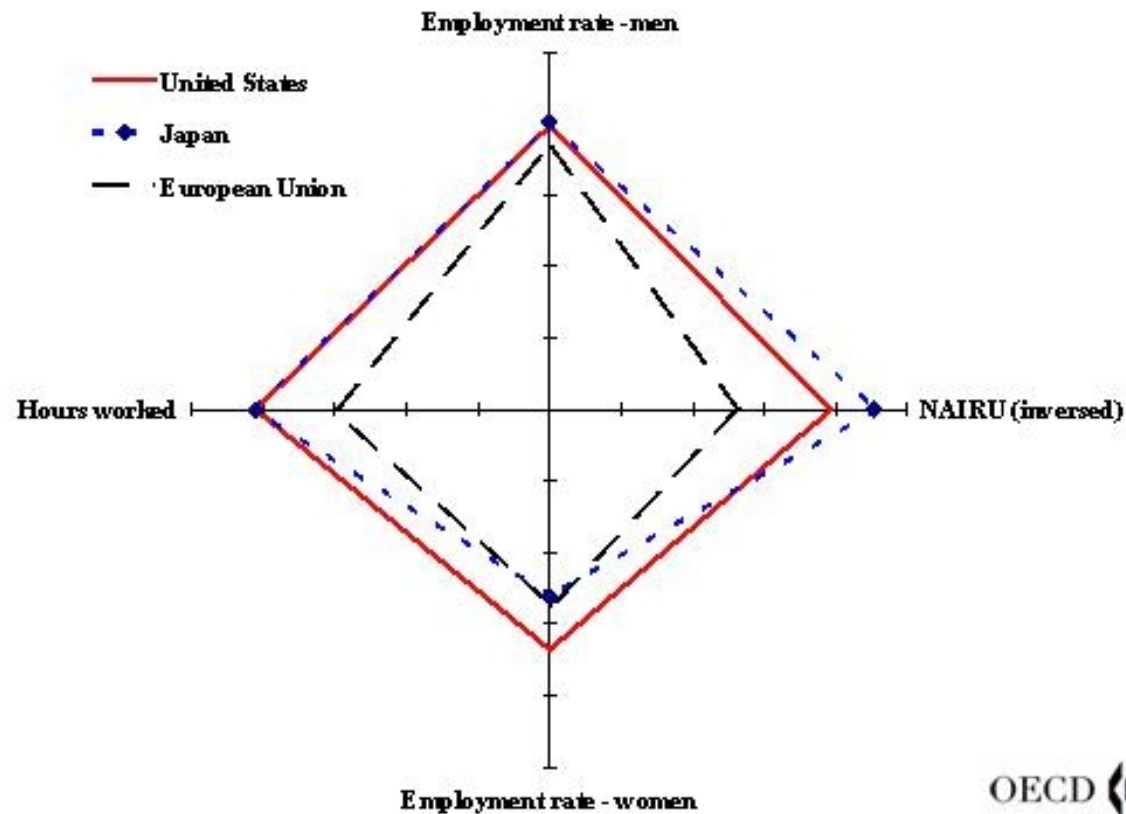
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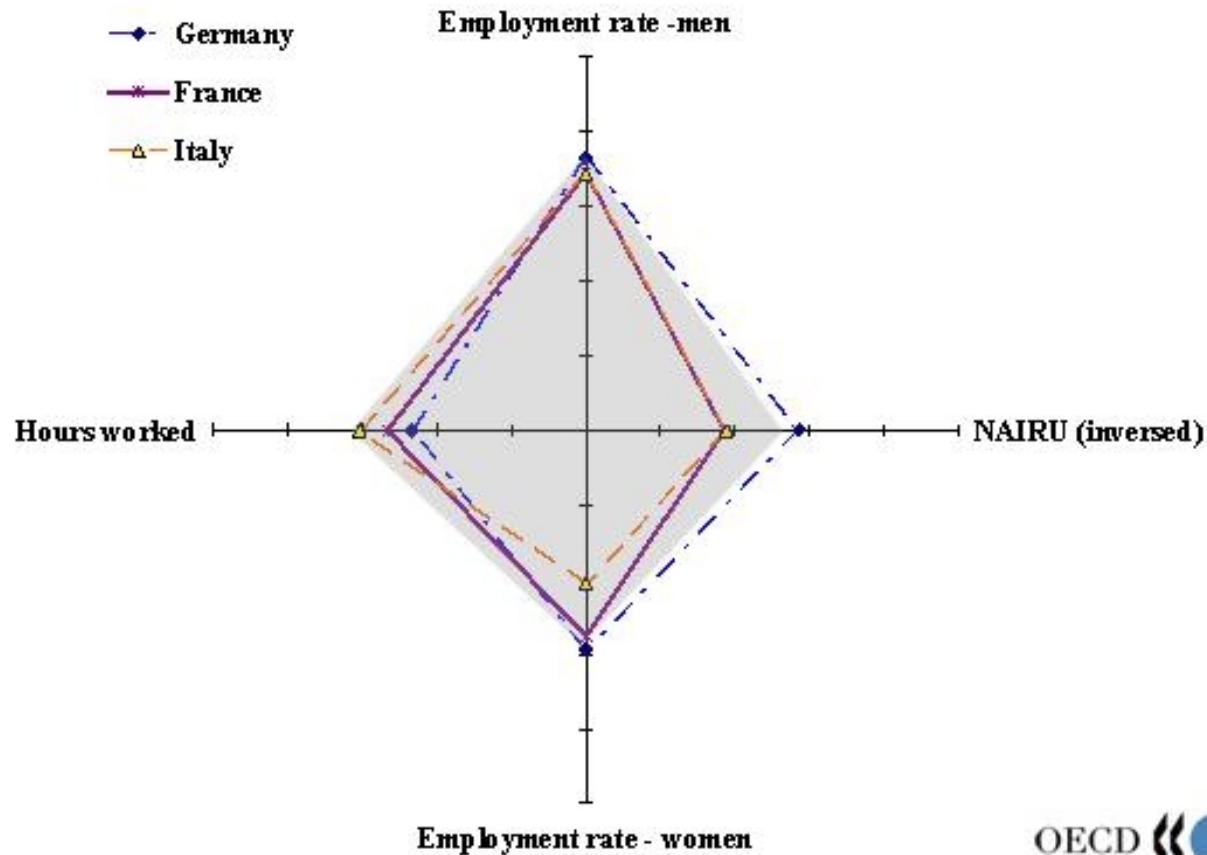
# How do countries perform in terms of labour force participation?

