ELEC – Economic and Social Commission

"Do Labour Market Rigidities in Europe Reduce Potential Growth in European Economies"

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Ladies and gentlemen,

the title of my presentation hides in fact two questions: the first one – the obvious one – is what is the impact of the particular way labour markets function in – shall I say Continental European countries – on macroeconomic outcomes, in particular regarding employment and output growth. The other one – less obvious this one – concerns the qualification we want to give to this particular "European" way of organising labour markets.

Part of the ongoing debate in many European countries is exactly about this latter issue: whether we shall characterise labour markets in Europe as being rigid. Some have claimed that lay-offs or job rotation rates – the amount of workers that enter or exit a job – are as high as they are in countries with supposedly flexible labour markets, such as in the US or the UK. Others have argued that nominal wage rigidity is not substantially different in Continental Europe than what we observe in other industrial countries[‡], although there are differences across countries.

You will not be surprised to see me on the side of those who stress the fact that European labour markets are indeed characterised by a substantial amount of what is rapidly described as "rigid". However, I will argue in my presentation that we should try to give this term its full meaning in order to understand its role in the process of economic growth, not least to better target our efforts for those structural reforms that

‡ R. Freeman and R. Schettkat (2000), "Skill compression, wage differentials and employment: Germany vs. US", NBER Working Paper, no. 7610; M. Burda and Ch. Wyplosz (1994), "Gross worker and job flows in Europe", European Economic Review, 38, pp. 1287-1315; O. Dessy (2002), "Nominal wage rigidity and institutions: Micro-economic evidence from the Europanel", CREST, mimeo; F. Kramarz (2001), "Rigid wages: What have we learnt from microeconometric studies?", in: J. Drèze, ADVANCES IN MACROECONOMIC THEORY, Palgrave, pp. 194-216.

are unavoidable and necessary shall Europe come close to reach the strategic target that it has given itself in the Lisbon agenda.

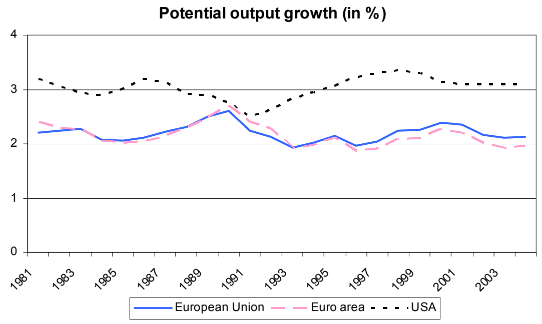
In my presentation, I will first put forward the particularities of the economic developments in the EU and the euro area and compare them with the US that has been chosen as a natural benchmark. These stylised facts motivate a first conclusion regarding the characteristics of European labour markets and their impact on potential growth. I will then continue to describe the current stance of structural rigidities and their reform in EU countries to move on in a second step to discuss their impact as analysed in the literature. Finally, I set on to provide a more extensive discussion on the different constraints that such a reform agenda has to satisfy and to conclude with some general remarks regarding the objectives and their implementation in the reform process.

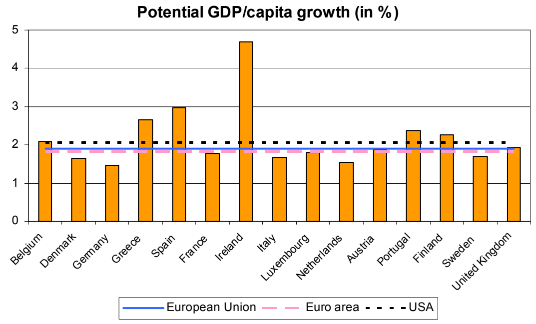
1. Getting the facts right

Let me start with some stylised facts about the evolution of potential output growth[§] in the euro area and the European Union. As a natural benchmark, I have chosen the US to show how evolutions have differed over the last two decades. In the following Chart 1, you can see that – except for a short period at the end of the 1980s – the potential output growth rates have been lower in Europe compared to the US by around 1 percentage point.

