Labour Market Reforms, Pay-Setting Systems, and Employment

by

Lars Calmfors

Institute for International Economic Studies, Stockholm University

Speech at the conference on "Economic Growth in the European Union" organised jointly by SIEPS (the Swedish Institute for European Policy Studies), the Center for Business and Policy Studies (SNS), and the Trade Union Institute for Economic Research (FIEF) in Stockholm on 29 April, 2004.

The topic of my speech is *labour market reforms, pay-setting systems, and employment*. But I want to start with a comment on the general theme of the conference, which is growth, in order to complicate things a bit, which I think is an important task for economists.

Usually in the public debate, it is just taken for granted that employment and growth are two sides of the same coin. Politicians almost always see it this way. The main reason is, of course, that over the business cycle, short-term variations in GDP and employment are strongly correlated because they mainly reflect variations in capacity utilisation. But it is not at all clear that countries that experience a process of long-run growth must also have low unemployment and vice versa. In fact, it can be quite important to make a distinction.

If we look at the effect of productivity growth on unemployment there are opposing arguments. One can argue that growth promotes employment because it increases the return to employers of investing in the hiring and training of new employees. But one can also argue the opposite, that high growth driven by structural re-allocations of labour causes frictional unemployment.

Looking at the effect of employment on growth, it could be argued that high employment increases the return to investment in capital, because higher employment means more workers per unit of capital, and because more investment stimulates growth. But there does not really exist any robust evidence of a strong empirical relationship between long-term growth and employment.

So, one does best to make a distinction between the problems of achieving sustained long-term growth and of creating jobs. Policies that stimulate long-term growth need not raise employment, and policies that stimulate employment need not raise long-term growth. Sometimes growth and employment policies may even be in conflict with each other, which means that one has to decide which goal to give priority to.

I shall focus on the *employment problem*, not the long-term growth problem, in my presentation, not because it is more important, but because I know more about employment generation than about long-term growth. It is, of course, the case that if unemployment can be reduced, then GDP increases will be larger than what they would otherwise have been during the period of adjustment.

So, how should one then characterise the European unemployment problem today. Well, it looks rather different today than, say, ten or twenty years ago. Then the picture was one of high unemployment throughout most of Western Europe. Today the picture is much more diverse. If we adopt a twenty-year perspective, a number of countries have succeeded in reducing unemployment quite substantially. The most successful countries are Ireland, the Netherlands, the UK, and Denmark.

Today unemployment in Western Europe is to a large extent the problem of the large continental economies: Spain, France, Germany, and Italy, and of some other countries, such as Greece, Finland, and Belgium.

How should we explain the persistently high unemployment in these countries? The general problem is how to decompose unemployment into *structural* or *equilibrium unemployment* – that is the unemployment that depends on a badly functioning labour market – and *cyclical unemployment* – the unemployment caused by weak aggregate demand. To make this decomposition properly is, of course, very difficult – there exist almost as many ways of doing it as there are economists.

But even if it is clear that there is significant cyclical unemployment in all European economies at present, most economists agree that there is also very substantial structural unemployment in the large continental economies. It must be because unemployment there has prevailed for so long.

There also exists a large body of empirical research, which tries to explain the differences in unemployment both among countries and over time in individual countries. This literature supports the view that most of the observed unemployment is indeed structural and is explained by fundamental factors in the labour market, by *labour market institutions* as economists like to put it. Indeed, about half of the variation in unemployment among countries and over time can be explained in this way.

Almost all empirical studies agree that high unemployment benefits, a long duration of benefits, a high degree of unionisation, and a high coverage of collective agreements contribute to high unemployment.

According to some studies, high labour taxes also cause unemployment, but according to others there is no effect. Most studies find no effect of employment protection on overall unemployment, although stringent employment protection seems to affect the composition of unemployment (increasing the shares of both youth and long-term unemployment).

Most studies find that large expenditures on active labour market policies reduce open unemployment, which is an issue I will come back to. As regards the structure of collective bargaining, the studies agree that a high degree of co-ordination seems to promote low unemployment, whereas it is unclear whether or not decentralised bargaining at the firm level also does that, which is an issue I will also get back to.

Overall we seem to have rather good knowledge of which changes in labour market institutions reduce unemployment, even if estimates of the exact effects of individual changes often vary a lot. The general presumption is then, of course, that in the more areas changes in an employment-friendly direction are made, the greater are the chances that unemployment is reduced.

