
Reforming the Labor Market and Social Programs

Some people change their ways when they see the light; others when they feel the heat.

—Caroline Schroeder

In chapter 2 we concluded that three interrelated factors caused the structural decline in Europe's employment. First, average real wages are too high to sustain full employment. Second, low-skilled workers are discouraged from taking jobs because of an inadequate return from work. Third, employers are required to pay high-wage rates and high payroll taxes that discourage them from creating low-skilled jobs. Thus, there is a problem in the level of wages and the distribution of wages.¹

In chapter 3 we found that one way to solve these problems is by increasing productivity with better business practices, stronger competition, and a progrowth regulatory environment. These steps will raise employment over the long run without reducing wages. But barring a productivity miracle in Europe, the road back to sustained economic growth will also require labor-market reform.² In fact, even if there was a productivity miracle it would probably occur with a good deal of employment restructuring that could raise unemployment in the short run.

1. The second and third reasons may seem contradictory. How can wages be both too high and too low? One answer is that in different countries or different types of jobs, employment may either be supply constrained or demand constrained. In addition, as noted in chapter 3, the large gap between company labor costs and worker net pay can cause the wage discrepancy.

2. Faster growth in Europe will also require an increase in aggregate demand, which will be discussed in chapter 6. This discussion, like the one in chapter 4, is about structural issues.

Reform and European Labor-Market Values

European policymakers recognize that employment incentives must be increased (European Council 2003), but some countries are still profoundly reluctant to increase incentives enough to generate an effective full-employment supply of labor. Reform programs in Europe are expected to be consistent with “European values,” which includes paying a full-time employee a high enough income to support a family. Any effort to lower the wage rates paid to low-skilled workers would violate that principle. Even when low-skilled jobs are available, many are undesirable tasks. If people receive an adequate income without taking such a menial job, they will choose not to work. Increasing the work incentives implies providing only a rather limited income to those choosing not to work, which violates Europe’s commitment to “social cohesion.” Similarly, both low- and high-skilled workers are often willing to retire early once they reach their 50s, if pension and guaranteed health insurance are available. Supporting cut-backs or the elimination of early retirement provisions is not only difficult politically but also seen as a violation of the social cohesion principle.

Another common belief in Europe is that existing jobs should be preserved as much as possible. Workers should not be expected to move to new jobs if a transfer entails a change of residence, a long commute, or a substantial decline in wages. Although worker mobility is recognized as inevitable, it is only grudgingly accepted.³

When thinking about preserving social values, however, it is important to take a broad view. First, social cohesion must take into account the burden that will be placed on future generations of workers. In chapter 2 we illustrated how life expectancy at effective retirement age has risen dramatically over the last generation while the size of the younger generation is declining. Many current European pension systems, if left unreformed, will be unsustainable going forward. The value of social cohesion should be viewed across both current and future generations.⁴

Second, the value of social cohesion should be applied to those excluded from the mainstream economy—not just those within the mainstream. Workers on the *inside* of the labor market are frequently in heavily protected well-paid jobs. Those *outside* the labor market are given basic

3. With the introduction of the euro the lack of cross-border labor mobility has achieved additional importance, since it may enhance inflation differentials between individual countries. In several European countries the lack of labor mobility has been linked to the high transaction costs of buying and selling a house, reflecting a lack of competition in the real estate market.

4. Some public opinion polls indicate that future European generations of retirees have limited faith in the sustainability of the current system. Up to 80 percent of workers under the age of 35 in France, Germany, and Italy believe that public pension systems will be substantially reformed within the next 10 to 15 years. See Boeri (2003).

income support but are not part of the active society. In European labor markets in 2002 fully 60 percent of the (large segment of) unemployed had been without a job for more than 6 months and 44 percent for more than a year.⁵ These high figures are not socially cohesive for the society as a whole. Immigrant communities are often part of the excluded segment.

Thus, it is important that European policymakers make hard choices now. After all, it will not be possible to continue to provide social insurance income support to the extent that has been achieved in the last decade or two. However, it is not necessary to eliminate social programs or create a harsh environment. Instead, social insurance programs can be restructured in ways that retain their ability to provide income insurance in the short run, while providing greater work incentives. Moreover, as noted in chapter 3, once employment increases, a virtuous cycle can be created where the tax burden created by payments to support the non-employed is reduced, and increasing workers' incomes can provide more work incentives.

Policies should be designed to facilitate job mobility instead of discouraging or preventing it. But to ease transitions, workers can be assisted in making job changes and provided with temporary income insurance rather than permanent jobless benefits.

The European labor market is currently not achieving its social goals. Segments of the population, including youth, are persistently unemployed or outside the labor force. The policies intended to preserve existing jobs are not successful either. Overall rates of job loss in Europe are high, as noted earlier in the OECD firm-level analysis. People argue that they are willing to sacrifice productivity in order to preserve jobs, but that is not what happens as a result of current social- and labor-market policies. The reverse, in fact, occurs since jobs are sacrificed and productivity is pushed up artificially.

Although the path to major labor-market reform will be arduous, there are clear indications that European views about social reform are changing, and policymakers and even voters are now more willing to tackle the problems. Some of the smaller European economies have already made reforms and the larger continental economies are being driven toward reform by current and future budgetary pressures.⁶ For example, in a speech given to the Bundestag on March 14, 2003, German Chancellor

5. Data are for the European Union. There are large differences among the countries. In Austria and Denmark only about 20 percent of the total unemployed have been unemployed for more than a year, whereas in Italy the number is a devastating 60 percent. In the United States in 2002 only 21 percent of the unemployed had been without a job for more than 6 months and only 9.5 percent for more than a year. All data are from OECD Labor Market Statistics, www1.oecd.org/scripts/cde/members/lfsdataauthenticate.asp (accessed October 8, 2003).

6. Major labor-market reforms have been carried out in Britain. Britain's labor market and productivity issues are discussed separately in chapter 4.

Gerhard Schröder made the case for significant reforms.⁷ He noted, “Non-wage costs have reached a level at which they have now almost become unbearable for employees. And on the employers’ side, they are an impediment to creating new employment.”⁸

In this chapter we look first at the principles that should be used to guide social policy reforms in ways that improve incentives while maintaining the essential elements of an economic safety net. Next, we evaluate the social policy reforms undertaken in the Netherlands, Sweden, and Denmark.

Whole treatises have been written on reform strategies for each aspect of social policy, so a detailed analysis of reforms in these programs goes far beyond the scope of this book. But the basic goal of reform is to rebalance programs so that employment incentives are improved as much as possible while ensuring that citizens are safeguarded against poverty. The next section will set out some principles for reform that draw upon the literature on this topic.

Social Policy Reforms

Health Care

Freeman (2002) has pointed out that health care likely influences workforce participation. He suggests that maintaining health insurance coverage is an important factor encouraging Americans to remain in the workforce. This is because Americans under age 65 generally receive employer-subsidized healthcare coverage through their employers but lose that benefit when they lose their jobs.

In contrast, Europeans are covered whether they work or not. Freeman supports the European system of universal coverage despite its impact on labor supply. He argues that the disincentive to work is worth the price to avoid the social cost from a lack of health insurance. After all, roughly 40 million Americans lack health insurance for some period each year, and millions more are concerned about losing their coverage. We agree with Freeman that universal health insurance to cover large medical bills or the cost of a chronic illness should be an essential part of the social safety net of any advanced economy, and it makes sense to encourage cost-effective

7. The discussion and the quotes are translated from an advance text of the speech. Gerhard Schröder, Policy Statement on “Courage for Peace and Courage for Change” at the German Bundestag, Berlin, March 2003, eng.bundesregierung.de/frameset/index.jsp (accessed December 8, 2003).