§ Potential output growth measures the evolution of GDP independent of any cyclical influences. It answers the question: How fast could an economy grow provided all factors would have bee fully employed?

Chart 1: Growth of potential output and potential output per capita



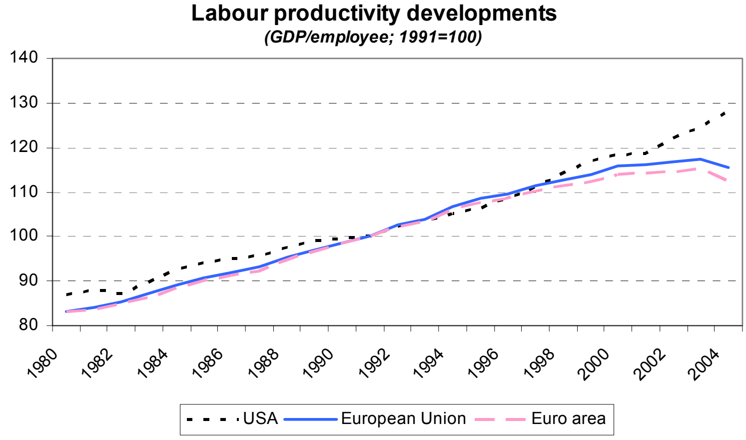


Source: IMF World Economic Outlook

Nevertheless, as can be seen in the chart on the right, this growth differential can mainly be attributed to different demographic developments as potential output per capita growth is roughly the same between Europe and the US. Let me nevertheless point out the important differences that exist across the EU, and in particular the relatively low per capita growth potential in some bigger countries such as Germany, Italy and to a lesser extent France.

When differences in the demographic dynamics are taken into account, potential output growth rates, therefore do not seem to be very different on both sides of the Atlantic. This is also reflected in the fact that labour productivity developments have been comparable in both areas (see Chart 2). While over the long run, the evolution has been quite similar, there is, however, a worrying sign of a more sluggish and even decreasing labour productivity development towards the end of the 1990s. In this period, the US is certainly the more dynamic economic area.

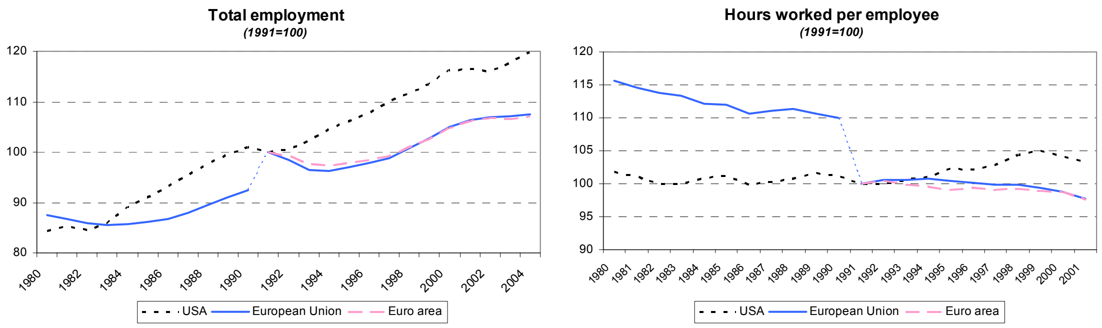
Chart 2: Similar labour productivity developments



Source: Eurostat, BLS

Although demographics may have played a major role in determining differences in potential output growth, the lower use of labour resources may have added to this effect (see Chart 3). While the lower employment growth may itself be determined by the low demographic dynamics, hours worked per employee have followed a secular declining trend in Europe, whereas they have been stable in the 1980s in the US and on the rise since then, adding to potential output growth differences.