A roundabout way of illustrating this is to compare the number of changes in labour-market institutions in an employment-friendly direction and the number of changes in an employment-hostile direction in different countries (employment-friendly and employment-hostile changes being defined according to my earlier slide). This has been done in a rather courageous way by an English colleague, Steve Nickell, who did find quite some correlation between the number of changes in an employment-friendly direction of various labour-market institutions and reductions in unemployment in the OECD countries between the 1980s and recent years with, as you can see, an excess of employment-friendly movements in countries that succeeded in reducing their unemployment rates substantially, such as Ireland, the Netherlands, the UK, and Denmark but with little change or an excess of employment-hostile movements in less successful countries like Italy, Germany, and France.

Overall, as you can see from the simple regression equation at the bottom of the table, the difference between the number of employment-friendly changes in labour-market institutions and the number of employment-hostile changes has quite some explanatory power for the development of unemployment. Of course, this is very crude – it is something you can do as a professor, but we would probably not allow our students to make such a simplistic analysis – but still it is very suggestive.

What are the prospects for more far-reaching labour market reforms in the continental European countries with high unemployment? In the jargon of economists there are a number of political-economy obstacles to labour market reform. Or, put more simply, voters just do not like such reforms. There are a number of reasons for this.

- One is *misconceptions* of how the economy works. Over the years, I have had a number of disputes with Swedish trade union economists, but if I compare them with their continental European colleagues, Swedish trade union economists must be considered world-class. If I take Germany, which I know the best, many German trade union economists – and many union members and voters – still seem to see no need for wage restraint to raise employment. Instead, they sincerely believe that the best cure for high unemployment is to raise wages in order to increase the purchasing power of employees. Such simplistic Keynesian views are views that no Swedish trade union economist would hold today – at least not in public – but these views are quite common in Germany, and also in France and Italy.

- Another political-economy obstacle to labour-market reform is what can be labeled *analytical myopia*: the negative effects of, for example, less generous unemployment benefits, in terms of income losses for the currently unemployed, are very concrete and occur already in the short run, whereas the benefits in terms of wage restraint and future higher employment are more abstract and occur in a more distant future.

- A third political-economy obstacle has to do with *conflicts of interest*. It may simply not be in the interest of those who already have a job – insiders in the labour market – with some labour market reforms (such as reductions in the extent of employment protection, changes in the bargaining system that restricts the right to strike, or reductions of legislated or collectively agreed minimum wages) that improve the employment opportunities of the unemployed at the cost of smaller benefits for the already employed.

Against this background one can be quite pessimistic about reform possibilities in countries like France, Germany, and Italy. In France, the government seems now to be reversing an earlier cut in unemployment benefits for long-term unemployed after the recent election defeat. In Italy, not very much seems to be happening in practice.

In Germany, quite radical reforms have been decided, such as cuts in the unemployment assistance levels for long-term unemployed and increased requirements on the unemployed when it comes to job offers they have to accept.

But these reforms are deeply unpopular and one cannot rule out that they will be reversed before they have been fully phased in. The worst thing that can happen in Germany is probably a limited cyclical upswing, which will only have a short-run effect on unemployment, but may give the false impression that things can be set right also without fundamental reforms.

So what then are the politically easiest things to do? One politically attractive option is always *active labour market policies*. This was what we focused on in Sweden with very unfavourable results in the 1990s. Similar policies with large programme placements have been followed in Germany and France with, as I understand, equally disappointing results. (In general, it is very unclear whether such programmes raise or reduce *regular employment*, even though most studies show that they reduce open unemployment.)

This insight has led to a shift at least in Germany from large placements in long-term training and practice programmes to more of activation measures designed to promote the search activities of the unemployed (originating with the proposals of the so-called Hartz Commission)

I believe this is a step in the right direction. There are studies indicating that outflow rates from unemployment can increase significantly (15-30 per cent) for limited groups that activation measures are focused on, but it is hard to believe that such measures by themselves can make a large difference for the whole economy in situations of generally low demand. To exaggerate just a little bit, such measures seem to work only if unemployment is falling anyway for other reasons (as happened in the Netherlands, the UK, Denmark, and also Sweden in the late 1990s).