8. In mid-December 2003 the German Bundestag finally approved the reform package, called Agenda 2010.

preventive care. However, the impact of healthcare coverage on labor supply is more complex than Freeman indicates.

There is no question that free health care is a substantial benefit to workers. If coverage is provided regardless of employment status, it plays an important role in determining work incentives. Universal health insurance then becomes a substantial income subsidy, which has been shown to lower labor supply (the income effect reduces labor supply). Many Americans contemplating early retirement decide not to retire before 65 because they do not want to lose employer-subsidized health care before the point at which Medicare eligibility begins.

However, Freeman overstates the extent to which the US healthcare system provides a work incentive. In comparing the two regions it is worth noting that the US system provides a substantial work incentive for only some Americans. If one member of a family has health insurance, other members do not need to work to receive coverage.⁹ On the employer side, providing health insurance to employees at very high premium levels (currently rising at 10 to 15 percent a year) creates a heavy payroll tax for US companies. It also makes employers reluctant to hire older workers or workers with chronic diseases (e.g., diabetes). Further, low-income families can face a substantial disincentive to work because if they fall below an income threshold they become eligible for government-provided health insurance under Medicaid. Medicaid is a more comprehensive insurance program than those offered by many employers of low-wage workers (indeed many such employers offer no health insurance at all). At the Medicaid cut-off point, many workers face a marginal tax rate of 100 percent or more in the United States (especially since other income-support programs also phase out as income rises). Finally, in most US states, hospitals are required to treat all patients that come into an emergency room. Thus, people without health insurance do have access to emergency health care, and many low-income, uninsured families rely on this free care. In short, the US healthcare system does not provide a clear-cut work incentive for many Americans and is not the main reason why employment levels are higher than in Europe.

The basic structure of universal coverage for large health expenses can be maintained in Europe while reducing the work disincentives—and the budgetary costs—the current system creates in two ways. First, the coverage that is provided on a comprehensive basis should be restricted to serious or life-threatening health problems and to cost-effective preventive care. Second, certain drugs and medical procedures for nonlife-threatening problems could be either subject to substantial copayments or not covered at all.

9. Most firms charge employees an additional premium for family coverage, so the additional coverage is not free.

Rationing health care is essential. Otherwise a healthcare system that pays doctors and other providers on a fee-for-service basis and grants patients unlimited access to any treatment paid for by a third party will spiral out of control in total cost. In order to ration health care, either doctors or other providers in a national system must face incentives to reduce marginal or unneeded treatments, or the market must limit insurance coverage for minor medical problems. A combination of both measures could also be used. Shifting the financial burden of minor medical treatments to individuals would be helpful as a rationing device for healthcare systems and would increase work incentives.¹⁰

Putting greater financial responsibility on patients has already been accepted in much of Europe. Some European countries have also initiated the practice of copayments for general medication and hospital treatment. In France, the insured person's share in the cost of medication is up to 65 percent for prescriptions against certain ailments and 100 percent for nonessential drugs. In Belgium, the insured person's share for medication, excluding serious illnesses, varies according to drug category but ranges between 25 and 80 percent. In Sweden, patients pay the full cost of medication up to \$97 (900 Swedish kroner) during the first year after initial purchase and then gradually their share of the cost decreases as drug expenses rise. Denmark has a similar system to Sweden—the patient pays the first €69 (540 Danish kroner), and then gradual support is increased to 85 percent above a certain level of costs. Note that patients in Denmark always pay some proportion of the cost of medication, although total out-of-pocket expenses are capped for those with very severe or chronic problems.

For doctors' fees, the insured person in France pays a statutory 30 percent while the insured person in Italy pays up to 36 percent for each visit to or test at a medical specialist. Sweden and Finland also charge copayments for doctors' visits.¹¹

In short, having patients substantially share the cost of their treatment is already well established in Europe and is reflected in the numbers shown in figure 5.1 for 2000. By extending the copayment approach throughout Europe—while preserving protection for catastrophic expenses—Europe has the potential to surpass the US system of protection, and still provides adequate work incentives.

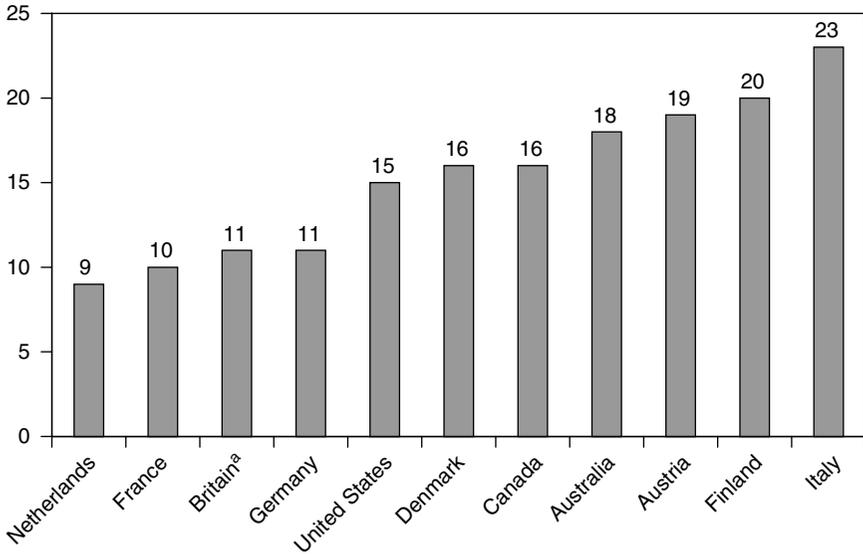
The second way work disincentives could be reduced in Europe is to improve healthcare providers' incentives, so they are motivated to reduce the overall cost of the system. This is especially important going forward as the number of elderly increases.

10. The discussion in this section is based on an extensive comparison of the healthcare systems of the United States, Germany, and the United Kingdom. See Baily and Garber (1997) and MGI (1996).

11. All data are from the European Commission MISSOC Database of Social Protection in Europe, www.europa.eu.int/comm/employment_social/missoc/index_en.html (accessed May 24, 2004).

Figure 5.1 Out-of-pocket patient financing as a percent of total healthcare expenditure, select countries, 2000

percent of total healthcare expenditure



a. Data for Britain are for 1997.

Source: OECD (2003c, annex table 3.9).

US hospitals are pretty efficient in providing treatment, largely because the public reimbursement schemes, which are copied by the private insurers, encourage the facilities to treat patients quickly and release them. Thus, high healthcare costs in the United States are a result of the high prices paid for drugs, supplies, and equipment as well as the high cost of administering the US insurance system (currently \$111 billion according to 2002 data¹²).

In contrast, financial incentives in Germany encourage excessive hospital stays because of the way doctors and hospitals are reimbursed. Hospitals have an incentive to keep their beds full, and doctors treat private patients in proportion to the total number of patients they have in the hospital. Germany has made improvements in the incentive structure of its healthcare system (e.g., limiting prescriptions), but more could be done to improve economic incentives and reduce the rate of increase of healthcare costs. Reducing the cost of the healthcare system would help control the

12. Testimony from Karen Davis and Barbara Cooper, "American Health Care: Why So Costly?" before the Senate Appropriations Committee, Subcommittee on Labor, Health and Human Services, Education and Related Agencies. Hearing on Health Care Access and Affordability: Cost Containment Strategies, Washington, June 11, 2003, www.cmwf.org/programs/quality/davis_senatecommitteetestimony_654.pdf (accessed January 5, 2004).

payroll taxes that pay for it and avoid squeezing the after-tax income of workers supporting the system.