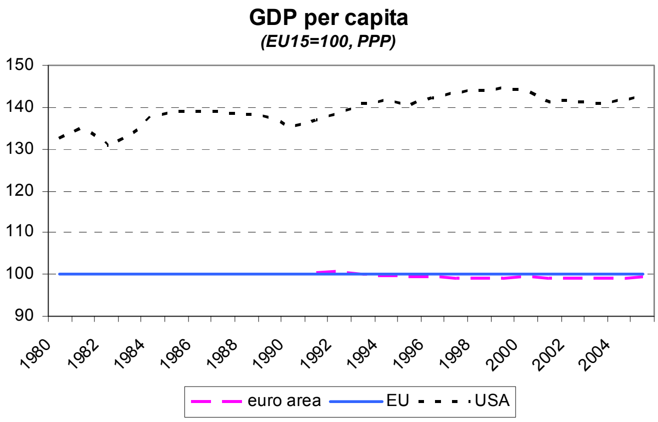
Chart 3: Declining use of labour resources in Europe



Break in EU series due to German reunification; euro area series starts in 1991 only
Source: Eurostat, BLS

As a result of these developments – in particular related to slow employment growth and declining hours worked – the convergence of European GDP per capita levels towards their US counterparts stopped in the 1980s and a slight divergence has appeared since then again (see Chart 4).

Chart 4: Lack of convergence to US levels



Source: IMF World Economic Outlook

Developments on the labour market, in particular the substantially lower degree of labour supply can therefore be seen as the main culprit for lower output growth rates. This has led researchers and policy makers to concentrate on the analysis of the labour market and to assess whether rigidities on this market are to blame for the much more disappointing economic evolution in Europe.

2. Labour market rigidities in Europe

a. What rigidities are we talking about?

Before going into details regarding the impact of labour market rigidities, let me first give you a short overview of the different types of rigidities economists are talking about. For the sake of this presentation, I would like to differentiate between three types of rigidities and their respective labour market origins:

- First, rigidities may present obstacles to the adjustment of real variables, such as employment and output ("Real rigidities"). These rigidities may arise, for instance due to employment protection legislation or measures regulating working time and the use of part-time employment.

- Second, rigidities may affect nominal variables, in particular nominal wages ("Nominal rigidities"). These rigidities may be caused, *inter alia*, by minimum wage legislation, wage bargaining systems or the administrative extension of wage floors across sectors or firms.

- Finally, specific social security systems may present rigidities in the sense that they affect the market outcomes, for instance by increasing gross wages. In particular, non-wage labour costs may reduce labour demand, while tax wedges or minimum revenue guarantees negatively impact on labour supply for high skills (tax wedges) or low income earners (minimum revenues).

b. Nothing changed?

These rigidities continue to characterise to a large extent the functioning of European labour markets. They may not be present in all countries to the same extent, but there are noticeable differences in particular when comparing the Europe-wide average with the corresponding level of the US[**]. Nevertheless, it would be unjustified to claim that nothing has changed over the last years. An extensive agenda for structural reforms has been introduced by the European Commission, and various countries within the EU have proceeded with their own specific reforms.

[**] The OECD has documented these differences constructing indicators for different types of labour market rigidities throughout several publications and working papers. Among these, the interested reader may consult: OECD (1997), IMPLEMENTING THE OECD JOBS STRATEGY, Paris; OECD (1998), "The OECD jobs strategy: Progress report on implementation of country-specific recommendations", OECD Economics Department, Working Paper no. 196; G. Nicoletti, S. Scarpetta and O. Boylaud (1999), "Summary indicators of product market regulation with an extension to employment protection legislation", OECD Economics Department, Working Paper no. 226.

On the EU level, the different reform agendas – starting with the Single Market Initiative that opened up goods markets across the EU since 1993 – have been grouped together to form an overarching strategic goal: the so-called Lisbon agenda. This agenda has the specific objective to improve the economic dynamics in Europe and can be considered as the focal point of the reform discussion on the European level. A particular aspect of this agenda concerns reforms on the labour market, which have been grouped together in the "Luxembourg process", including provisions to raise employment for the elderly, improve human capital investments and diminish structural unemployment.