## The European Union, the United States and Japan



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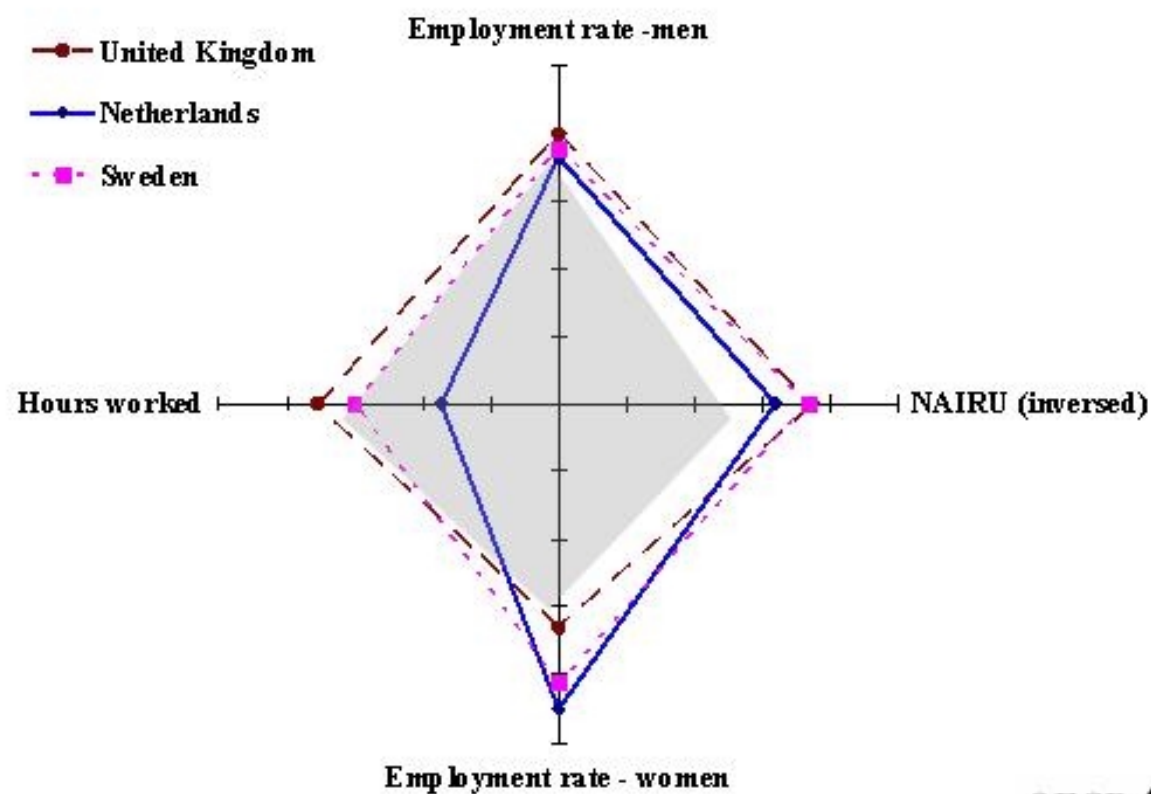
## The European Union