The structure of health insurance is particularly important in the retirement decision, which we discuss below. As noted in chapter 2, a large fraction of healthcare costs are provided to persons who are elderly. In both Europe and the United States most of these costs are supported by payroll taxes on current workers. If retirees were required to pay for a portion of their own healthcare costs they would likely work longer and retire later. It is reasonable that workers deciding whether or not to take early retirement at, say, age 55 should think about what financial resources they would need to contribute to their own healthcare costs over the additional 25 years or more they could live.¹³

Reducing Income Risk and Facilitating Mobility

Job loss can be a painful and sometimes traumatic event for workers. Some workers are hit hard and risk becoming unemployed long term whereas others manage to move to even better jobs. Lori Kletzer's research (2001), which was based on the 1998 Displaced Worker Survey in the United States, found that among those who had new jobs, younger workers (under age 45) on average did well.¹⁴ Younger workers actually *increased* their earnings by 5.5 percent when reemployed. Older workers did not fare as well, since they found it harder, for example, to acquire new skills and relocate. Workers aged 45 to 64 experienced earnings losses averaging 12 percent when they were reemployed. In addition, not all displaced workers had found new jobs at the time of the survey (about two years after the job loss). Kletzer's research also found that women were more likely to remain jobless than men, which may result from their inability to relocate because of their husbands' employment.

Given the uncertainty created by economic change, it is desirable that some form of unemployment insurance (UI) be provided to workers¹⁵ who lose their jobs. UI programs in Europe operate differently in each economy with variations in the amount of time for which benefits can be collected and differences in the generosity of benefits. There are also differences in the use of "active labor-market policies" in combination with UI. For example, displaced workers may be required to attend training pro-

13. We have argued that catastrophic insurance should be provided to all. There are, however, difficult issues at the intersection of ethics and economics concerning the desirability of heroic and very expensive treatments that prolong the lives of very old patients by only a few days or weeks. That issue is beyond the scope of this study although, as a principle, the provision of catastrophic insurance should be limited by reasonable cost-benefit criteria.

14. The US labor market was very strong at that time with low and falling unemployment.

15. Typically, employees become eligible to collect UI benefits after working at a company for a period of time.

grams or face penalties for refusing any available job. In this section we review the issues that arise with different benefit payment structures. Later in the chapter we will see how active policies have been used in practice in specific countries.

The effect of UI on European and US unemployment has been studied empirically,¹⁶ and the strongest finding is that the duration of UI benefits affects unemployment—particularly long-term job loss (e.g., Layard, Nickell, and Jackman 1991). The structure of benefit programs has also been examined theoretically, and it is important to note that UI serves a positive function in the economy. UI acts as an automatic stabilizer against macroeconomic fluctuations and provides greater income security in a way that the private market would not match.¹⁷ UI can encourage people to work secure in the knowledge that they are protected from the effect of job loss. Thus, a well-designed UI program can actually contribute to increasing labor force participation.

Theory reinforces the conclusion of the empirical literature that time limits should be placed on unemployment benefits. Economic analysis suggests that UI benefits should start at a rather high level—covering almost all prior wages—and then gradually decline to provide incentive for workers to find new jobs. If this “economists’ solution” is too difficult to explain or track, the alternative is to simply set time limits. Six months, give or take, may be the right time frame for UI benefits. A policy reform that placed a six-month time limit on UI would have a large effect on measured *unemployment* rates in Europe. It would have a substantial impact on *employment* rates only if it was combined with reform in welfare, pensions, and disability programs (discussed in the next section). A time limit on UI benefits would not be effective if the unemployed could simply transfer to another benefit program and receive a similar amount of money.

The generosity of UI benefits also strongly affects unemployment. In some European economies, low-wage and some high-wage workers can receive UI benefits equal to 60 or even 80 percent of their previous wage if they lose their jobs although in most countries such benefits are capped at certain payout levels. Providing such a generous benefit without requirements such as job training classes only encourages unemployment at taxpayers’ expense.

Combining UI Benefits and Wage Insurance to Encourage Mobility

The above discussion has kept within the conventional bounds of UI in which benefits are paid to the unemployed and then cease once a new job

16. See Atkinson (1999) for a discussion of evidence and theory. Design of an optimal UI program is explored in Baily (1978) and Shavell and Weiss (1979).

17. Workers prone to unemployment would likely buy private insurance. The market equilibrium might well involve either no insurance or very little, very expensive insurance. As in many insurance situations there are problems of “moral hazard” and “adverse selection.”

is accepted. It is possible to go beyond the conventional framework and provide wage supplements as an alternative form of insurance and to encourage displaced workers to take new jobs.

In the 1980s Lawrence and Litan (1986) proposed a program of wage insurance for workers displaced by the effect of international trade. This idea was picked up again by Kletzer and Litan (2001), who suggested a program in which workers would receive a supplement to their wages. The supplement would be a fraction of the difference between the previous wage and the new wage for a period of up to two years. Kletzer and Litan showed that the budgetary cost would be moderate if assistance were provided equal to 50 percent of the wage gap. The authors' study focused on workers who lost their jobs as a result of expanding international trade since open markets benefit economies as a whole while detrimentally affecting specific individuals. However, job displacement occurs for a variety of reasons: technologies change, low-productivity firms contract or close, and consumers buy different goods and services. This dynamism is a key factor in productivity growth, as we described in chapter 3, but it does impose a cost on those workers who lose their jobs.

Expanding the program of wage supplements or wage insurance to cover workers displaced for a broad range of reasons would facilitate job mobility, encourage productivity growth, and increase employment. Burtless and Schaefer (2003) propose to use expanded wage insurance in Germany. They point out that UI benefits in Germany in 2000 were about \$20 billion, about the same amount as in the United States, despite a much smaller economy. Burtless and Schaefer propose a wage insurance program for displaced workers that would cover 50 percent of the gap between the wage in a new job and the wage in the lost job—the same as proposed by Kletzer and Litan (2001). They estimate that this would cost the German government \$3 billion a year if there were no cap on the amount paid out. If the maximum annual wage insurance supplement were capped at \$10,000 then the cost would fall to \$1.8 billion.

Germany, as part of the recommendation of the Hartz Commission of 2003, has actually implemented a very small version of a wage insurance scheme. This is open to workers only above the age of 55, who can receive up to 50 percent of the wage differential between their new and old jobs for up to 12 months. This is an encouraging development, yet regrettably the program remains almost wholly unknown and of limited extension. Thus, while its impact cannot yet be discerned, it will likely be very limited.¹⁸

If wage supplements were simply added to existing benefit programs and provided to all eligible displaced workers the cost would be prohibi-

18. For additional information, see Howard Rosen and the Trade Directorate Trade Committee TD/TC/WP(2003)34, *Structural Adjustment in Textiles and Clothing: Trade-Related Labor Adjustment Policies* (2003).

tive. But if wage supplements were used as an alternative or complement to long-term UI benefits, they could actually become a money saver in Europe. As noted earlier, in some European countries workers can collect UI benefits almost indefinitely or move to another income support program once UI benefits are exhausted. Therefore, if UI programs were reformed and benefits restricted to six months reemployed workers could supplement their new income with wage insurance. Both studies propose offering 50 percent of the wage gap for two years as an appropriate amount and time period, but the figures could be adjusted on the basis of experience with the program. The wage supplement would be available as soon as a displaced worker took a job, whether that was immediately after losing a previous job or at the end of an unemployment spell. Like any benefit program, safeguards would need to be in place to ensure that people did not abuse it. For example, individuals could not simply move from job to job in order to continuously collect the wage supplement.