On the country level, reform efforts – in particular in the very recent period – have been concentrated on measures to guarantee sustainability of public finances, especially regarding the increasing burden related to population aging in Europe (Agenda 2010 in Germany, Agenda 2006 in France). Other countries have opted for more direct measures to improve access to the labour market by facilitating the use of part-time work such as in Spain and the Netherlands, or by introducing modest elements of flexibility in regular contracts such as in Italy. Overall, however, the progress with reforms especially on the labour market is assessed as being too timid to produce any strong impact over the short term[††].

[††] There are, however, some observers considering the current efforts as being sufficient to produce more pronounced positive developments in the long run (O. Blanchard (2003), "European Growth over the Next Decade", MIT Economics Department, http://econ-www.mit.edu/faculty/download_pdf.php?id=786).

3. A primer on rigidities and growth

a. What is the impact of rigidities on labour markets and potential growth?

On the basis of this rather unsatisfactory assessment of the structure of labour markets across Europe, let me now discuss the consequences this may have for the evolution of potential growth and the conclusions we should draw from this analysis for a balanced and ambitious reform agenda. As I have indicated in the introduction, here will be the place to develop more thoroughly the impact structural reforms may have. In particular, we will see some important constraints that such an analysis is imposing on any reform agenda. I will nevertheless start with exposing the consensus view on the impact of structural reforms.

In this view, structural reforms on labour markets are thought to be able to cope with some or all of the above indicated rigidities. In particular, they may

- reduce employment adjustment costs: This should strengthen incentives for employment growth in cyclical upturns as entrepreneurs do not expect large layoff costs, once adverse shocks interrupt the expansionary period. Over the cycle, the total effect on employment growth is ambiguous, but may nevertheless be positive, when it allows a more rapid turnover of the workforce, helping to avoid costly loss of skills and experience;

- reduce nominal wage rigidity: nominal wage rigidity can be considered as part of the reason for more pronounced labour shedding in a downturn as firms have to adjust their overall wage bill. In combination with real rigidities caused by employment protection, nominal wage rigidity are considered to be a strong burden on firms that helps to explain why rigid economies are characterised by more severe downturns and less employment- and growth-intensive upturns;

- improve incentives for labour supply: reducing tax wedges and lowering implicit taxes that result from poorly designed social security systems help to improve the supply of labour and restore incentives to invest in human capital, thereby upgrading the quality of labour supply.

While structural reforms on labour markets may have immediate (positive) results for employment growth and labour market participation, they are also though to help to improve the outlook for potential growth.

On the one hand, structural reforms are meant to increase labour supply, thereby automatically fuelling into potential growth rates, or at least compensating for a declining work-age population. This is, however, only a transitory effect. Once a higher steady state has been reached, potential output will stay at a higher level but not growing faster.

In addition, structural reforms will also improve the microeconomic functioning of the labour market, which may have important repercussions for growth. In particular, to the extent that labour market turnover increases, the adjustment to new technologies may become less costly for firms, helping to increase the rate at which innovations are introduced in the production process.

Moreover, improved incentives for both firms and employees to invest in human capital of a firm's workforce help to upgrade the skills and competencies of the overall labour force, which constitutes an important additional input in the innovation and production process[‡‡].

Finally, it has been noted[§§] that increased and facilitated labour turnover leads firms to experiment more often with new technologies as they have to face less exit costs in case the experiment fails. In particular, in periods of soaring innovation and high uncertainty about the profitability of new technologies, low labour turnover costs may prove a considerable advantage over competitors which face a more rigid labour market.

b. Are structural reforms a free lunch?

It seems therefore that structural reforms could be considered as a free lunch: Remove the sand in the wheels, and potential output raises, making everybody better off. Unfortunately, things turn out to be a little bit more complicated than that and the effects that have been described in the preceding section should only be taken as a first indication as to the likely outcome of reforms.