What other measures can be adopted? One substitute for labour market reforms, which is politically easier to carry through, even if it may meet resistance form particular interest groups, are *deregulations of product markets*. Such deregulations have an employment-increasing effect both because they eliminate monopolistic behaviour – and thus boost output and employment – and because they restrain wages to the extent that monopolistic rents that can be appropriated by unions are reduced. Here, I think the continental European countries would be well advised to follow the Swedish example of deregulating product markets much more.

Another option is to increase the pay-off of work, as opposed to living on welfare, for low-wage earners through *employment tax credits* of the US or British type, where taxes are reduced on income from employment, but not on welfare payments. This is the *Earned Income Tax Credit* in the US, and the *Working Family Tax Credit* in the UK. One can either conceive of general tax rebates for all low-wage earners – which are very expensive – or rebates that are targeted on long-term unemployed or earlier welfare recipients – which are less expensive.

It ought to be much easier to get political support for tax rebates on income from employment than for cuts in unemployment benefits.

(Here one should note, though, that there may be a trade-off between long-term growth and employment. General tax reductions for low-wage earners will raise the employment rate, which is good, but will, on the other hand, reduce the return to education, which may have a negative effect on growth. But this may be a price one wants to pay for inclusion of more workers in the labour market.)

A final measure that one should in my view contemplate is *tax rebates on household-related services* in order to stimulate employment. As we all know, this is no area where Sweden can teach other countries anything. But there are good social-efficiency reasons for such tax rebates, as high taxes seem to have more distortionary effects in the market for such services than in most product markets (because demand is more price sensitive when the alternative to buying services in the market is production within the own household). (One can also regard temporary such tax reductions in recessions as a form of active labour market policy, which does not suffer from any crowding-out effects on regular employment, because these are services where no such regular jobs to be crowded out exist in the first place, except of course in the black market where crowding-out is a desired objective.)

(Again, a measure like this could have negative effects on long-term growth because it increases the pay-off to low-wage jobs, and therefore reduces the return to investment in human capital. But again, this might be a price worth paying for having more jobs.)

It seems to me that the least risky way to tackle the unemployment problem is to go for limited reforms in many areas rather than huge reforms in just a few areas: incidentally, this was the way that the Dutch did things in the 1980s and early 1990s. It is probably much easier to get political acceptance for such limited reforms in many areas than for very far-reaching reforms in individual areas.

Reforms in one areas are also likely to be much more effective if there are simultaneous reforms in other areas. One example is wage setting. If the wage bargaining system remains very rigid, then it will take a long time before, for example, a less generous unemployment benefit system – as is now being devised in Germany – gets full effect on wages and employment. This brings me to my last set of issues, that is possible reforms of wage setting.

Looking at the wage-setting systems within the EU, one is struck both by the similarities and the differences. One similarity across the continental countries in Western Europe and the Nordic countries is the high coverage of collective agreements with coverage rates usually over 60-70 percent. This holds true, even though unionisation varies quite a lot: with as low rates as 10-15 per cent in France and Spain.

The main locus of collective bargaining in most of Western Europe is the sectoral level. This applies in particular to countries like Austria, Denmark, Germany, Italy, and Spain. But there are also many examples of co-ordination of bargaining at the national level, sometimes through various social-pact arrangements in smaller countries like Belgium, Finland, Ireland, and the Netherlands – and, through arrangements such as “Industriavtalet”, also in Sweden.

What do we know about the impact of various wage-setting arrangements?

1. As I said before, there is a lot of support in various empirical studies that, everything else constant, highly co-ordinated collective bargaining contributes to wage moderation and low unemployment as compared to less co-ordinated bargaining at the sectoral level.

2. It also seems clear that lower unionisation and coverage of collective bargaining contribute to lower wage levels and lower unemployment.

3. It is not clear how decentralised bargaining at the firm level compares with bargaining at the sectoral level. There are about as many studies saying that, again holding everything else constant, decentralised bargaining produces lower wage outcomes and lower unemployment than sectoral bargaining (although not as good results as highly co-ordinated bargaining) as there are studies saying the opposite.

4. But in the real world everything else is not constant. On the contrary, decentralisation of collective bargaining to the level of the firm usually goes hand in hand with low unionisation and low coverage of collective agreements, so that

the net effect is likely to restrain wages and reduce unemployment, even if decentralisation of collective bargaining *per se* does not do this.