Financially, limiting the duration of UI benefits and providing wage supplements could be cheaper than the current UI system. The government is providing only a fraction of a worker's income while the new employer and reemployed worker are paying taxes, which lowers the net cost of the proposed program. Thus, cutting only a third out of UI benefit costs in Germany would easily pay for the program described by Burtless and Schaefer (2003).

The wage-insurance program could be abused. For example, employers might lower wage rates knowing that the government would provide a half or more of the cost to employees. Given that greater wage flexibility is desirable in Europe, this form of abuse does not seem that severe—in fact it might help move the economies toward full employment. Another possibility, however, is that employers would find a way to cycle workers into and out of jobs as a way of receiving an effective wage subsidy over the long run. Again, given the rigidities in European labor markets, it is not clear this abuse would really be that severe. Nevertheless, as noted earlier, safeguards such as monitoring both recipients and employers to prevent abuse must be in place. Unfortunately, abuse of one kind or another occurs in almost any government program—in fact, many people abuse the current UI system. Often these abuses can be reduced over time as administrators gain experience with the program. Also, one of the advantages of wage insurance is that displaced workers must be employed in order to receive the subsidy, which makes it less prone to abuse.

Wage insurance encourages rather than discourages employment. Compared to UI, it represents a different mindset. Instead of viewing a displaced worker as someone who has been irreparably harmed, it views him or her as having choices and opportunities and the ability to acquire new skills. It reinforces the fact that job mobility is inevitable and displaced workers have an obligation to actively seek new jobs.

Welfare, Pensions, and Disability Programs

Europeans want social programs to be reformed in a way that preserves social cohesion, which means that all citizens sustain a minimum standard of living. For example, Europe already provides universal access to health care, which is a big step toward supporting a minimum living standard. The next big step in preserving social cohesion is to determine the minimum level of income support a family needs to remain out of poverty. Cash welfare payments or in-kind transfers, such as shelters for the homeless and free or subsidized food, can provide this additional support.¹⁹

If this minimum is in fact available to all, and if work incentives are to be maintained, it follows inevitably that the minimum level of income must be lower, by a significant amount, than the take-home income of a low-skilled worker. Without a significant financial incentive, most low-skilled workers will choose not to work.²⁰

The exact size of the financial incentive needed to encourage low-skilled employment is subject to empirical determination, but it seems very likely that the criterion would set a pretty low minimum income requirement, which could create greater income inequality and negatively affect a significant number of families in Europe by reducing or terminating existing support. However, the situation is not as dire as the previous sentence implies. First, a welfare payment that is higher than the minimum subsistence level can be paid to individuals less affected by work incentives such as the elderly and disabled. Second, social insurance can be provided in creative ways that preserve work incentives—providing temporary UI benefits combined with a wage insurance program, for example.

Retirement Benefits

All the industrialized economies have policies based on the presumption that persons beyond a certain age should not be required to work to support themselves and that people often fail to save when working enough to cover their future retirement.²¹ A minimum base level of retirement benefits is provided to all workers and their families. Given this, the base level of retirement income should approximate the level that would be chosen optimally by workers who have worked in a low-skill job during their lifetime. This proposal means that the state assumes the responsibility for re-

19. The relative merits of both cash and in-kind transfers can be debated. Cash is simpler and easier to administrate, but in-kind transfers may do a better job of channeling assistance to the truly needy. This debate goes beyond the scope of this book, so we will refer simply to cash or cash-equivalent payments.

20. The problems with violating this condition were explored in chapter 2.

21. For descriptions of individual countries' pension systems see Oshio and Yashiro (1997), Blundell and Johnson (1997), Palme and Svensson (1997), Boldrin, Jimenez-Martini, and Peracchi (1997), Boeri (2003), Borsch-Supan and Berkel (2003), and Mitchell (1999).

retirement provision for low-wage workers. This is already the case in both Europe and the United States, so this principle is widely accepted.²²

The provision of a minimum retirement income implies some erosion of both work and savings incentives. Government retirement programs in Europe and the United States are mostly financed on a “pay-as-you-go” basis—retirees are paid out of current tax revenues. Therefore, neither real savings nor accumulated assets support the liability for future retirement benefits. If a minimum retirement program were designed from scratch, there would be a strong case for building up a retirement trust fund with real assets rather than a pay-as-you-go system. Unfortunately, it would be difficult to make these changes to the current European and US systems since the baby boom generation is about to retire.²³ Preserving the base-level retirement system is preferable to having workers in poverty as they age.

In principle, it is reasonable to expect that persons with middle and higher levels of income and education will save in order to provide additional income for their own retirement (above the minimum base retirement income level provided by the state). To facilitate this, the government could either certify privately run funds or encourage employers to offer additional retirement plans and provide secure retirement funds to which people could contribute. Given the need for job mobility in a modern economy, it is essential that retirement programs be portable as workers change jobs.

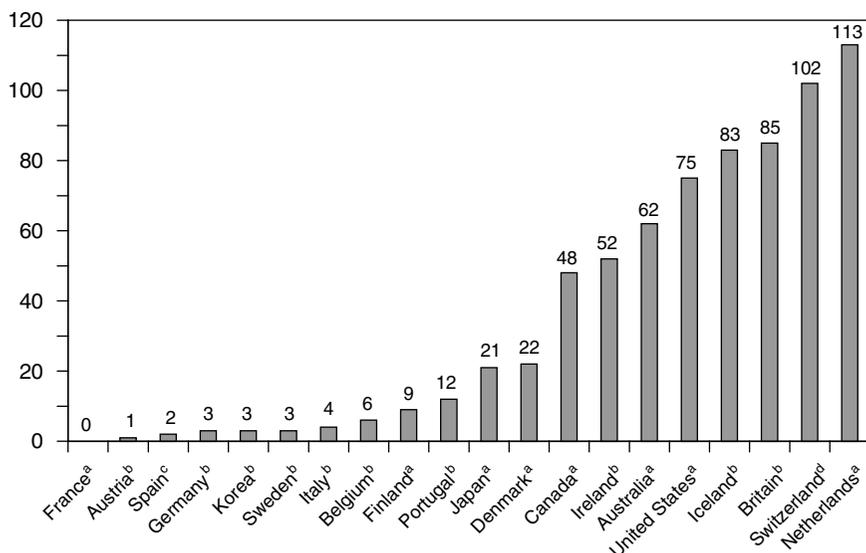
The US Social Security program provides only a modest basic income that is supplemented with private pension contributions. In contrast, many European economies have set up more generous pay-as-you-go pension systems for most employees, which offer substantially more benefits than basic income but are not generally backed with real private-sector assets. For many European countries, it may already be too late to establish a system in which people must save for their retirement without government support. Current workers would understandably feel cheated if they were required to pay for current and near-term future retirees only to lose support for their own retirement.

22. The average retired worker receiving Social Security benefits in the United States received \$895 a month in 2002. The average for a retired worker and spouse was \$1,494 a month. The income provides only a basic standard of living since retirees currently must pay for outpatient prescription drugs. Data are from the *Statistical Abstract of the United States* (US Census 2003, 362).

23. Creating a pay-as-you-go pension system from scratch will inevitably provide a generational bias in favor of retirees at this time since they will immediately benefit from the new system without having paid for it. On the other hand, such early beneficiaries of a pay-as-you-go pension system will likely have provided direct support for their elders—living with them, for example, in an early form of “privatized old-age care.” Nonetheless, it is important to realize that the creation of any pay-as-you-go system does create an immediate “generational liability” that will effectively have to be shared over future generations.

Figure 5.2 Total assets of private pension funds, select countries, various years

percent of GDP



- a. 2001 data.
- b. 2000 data.
- c. 1999 data.
- d. 1998 data.