A first, obvious objection is the fact that many structural reforms imply short-run transition costs as some economic agents will be made worse off initially, for instance through rising pressure to lower their real wages or higher employment insecurity. These short-term costs should play themselves out – at least in theory – once the new long-run steady state has been attained, but even if the long-term benefits are much

‡‡ On the importance of human capital for innovation and growth, see for instance A. Bassanini and S. Scarpetta (2001), “Does human capital matter for growth in OECD countries?”, OECD Economics Department, Working Paper no. 282

§§ S. Scarpetta, Ph. Hemmings, T. Tressel and J. Woo (2002), “The role of policy and institutions for productivity and firm dynamics: Evidence from micro and industry data”, OECD Economics Department, Working paper no. 329

more important than these transition costs, they can create formidable barriers to political reform and prevent the reform process to take place altogether.

But there is a second aspect to structural reforms that usually gets neglected in the policy debate: This has to do with the fact that structural reforms will also have long-term consequences, of which the direction is not immediately obvious. This is linked to the fact that many of the rigidities that arise in modern economies – be they European or not – do respond to deeper market imperfections and in particular to the impossibility of full insurance for many (risk-averse) market participants on imperfect capital markets[***]. In other words: where markets fail, rigidities arise.

In general, these market imperfections imply that the Walrasian (first-best) outcome – where fully-specified contracts can be written – is usually not in reach for economic agents or policy makers and that work-around (second-best) arrangements will emerge in order to provide instruments that at least partly resolve the underlying problem[†††]. These deliberately introduced – or unintentionally emerging – rigidities, however, will in turn shape – not necessarily reduce (!) – the incentives to undertake certain activities, such as innovative outlays, investment in human capital but also the effort employees display on their workplace. These activities constitute the cornerstone for advanced economies and will shape the profile of a country's competitiveness as has been documented a decade ago by Michael Porter[‡‡‡].

[***] For instance, employment protection legislation has recently been interpreted as being a second-best policy response to lack of insurance on underdeveloped capital markets (see G. Bertola and W. Koeniger (2003), "Consumption smoothing and the structure of labor and credit markets", IZA Discussion Paper, no. 1052).

[†††] See, for instance, the insurance function of employment protection or social security system and the "balancing market power" argument for the introduction of minimum wages.

[‡‡‡] M. E. Porter (1990), THE COMPETITIVE ADVANTAGE OF NATIONS, The Free Press

But if we accept the view that many structural policies and rigidities currently in place respond – at least partially – to underlying market imperfections, then a change introduced by structural reforms will also modify the incentives for these essential economic activities. A first and immediate corollary is the impact on the composition of output that has to be expected from such reforms, and that – in some cases – is explicitly put forward in the policy debate, for instance when it comes to the development of IT manufacturers and services.

A second consequence of this view, however, concerns the reaction of potential output growth following structural reforms: In the simple view introduced above, a monotonic relationship was to be expected, in the form: “less rigidities = higher output growth”. However, when rigidities correspond to such ‘second-best’ policies in the way described above, this simple equation does no longer hold and the reaction of output growth can be highly non-monotonic[§§§].

c. *Short term costs: How short term is short term?*

Even if we accept, however, the consensus view regarding the long term benefits of structural reforms, it is important to ask how quickly these benefits will settle in, as the distance to their realisation may constitute a formidable barrier to any reform agenda.

As I have presented above, an ambitious reform agenda is likely to change the composition of employment and output, implying that employees will have to switch sectors, jobs and occupations. Such a process is, however, usually very slow. Even in

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[§§§] In a recent paper, I have shown that this can have rather drastic consequences for the impact of (some) structural reforms on the expected potential output growth. In particular, the effect depends on the initial situation an economy finds itself; for some situations, the reforms may have the expected effect, for others a reverse effect appears, nullifying any positive impact on potential output. However, this applies only to certain reforms, while a range of other reforms have the expected effect disregarding the initial situation (see Amable and Ernst, “Financial and labour market interations: Market liquidity and specific investments”, CEPREMAP, mimeo, 2003).

small countries that have been hit by strong external shocks[****] such a process may take several years or even decades as has been documented in a recent ECB publication[††††].

This constitutes an important stress for the political system as the long term benefits are likely to settle in only once the new equilibrium has been reached. It is therefore important, shall such an agenda be implemented to time reforms in a way as to create irreversibilities ("tying one's hands") in order to avoid reform reversal in case the current administration gets voted out of office.