5. The most evident relationship between the wage-setting structure and wages is that high unionisation, high coverage of collective agreements, and high co-ordination of collective bargaining are all associated with a *compression of the wage structure*, mainly by reducing wage dispersion between the median income and low incomes. This is easy to see from the diagram, which I have borrowed from an Italian colleague, Claudio Lucifora, where the curve shows the ratio between the wage of the 5th and the 1st decile (RHS scale) in the mid 1990s. This ratio is higher in countries to the left, most of which are countries with limited importance for collective bargaining and decentralised such bargaining at the firm level. Such reduced wage dispersion tends to reduce the amount of low-wage employment in the economy (the staples show the ratio in total employment of those that are paid less than 2/3 of the median wage).

6. Finally, we know that wage-bargaining institutions are extremely persistent. Fundamental changes either take a very long time to accomplish or require extreme situations or possibly both (such as in the UK in the 1980s or later in New Zealand, and to some extent in Australia).

Which conclusions should one draw from all this? One concerns those smaller European economies that have been successful in moderating wage increases through co-ordination of bargaining. It is difficult to see any reasons for them to abandon this approach, even though these countries should be able to achieve even better employment results if they were to allow more of flexibility of relative wages. Now, the positive employment effects of co-ordination are achieved through aggregate wage moderation, but these effects are counteracted by employment losses for low-productivity workers, which are squeezed out from employment by wage compression at the bottom of the wage scale.

The need for more relative-wage flexibility is even clearer in countries that have not been so successful in adjusting their real wage levels so as to reduce unemployment.

The prime example is Germany, where the relative wage in eastern Germany versus wesern Germany is 77 percent, while relative productivity is only 57 percent. This relative-price-distortion is the main reason for the much higher unemployment in eastern than in western Germany and is something that the present German wage-setting system has not been able to handle.

In Germany it has proven even more difficult to reform the wage-bargaining system than to do other labour-market reforms. This is what one should expect, since reforms of the pay-setting system has a direct impact on the already employed “insiders” in the labour market, whereas less generous unemployment benefits and tougher job search requirements have their first-round effects on the unemployed and not on the already employed.

If reforms of pay setting in Germany are to be swift, they would have to be done within the existing system. They could encompass elements like:

1. Wider possibilities for “*opening clauses*”, allowing local wage agreements on lower wages than in the sectoral agreements if employers and employees agree on that (either through an agreement between the local works council and the employer or if a majority or employees accept this in a ballot at the firm level).

2. Another possibility would be to import the Swedish practice of “*sifferlösa avtal*” at the sectoral level (I am not quite sure how to translate this into English, neither “numberless” nor “figureless” agreements seem to be the right term) delegating the decisions on the margin for wage increases to the local level. The Swedish experience shows that such a change could be accepted easier than moving over to a system of bargaining only at the enterprise level, because collective agreements then continue to exist at the sectoral level, which always makes it possible to “recall” the delegation if one wants to do that.

3. A third possibility is more of *profit-related pay*. To the extent that profit-related pay is substituted for a fixed wage, it becomes profitable for firms to hire more labour on average over the business cycle, at the same time as cyclical

employment fluctuations are counteracted. But the trade-off between such profit-related pay and ordinary wages can only be bargained at the level of the individual firm. So if this is to be possible, higher-level collective agreements must find a way of delegating such decisions to the local level.

I am rather pessimistic that the present bargaining system in Germany will be able to reform itself sufficiently. If so, I think that a development is likely, where unionisation, membership of employers´ associations, and coverage of collective agreements will slowly fall over time, as it has in eastern Germany.

Then I see two main possible scenarios. One is that the present unemployment situation continues with only marginal improvements for quite a long time. Another is a development of a more Anglo-Saxon nature, where at some point it becomes politically possible to revolutionise the whole pay-setting system in a market-liberal direction. But as in the UK and New Zealand this would then require massive legal interventions. Such radical change is at present very far away, but we know from experience that it could suddenly become politically feasible after a long time of crisis and disappointment with the existing system.

But to conclude, I am not optimistic when it comes to the possibilities of reducing unemployment substantially in the Western European countries that still have high rates. Of course, things will become better in the cyclical upswing, but this will not solve the problem of high structural unemployment. I believe it would be possible to reduce unemployment in these countries quite substantially through a combination of not too radical changes in a number of areas – as other countries have already managed to do – but the political obstacles are still very large. So, I don’t think we should expect large reductions in unemployment in the large continental economies within soon. Thank you.