Source: OECD (2001f). Secretariat compilation from various national sources and Institutional Investors database.

Some European countries have gradually introduced private (usually supplementary) pension plans that hold sizable private assets. As shown in figure 5.2, pensions in the Netherlands seem comfortably backed by private assets while the opposite is true for the major continental European economies. Obviously this leads to wide discrepancies among European countries in terms of the fiscal sustainability of their pension systems. Any transition to a fully funded system will take a very long time to achieve. Given the demographic trends outlined in chapter 2, the way forward for countries without fully funded pension plans is difficult. Reform will require gradual downward pressure on the pensions of current and future retirees combined with increased incentives for current workers to save.²⁴

24. Attempts in this direction were introduced in Germany in 2001, as state subsidies were introduced to encourage individuals to take out private supplementary pension plans. However, these initiatives are widely regarded as inadequate and rather unsuccessful. See, for instance, the conclusion of the government-sanctioned Rurup Commission report (2003).

One way to ease the pension problem and the looming demographic pressure in Europe is to encourage workers to retire later rather than sooner. As we saw in chapter 2, the average retirement age in Europe decreased in the 1980s. This was done in part because it was popular to offer workers the option of early retirement especially when restructuring over-staffed industries. At the policy level, there was often a mistaken belief that a limited number of jobs exist in an economy and offering early retirement would therefore increase employment among younger workers.

Because of budget pressures, government retirement programs in Europe are increasing either the statutory retirement age or the number of years (of contributions) required to obtain full pension benefits. These reforms seem to be a move in the right direction. Given the need to improve work incentives and keep payroll taxes under control, the age at which workers can collect retirement benefits should be gradually increased. However, it would be helpful to estimate how the retirement age should be varied given the increase in life expectancy. The starting point is to estimate when an average person would retire if he or she had made far-sighted decisions during his or her lifetime and saved the optimal amount.²⁵ The decisions on the level of savings and the retirement age are jointly determined, of course, and so that is not an easy estimate to make but it is not essential to get the answer exactly correct. But a precise age is not necessary since individuals may choose their retirement age within a state-provided pension program, which is adjusted on an actuarially fair base. For example, the US Social Security system allows workers to retire any time between the ages of 62 and 70, with the benefit level adjusted by an amount that is roughly actuarially fair. (See box 5.1.)

Welfare and Disability Programs²⁶

There is strong support for providing additional income to assist single-parent families and the disabled. These two groups are important, but complex to analyze. Figuring out the right way to help them does not easily lend itself to the application of optimality principles.

25. A somewhat similar approach, albeit at a different unit level, was proposed by the Rurup Commission in Germany when it suggested introducing the so-called sustainability factor (*Nachhaltigkeitsfaktor*) into the pension system to ensure generational fairness. The proposal would ensure that the retirement age was adjusted upward or absolute pension level downward to guarantee that the rate of pension contributions would not rise above a given level—20 percent of wages by 2020 and 22 percent by 2030—while keeping the system solvent. Detailed estimates of the potential effect of the “sustainability factor” on German retirement ages or pension levels were not been provided but will unavoidably be enormous—especially politically (Rurup Commission 2003).

26. For a helpful review of lessons Europe may learn from the US experience in welfare reform in the United States, see Blank (2002).

Box 5.1 Offshore assets in Europe

Figure 5.2 shows a very wide difference in the amount of real assets in OECD countries' pension systems. This difference in asset levels can obviously be ascribed, to a large extent, to disparities in pension system structures—for instance, private pension funds are unknown in France but make up the bulk of the pension system in countries such as Britain and the Netherlands. Hence, many European countries rely almost wholly on state-run pay-as-you-go pension systems, where payments to pensioners at a given point in time depend ultimately on the taxing power of the government. As pointed out in chapter 2, there are large differences in the degree of long-term sustainability of European government finances, and this could affect the certainty of government pension payments (at current levels) in the future.

Yet, the quantity of people's assets in private pension funds and the certainty of the level of public transfers in the future may not yield the full picture of the size of Europeans' "nest eggs" for retirement. This is due to the fact that just as many Europeans have income in the nonobserved economy (see appendix 5.1); many also have large savings outside regular private pension funds and—importantly—outside the reach of European tax authorities. Billions of euros in savings are kept in tax shelters, particularly in Switzerland, by a large number of Europeans; these savings are normally not counted as part of their financial wealth. There is subsequently a risk that the official picture of their prospective standards of living in retirement is somewhat direr than it should be.

Because of banking secrecy it is impossible to know with certainty the level of tax-sheltered European assets in Switzerland and other similar locations. Some estimates exist, however, and there seems to be some reason to believe that the issue is relatively larger in magnitude in the countries to the left in figure 5.2. The Bank of Italy estimates that in 2002, before the Italian tax amnesty (see below), up to €515 billion (Private Banker International, March 2002) of Italian assets might have been held abroad—this is equivalent to more than 40 percent of Italy's 2002 GDP of €1,258 billion. Similarly, German government 2000 estimates range between €300 billion and €400 billion in private holdings and up to €960 billion if corporate holdings are included—equivalent to up to 20 percent of GDP in private offshore holdings in 2000 (rising to nearly 50 percent with corporate holdings) (PBI January and July 2003).

Estimates thus indicate that such offshore European assets are indeed substantial. The sheer magnitude of the estimates indicates that offshore accounts are not kept by

(box continues next page)

Single-parent families with young children are typically led by females. It is not reasonable to expect a woman whose spouse or partner has recently departed to work full-time and look after small children on her own. Families in such a situation should be provided with an income that is above the minimum subsistence level. When welfare programs to support such families were first introduced no one thought that any major distortions of behavior would occur. Few people seriously believed that providing financial assistance to single parents would induce people to have children, have more children, or change their marital status. Today we know better. These distortions are compounded by the fact that child-support payments from the noncustodial parent are often in default.

Discussing all the pros and cons of different approaches to assisting welfare families goes beyond the scope of this book. However, we believe that part of the solution involves limiting the duration of additional in-

Box 5.1 *(continued)*

only the super-rich in Europe but by a much larger number of people. Nonetheless, as one likely needs to be at least in the upper-middle income bracket to find it worthwhile to open an offshore account, adding such holdings to a country's private pension assets will not affect the standard of living in retirement projections of the majority of Europeans—although including offshore holdings will further skew the wealth distribution.

In recent years several European governments have attempted to lure back home such offshore assets with promises of tax amnesties and “no questions asked,” by letting their citizens move undeclared assets from, say, Switzerland back to their home country and only pay a fixed percentage of the amount in tax—a percentage frequently much lower than regular national capital income taxation levels. Italy from late 2001 to mid-2002 brought back from abroad between €60 billion and €80 billion under the so-called Tremonti law. This law stipulated that investors either pay a fee 2.5 percent of repatriated funds (much lower than either Italian capital gains taxes or higher brackets of personal income taxes) or put their funds into low-yielding government bonds. Germany currently has a similar scheme running until 2005Q1, under which people who have evaded tax between 1993 and 2002 can repatriate funds against a 15 to 25 percent one-off fee—this should be compared with the usual taxation up to 48 percent on such income during the period concerned (Kellner 2004). Due to the significantly higher repatriation fee involved, however, the German scheme is not expected to be nearly as successful as the Italian version.

Evidently, the politics of such amnesty schemes are problematic, in that they need to weigh the benefits of bringing back assets (in the case of Italy, the proceeds were not insubstantial for a government fighting to adhere to the deficit restrictions of the SGP) against rewarding tax evaders. Nonetheless, both Belgium and France have recently also mulled similar schemes.