Moreover, policy makers should aim at designing reforms in a strategic way, as to avoid strong resistance[‡‡‡‡]. In particular, combining reforms to share costs and benefits equally across the economy, or implementing compensation schemes are possible way to avoid reform failure. Similarly, reforms and reform initiatives may be delegated to a third body, presumably supra-national and independent. This seems to be the approach that has been taken by the EU at least regarding the deregulation of product markets.

Finally, it has been argued in the past – and some countries including the US seem to have applied such a principle – to push forward with reforms only in periods of low unemployment and strong or sustained growth ("nice weather reforms"). This, however, bears the risk that reforms may be delayed if the pressure to reform is not felt to be urgent by policy makers. It seems to be a more promising approach to attempt reforms as soon as their importance has been acknowledge, trying to build what has

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[****] A good example is the Finnish economy that had been hit in the early 1990s by the breakdown of the Soviet economy.

[††††] European Central Bank (2004), "Sectoral specialisation in the EU : A macroeconomic perspective", Occasional Paper, forthcoming.

[‡‡‡‡] For a good overview of structural reforms and their designs, see the recent discussion in the IMF World Economic Outlook, ch. 3, which can

been called "national reform pacts" at a recent EU Council summit and to build on a more consensual method for reform.

d. What do we want to achieve in the long run?

While these short term obstacles may be considered a problem for policy makers to find and define a reform agenda that is sufficiently well designed to overcome these problems, my discussion of inherent constraints to structural reforms shows that we also have to be clear about our objectives that we expect to realise in the long run. Here, it seems, policy makers have been rather inconclusive, hoping that a general reference to the long-term benefits of structural reforms as I have described the general consensus view above would be sufficient. This, however, has not been very successful in overcoming reform failure, partly because the underlying reasons of why the institutional framework in Europe has to be changed are not agreed upon.

It has repeatedly pointed out that the current European framework on the labour market is largely in place since the 1960s, while the developments – in particular the rise in unemployment – have started at a later stage and according to different patterns across Europe. So it is natural to ask what has changed to make this institutional framework unsuited for the current situation?

- Some have claimed that the current institutional environment – largely inherited from the immediate period after the Second World War and developed since then – is particularly suited for catching-up economies that try to converge to the technological leader through high investment ratios[§§§§]. These countries can

[§§§§] D. Acemoglu, Ph. Aghion and F. Zilibotti (2002), "Distance to frontier, selection, and economic growth", CEPR Discussion Paper, no. 3467;

benefit from rather rigid economies when these rigidities help to appease the labour movement and do not represent strong obstacles in a period of fast and continuous growth. However, this hypotheses does not match with the fact that some of European countries have been technological leaders themselves relatively soon and at least already before the current slow growth period.

- Others have pointed out to the fact that the current introduction of information technologies in all aspects of our (economic) life constitutes a similar revolution as that of the steam engine and electricity[*****]. Hence, the change towards a new, "knowledge-based" economy may imply that we need to adjust rapidly to this new equilibrium, which is prevented by the current, rigid institutional framework in Europe. In its stronger version, this hypothesis even claims that the New Economy as such is not compatible with any kinds of rigidities on the labour market. Recently, however, observers have claimed that the IT revolution is over and that IT has reached a state comparably to a public good, quite similar to what electricity and the steam engines have been at their time. This would mean that firms will have to grow and innovate more along the traditional lines again, removing reform pressures in some areas.