Note: European Union average shown in gray area.  
Source: OECD.

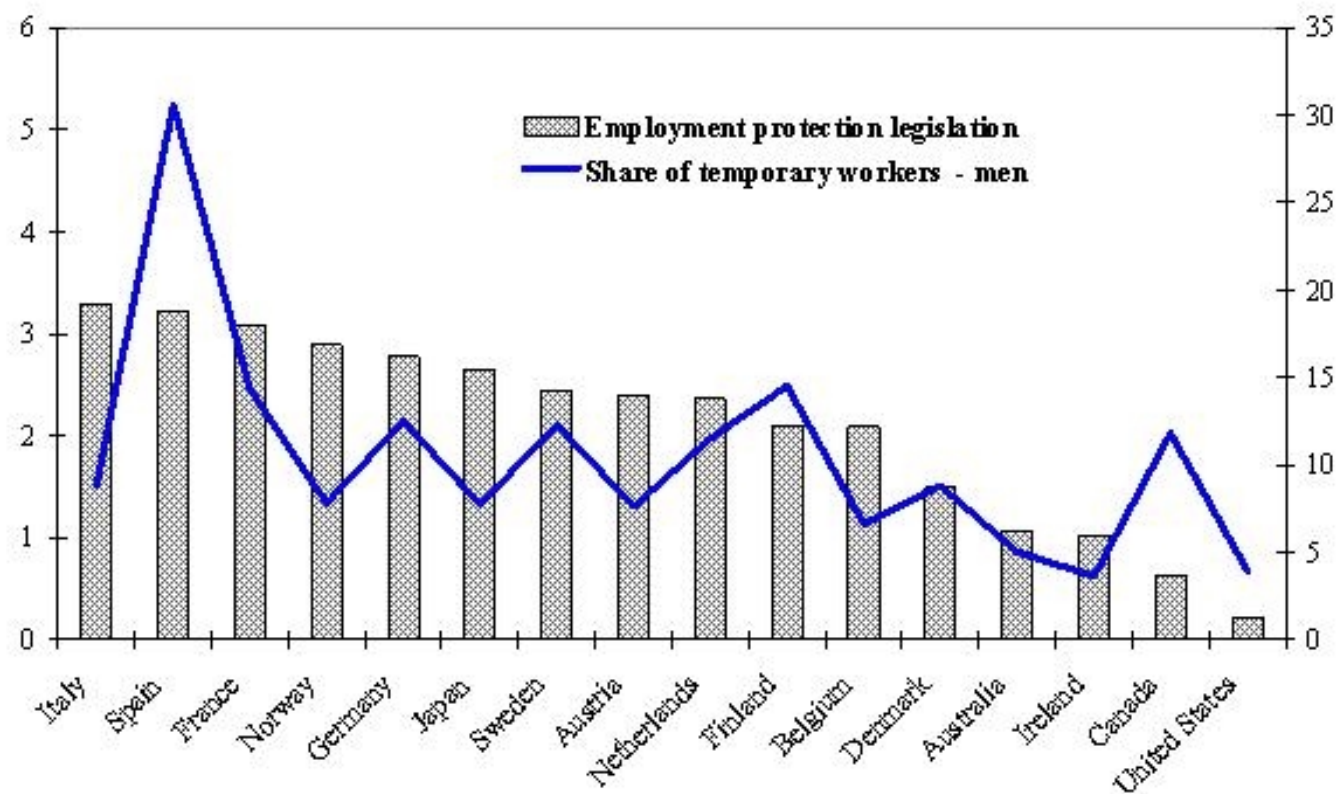
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## The European Union



Note: European Union average shown in grey area.  
Source: OECD.

## The link between EPL and temporary employment



Note: The scale of employment protection indicators is 0-6 from least to most restrictive. See Nicoletti *et al.* (1999).

Source: OECD.