Importantly, EU member states in May 2004 reached an agreement among themselves and with (notably) Switzerland and other adjacent offshore tax havens that an anonymous across-the-board 15 percent withholding tax be levied on all accounts belonging to (other) EU citizens (rising to 20 percent in 2007 and 35 percent in 2011). With 75 percent of the proceeds going to the EU member whose citizen holds the account, this agreement may present a significant new way for EU member states to raise tax revenues from their citizens' offshore accounts. Yet, on the other hand, it may also simply drive such assets even further offshore to, for instance, Asia or the Caribbean.

come support (above the minimum level) so that single parents gradually become more self-sufficient rather than permanent welfare recipients. Subsidized child care could also encourage single parents to enter the workforce. In Sweden, for example, single mothers are provided with substantial incentives to enter the workforce through subsidized child care.

A separate disability program is clearly needed since severely disabled persons cannot support themselves by working. But how does one determine disability? After all, individuals with major health problems are sometimes denied support while others feigning disability end up with undeserved assistance.²⁷ In some countries requesting disability support has become an alternative strategy for millions of workers who have ex-

27. There are a variety of musculo-skeletal and mental problems that are hard to diagnose with X-rays or other standard medical tests.

hausted UI but want to remain out of the workforce. For example, the Netherlands has successfully reduced its unemployment rate to the 4 percent range (3.7 percent in 2002 and 4.6 percent in early 2003), but its disabled population is rising—from 5.6 percent in 1998 to 6.1 percent in 2002. The number of disabled in the United States has also grown very rapidly in recent years as eligibility conditions have been eased.²⁸

Disability rates differ widely by country and have varied over time within countries. Participation apparently depends on system design changes. Therefore, changes in the classification requirements and/or the procedures for determining disability can significantly influence the number of persons entering disability programs. For example, those who are disabled in a way that makes it impossible for them to continue working at their current occupation—either because of age or a physical impairment—can often become self-supporting in an alternative, less demanding position or occupation and should be expected to do so. This principle is consistent with the overall strategy of social policy programs outlined in this section, which is to encourage worker mobility.

Payroll-Tax Abatement and Negative Taxes

Work incentives are affected not only by the level of benefits paid to those who do not work but also the taxes levied on workers. Payroll taxes are one of the main sources of tax revenue in Europe. However, these same taxes reduce the incentive for low-skilled workers to accept jobs when wages are flexible and the incentive for an employer to offer a job when minimum wages are high. Several countries have attempted to alleviate this problem either by lowering the payroll tax rates on low-wage workers or by providing negative taxes to low-wage workers that partially or fully offset the payroll taxes.²⁹ For example, France followed the strategy of payroll tax cuts for low-wage workers, which accounted in part for the country's strong employment growth in the late 1990s. The Earned Income Tax Credit (EITC) in the United States is also an example of such a negative tax and, together with welfare reform, has encouraged many low-skilled women to enter or reenter the workforce.³⁰ The United Kingdom has developed a program called the "working tax credit" that is sim-

28. Autor and Duggan (2001) note that the share of nonelderly adults receiving benefits from the US Social Security Disability Insurance and Supplemental Security Income programs rose from 3.1 in 1984 to 5.3 percent in 2000. They trace this increase to reduced screening requirements and a rising earnings replacement rate.

29. For a discussion of how subsidies to low-wage workers might reduce the nonaccelerating inflation rate of unemployment (NAIRU), see Baily and Tobin (1977).

30. Requiring workers to pay payroll taxes and then giving a tax refund may seem—and is—a rather convoluted way of operating. The United States uses this approach to help preserve the "integrity" of the social insurance funds that the payroll taxes support—the Social Security and Medicare trust funds, for example.

ilar to the EITC in the United States, as has the Netherlands with its “labor tax credit,” France with “prime à l’emploi,” and Belgium with its “work tax credit” (Blanchard 2004).

Payroll tax reductions or negative income taxes are a powerful tool to encourage work while improving income distribution. Taking money away from the benefits of those that do not work and using it to add to the incomes of the employed shifts the trade-off between nonworkers and workers. Therefore, these efforts should be strongly encouraged and the scope of the programs should be increased.

The limits of such work-incentive programs are set by the need to maintain reasonable marginal tax rates at all levels of income. The US EITC program, which phases out as income rises, together with the provisions of Medicaid, food stamps, and housing allowances often create high marginal tax rates (around or even greater than 100 percent) for low-income workers, as noted earlier. It is a basic problem that either negative income taxes phase out rather quickly (pushing up marginal tax rates) or become very expensive for the budget.

There is a parallel here, however, to the earlier discussion of wage insurance. If one is deciding between welfare and a job, a wage subsidy can provide an important push into the labor market. Earlier, we argued that reducing the duration or generosity of existing UI payments could pay for a new wage-insurance program encouraging worker mobility. Similarly, reducing the duration or generosity of welfare support payments or reducing or eliminating early retirement pension benefits could pay for a wage subsidy for low-skilled workers.

As in the previous case, the key is to change people’s mindset and shift social insurance programs away from payments to those who stay out of work and toward support programs for people who take jobs.

The Wage-Setting Process: Making Jobs Available

Increased work incentives can increase the number of people willing to work or the hours they work (increases labor supply), but in order to increase employment, there must be an increase in labor demand—jobs must be available for the people that want to take them. Labor demand can be increased in two ways: Either the cost of labor must come down (the amount employers pay per worker or per hour), or the demand for labor must increase at a given cost of labor.³¹ This latter case could occur if productivity increased or during a cyclical recovery.

Although most of this book focuses on structural rather than cyclical issues, the economic cycle is important. Chapter 6 examines Europe’s mon-

31. In simple economics employment can increase by moving down a given labor demand schedule or moving the schedule.

etary and fiscal policies and stresses that structural reforms can raise employment successfully only if there is sufficient aggregate demand in the economy. As this is written, it appears that Europe is making a slow recovery from a mild recession. If that recovery falters, structural reforms will not deliver on the promise of substantially higher employment. On the other hand, if structural reforms are not achieved Europe's recovery will be weaker and possibly shorter than it could be. We postpone any further discussion of cyclical questions until chapter 6.

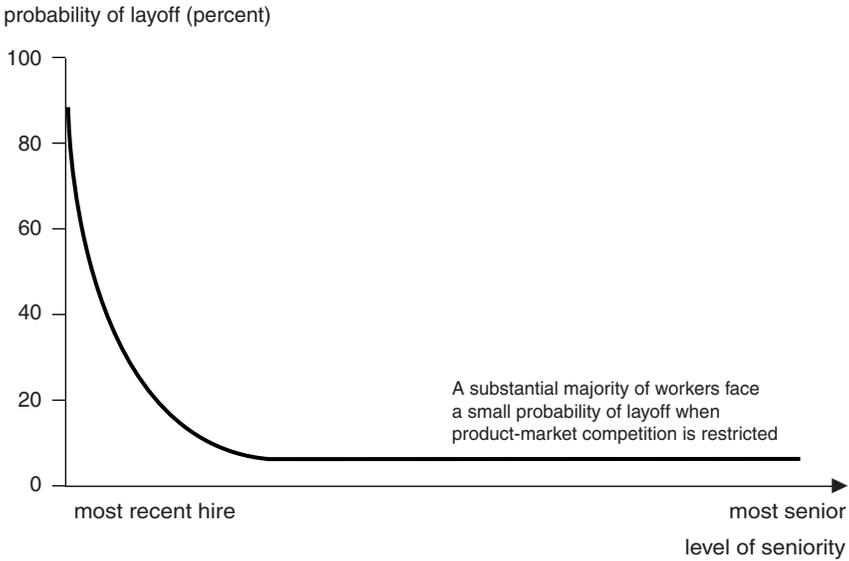
Leaving aside recession, the main reason employment would fail to increase following an improvement in work incentives is if wage rigidity made it unprofitable for employers to hire new employees. If employer wage and benefit costs are kept above the level consistent with full employment, then underemployment will persist. Reforming social programs as suggested earlier may help to increase labor demand—for example, reducing payroll taxes on low-skilled workers or providing a negative tax could greatly alleviate this problem even without changes in before-tax wages. But only a broader degree of wage flexibility will encourage a return to full employment in Europe.