- Finally, globalisation and the increasing economic openness are blamed for the increasing pressure that is put onto the "European Social Model"[†††††]. While Europe could hide behind high tariff walls and strong capital controls that have only been lifted starting with the early-1980s, institutional rigidities imposed a

[*****] G. Saint-Paul (2002), "Employment protection, international specialization and innovation", European Economic Review, 46, pp. 375-395

[†††††] H. W. Sinn (2002), THE NEW SYSTEMS COMPETITION, Blackwell

> tax on European entrepreneurs, which could not be avoided. Once the frontiers gradually open, capital becomes more and more mobile putting pressure on the resources necessary to finance these social benefits and to support labour market largesse. To the extent that these resources can no longer be generated through high-value added products, social systems have to be scaled down or at least to converge to a lower standard. Again, this hypothesis seems to neglect recent experiences – in particular in Scandinavian countries – where reforms on the labour markets have been fruitfully introduced without a significant scale-down by strengthening incentives for employment growth.

All three hypotheses seem to catch part of the changes that European economies have experienced, but all three lack the vision for the heterogeneous developments of European economies. In particular, they do not account for the fact that it may indeed be *different* reasons across countries in the EU due to which the institutional framework has to be adjusted.

Referring again to my previous idea that the Walrasian state of the market economy cannot be reached, it would indeed be possible for different countries to occupy particular niches in the international division of labour that still would guarantee strong employment and output growth. Indeed, it has been argued recently, that system competition may exactly have this kind of outcome as countries tend to specialise within a particular product segment, which best exploit their "institutional comparative advantages"[‡‡‡‡‡].

[‡‡‡‡‡] There has been an extensive discussion in the literature on the emergence and stability of these "Varieties of capitalism", see for a recent ove

4. Conclusion: Can we do better and how?

Let me finally draw some conclusions on the basis of this assessment. In particular, I would like to point to the constraints that a reform agenda should satisfy in order to respond to the imperatives that I have introduced at the beginning of my presentation – related to the slow-down of European potential growth.

First and foremost, the objectives of any reform agenda should clearly be fixed and communicated. While this seems to be straightforward, the recent opposition that the implementation of reforms has faced in several European countries show that this has not been respected in all cases. Part of this exercise of clarifying the objectives means that two important constraints have to be respected:

(i) The imperative of real-life economics vs. the temptation to attain an "imaginary" first best optimum.

(ii) The internalisation of inherent institutional constraints instead of defining individual benchmarks that run the risk of mutual incompatibility.

Respecting both constraints for fixing a reform agenda simply means that one does not only specify what targets should be reached but also how to get there, i.e. to define a sustainable trajectory.

This leads me to a second important point related to the logic that policy reforms are following. One point has already been noted earlier and is related to the timing and sequencing of reforms. Any ambitious reform agenda will have to face resistance at one point in time. Sequencing reforms in a way to "tie ones' hands" helps to reduce resistance to individual reforms but runs the risk – on the other hand – of not exploiting fully the benefits that come with reforms. It must be borne in mind that some reforms deliver their benefits only when implemented in a package and may actually have reverse effects when implemented individually.

Such a more clearly designed reform agenda also includes the better assessment of all short- and long-term costs and benefits that such a reform agenda may entail. Basing one's assessment only on a partial equilibrium model will not only bias the decision for or against a particular reform but may also jeopardize the construction of political support for such an agenda.

Finally, let me address some of the concerns that we regularly hear notably regarding the sustainability of a particular "European Social Model" and the fears that we eventually will have to converge towards an American model.

As you may deduct from the points I have developed above, I think that a more "rational" approach to analyse rigidities may help to better assess their impact on both employment and productivity developments and ulterior on potential output. One should not underestimate the importance of firm-specific investments that help to improve a firm's competitiveness; these investments will, however, react to any changes in the structural environment. Analysing the impact of the reform agenda on these investments is therefore crucial to determine the overall – long-term – impact of the agenda.

This is related to my last remark: that indeed there may be a scope for a European Productive Model that is based on current strengths and the development of new opportunities. These current strengths may be related what has been called before “institutional comparative advantages” that arise from the specific incentives and resources the European structural policies are providing, in particular in relation to human capital formation and effort choice that continue to uphold productivity both on the aggregate and at the firm level. The opportunities relate to the impetus that can be given be modifying the current institutional framework by levying obstacles where they do not correspond to any clearly-stated economic objective and modifying rigidities in such a way as to make their economic cost identifiable.