The insider-outsider view of the labor market was mentioned earlier in which wage rates and other working conditions are determined by a bargaining process between employees and their employers, with little regard to whether there are large numbers of workers who would like to work. A variation of this view involves the incentives facing different members of the insider group since some workers may be further "inside" than others. Within a company or an industry, for example, some workers have much more seniority than others. Figure 5.3 illustrates that if layoffs occur, the most recent hires lose their jobs first. Thus, if real wages are pushed up, the majority of the workers face a very low probability of losing their jobs, even if there is some job loss overall. They are laid off only if the company shuts down. Therefore, in any union vote on a wage settlement, the majority of workers have an incentive to hold out for the largest wage increase without endangering the company and their own jobs.

A centralized wage-setting process is one way of restraining wages. Some of the smaller European economies have created a cooperative situation where representatives of labor unions accept that excessive wage increases at the national level will result in job losses.³² The centralized bargaining process occurs in a setting that recognizes the interests of the outsiders as well as the insiders. However, such a centralized wage-setting process is harder to implement in larger economies with disparate nationwide union groups. For example, in France and Italy the situation is usually aggravated as unions compete by appearing to be the most uncompromising. Moreover, there are dangers in any system in which wage

32. For a discussion of how wage-setting systems affect unemployment see Layard, Nickell, and Jackman (1991).

Figure 5.3 Probability of layoff following wage increase with restricted competition



rates are set politically or institutionally rather than through market forces. It is very hard to facilitate job mobility and structural change in an economy where the labor market is so controlled.

A second approach to wage setting is to force a political confrontation with labor groups. Prime Minister Thatcher survived a long period of chaos and adverse economic times in order to create a more flexible workforce in Britain. Even though many of her actions were very unpopular, Thatcher stayed in power because she had the major political advantage of a divided opposition in parliament. Her party never won a majority of the votes in parliamentary elections.

US President Ronald Reagan also altered labor relations in the 1980s. When the air traffic controllers' union went on an unauthorized strike, he hired replacement workers. This move changed the US labor market by making it acceptable for corporations to hire replacement workers following a strike and by encouraging corporations to take active measures to oppose union organizing drives. The United States and Britain were both able to achieve almost full employment in the 1990s, and the labor market's flexibility may have made the critical difference particularly in Britain, where the labor groups previously had been very rigid and confrontational.

Thatcher's strategy is unlikely to be followed by the rest of Europe—in part because Britain has a different election system, which allowed policy changes to occur even though they were unpopular. Moreover, the

Thatcher-Reagan approach to flexibility comes at a cost. Unions can play a constructive role in protecting workers against mistreatment and providing a powerful, unified voice so that their interests are heard (see Freeman 1980). Often employers favor dealing with unions, since they frequently control the level of industrial unrest and strike activity.³³ However, problems arise in the labor market if unions raise wages too high, distort the wage structure, prevent needed restructuring, and protect a select group of workers (with seniority) while the majority of workers (often lower-skilled) remain unemployed.

In Europe, unions are not the sole reason for distorted wages. In France, for example, unions represent only a small fraction of the workforce, so the rigid wages and the high minimum wages can be blamed primarily on government policy. The key problem is that wages determined by union bargaining then apply to all workers throughout an industry and not just those who negotiated the settlement. The universal industry wage subsequently limits the domestic competitive pressure placed on the wage-bargaining process.

The rules extending wage bargains nationally are not applied universally now, as small firms are given greater freedom over wage setting. In reality, however, this distinction just keeps a fringe of small, low-productivity companies in business.³⁴

One way to increase wage flexibility is to repeal laws and regulations that extend wage contracts negotiated by a small group of workers and employers to virtually all employees in an industry. If individual companies or even regions were able to freely negotiate their own wage contracts the overall competitiveness and flexibility of the labor market would increase substantially.

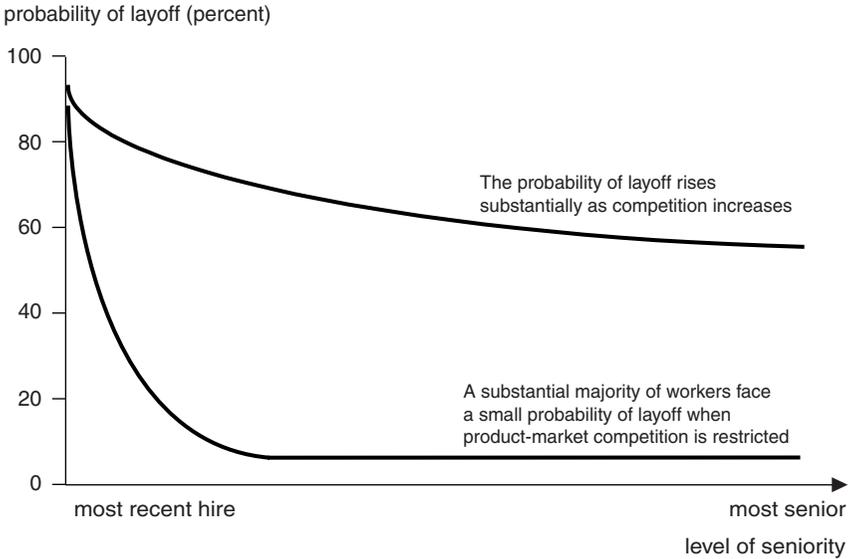
Bringing about Labor-Market Flexibility through Product-Market Competition

Another way to bring greater flexibility to the labor market is to increase the level of competition in product markets. Even if individual European economies have rules that extend their wage and employment provisions, as long as their industry competes internationally, market forces will be brought into labor-market decisions. For example, if competition opens the manufacturing market and subsidies for failing firms are removed,

33. Countries with strong centralized bargaining systems such as Germany or Austria are consistently ranked by the European Industrial Relations Observatory (EIRO) as having the lowest average loss of working days due to strike activity in Europe.

34. Several developing economies (Brazil is a prime example) have created an extremely unlevel playing field for business with small companies completely avoiding taxes and regulatory requirements. Thus, small companies have a cost advantage relative to larger and more productive companies. The restructuring of some industries is then slowed or stopped because the most productive companies are not able to compete.

Figure 5.4 Probability of layoff following wage increase with competition



then wage concessions that are needed to preserve employment will come more quickly. The threat of bankruptcy can also prompt unions to quickly concede to lower wage increases. Figure 5.4 illustrates the idea that if the probability of layoff rises for senior workers, the willingness to accept wage concessions greatly increases—as we are seeing, as companies threaten to move to eastern Europe.

Many Europeans argue that manufactured goods already exist in a very competitive product market, but as we noted in chapter 3 that is not always true. Trade barriers in Europe are sometimes clear and sometimes both subtle and difficult to determine.³⁵ In the automotive industry, for example, formal and informal barriers to Japanese imports existed for years, and even now a 10 percent tariff (a pretty substantial barrier) remains. In other sectors, the trade barriers take the form of subsidies or low-cost financing, or restrictions on access to the distribution system. Eliminating existing trade barriers, within and outside the European Union, would not only help increase productivity but would also put pressure on workers and unions to demonstrate wage restraint.

As described in chapter 3, international trade can also increase competitive pressure in the labor market. If French companies can freely enter the

35. See Messerlin (2001, chapters 2 and 6) and the European Commission report (2002d). The latter deals particularly with the problems related to trade in services, and the numerous problems it laid bare played a key role in the European Commission's decision to bring barriers to trade in services to the top of the 2003–06 Internal Market agenda. See European Commission press announcement IP/03/645, May 7, 2003.

German market and vice versa, overall competitive pressure will increase. Under EU policies, these changes are taking effect, but the reality is that countries can restrict competition if they so choose.

However, international trade is not the only way to increase competitive pressure. Allowing new entrants and letting weaker firms fail would force changes in labor practices including wage setting. There are strong interactions between the labor and product markets. Many of the restrictions on product-market competition remain in place because of pressure from labor groups. A commitment to greater competitive intensity in the product market would be a major step toward a more flexible labor market. We noted earlier that some foreign competitors are struggling in Germany's retail industry. Amazon.com, the online superstore, is extremely successful, however, and putting pressure on domestic bookstores to stay open in the evenings and reduce prices.

The Paradox of Competition and Job Creation

The belief that open competition will result in job loss is the biggest reason product-market competition is restricted in European markets. Admittedly, for individual companies and workers this belief is not a false fear. But, paradoxically, the same forces that can destroy some jobs will also create others elsewhere in the economy. The job creation that occurs may be accompanied by a widening of the distribution of wages, however, which is another reason for resisting competition. But the discussion above illustrates how redistributive policies to reduce after-tax income inequality, which are part of the social policy reforms, can be used to overcome the wage gap.

Avoiding End-Game Solutions

The above discussion asserts that product-market competition will create pressure for labor-market flexibility. That argument can break down if workers can hold onto their jobs for a period of time. Some industries have very large fixed costs, and if these costs have already been incurred it may be possible for companies to compete even if their labor costs are far higher than companies in other countries (as long as they have marginal costs that are below the market price of what they produce). The companies will still have a positive profit margin, although they will not be earning a normal rate of return on their capital stock.³⁶ Major new investments will not be made, although smaller investment upgrades to existing capital may still be profitable.

From the narrow viewpoint of workers in such industries (the insiders) it may make sense to refuse wage reductions or changes in work rules and simply allow the company to operate until they reach retirement age.

36. Lawrence and Lawrence (1985) analyzed the end-game situation in the US steel industry.

Competition will not necessarily result in greater labor-market flexibility in such situations.

Many European companies seem to be operating in such a situation. They are making new investments in Eastern Europe or other low-cost locations, but not investing much in their traditional base of operations. Older US companies in such sectors as automotive and steel have labor costs (including obligations to retired workers) that make it hard for them to compete as well, and they are facing a similar situation.

European governments will have to make hard decisions. A government can continue to waste its investment by subsidizing companies with low or even negative economic returns, or it can encourage companies to confront their workers and hold out for greater flexibility. Another option is to allow some large-scale companies to go bankrupt thereby signaling that there are fatal consequences for failing a market test over the long run. The first solution is the easiest politically in the short run and has often been implemented in Europe. The second and third choices are more difficult but will pay off in the long run with better economic performance.

Overall Conclusions from Social Policy Reform

- It is not necessary to dismantle the established framework of social protections in Europe. However, this framework will require fundamental reform involving greater financial incentives on the unemployed to look for and accept jobs. The minimum level of income support provided to any individual or family must be set so that the work incentive remains strong.
- Many social insurance programs currently provide permanent or semipermanent income support. These programs should be changed so they provide only temporary support.
- Low-wage workers should be helped by negative taxes or reductions in payroll taxes, or a combination of the two.
- Labor-market policy should now assume worker mobility. Unlike past generations, members of today's workforce will undertake a variety of jobs and cannot expect to remain with the same employer or in the same location throughout their working lives.
- Given this presumption, the UI programs in Europe should be reformed. UI benefits should be paid for only a limited time, and wage supplements should be given to reemployed workers for a period of about two years as a form of wage insurance to encourage mobility.
- Ideally, wages set by either bargaining or the government should be applied only to relevant—and not all—workers in an industry. When

wage rates are determined, those who have jobs (the insiders) should face the threat of market competition from outsiders who want jobs.

- Repealing the laws or regulations that extend negotiated wage contracts to the entire industry would increase the flexibility of the labor market and the degree of competition.

Given the political difficulty of imposing full flexibility on the labor market, an alternative—or complementary—approach is to increase competitive intensity in product markets. To effectively encourage competitive intensity, it may be necessary to allow some large, established landmark companies to go bankrupt and close.

Labor-Market Reforms: European Solutions That Have Raised Employment

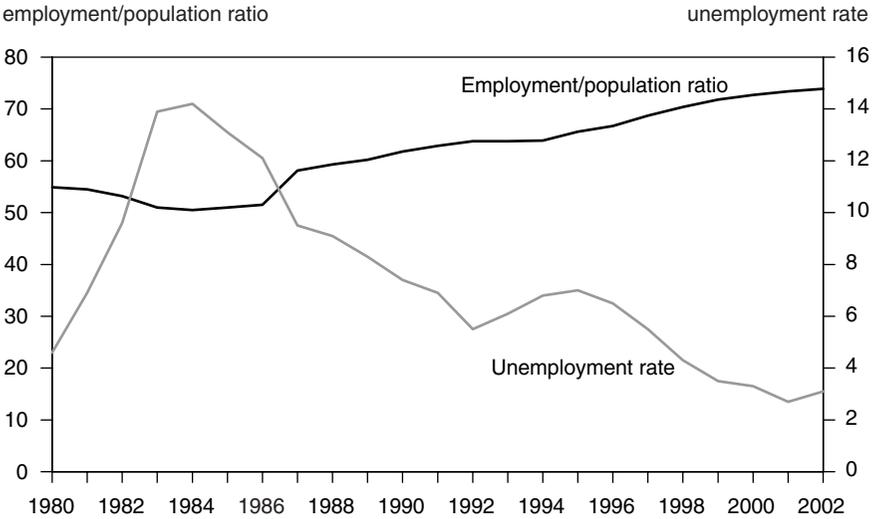
In the first half of this chapter, we looked at some principles that could govern the design of social welfare programs, thereby improving their incentive structure while maintaining their ability to cushion families against adverse economic shocks. Although these ideas are fine in theory, is there any practical evidence that social policy reforms can increase employment? The rest of this chapter will examine the reforms that have been adopted by the Netherlands, Sweden, and Denmark. All three countries have achieved the goals of the EU Council of at least a 70 percent ratio of employment to population ratio as set at the 2000 Lisbon meeting. They each achieved this goal by modifying—but not forsaking—their social protections. The experience of the Netherlands, Sweden, and Denmark can provide insights for other European countries about reforms that have worked and areas where problems still remain.

Before proceeding, it is important to emphasize that the precise legal instruments used to achieve labor-market reforms often will vary from country to country and depend on each country's institutions, historical traditions, political sensitivities, and decision-making processes. However, this review will be organized on the basis of the economic incentives that were changed in each country and the subsequent result of these changes rather than on the specific legal or institutional details of the reforms.

The Netherlands: From Dutch Disease to Dutch Job Creation

In 1982 a deepening economic crisis caused a marked shift in economic policies in the Netherlands. Major reforms to fiscal, monetary, labor-market, and social policies were implemented with astounding, if crisis-induced, speed and laid the foundation for the impressive turnaround in

Figure 5.5 Employment/population ratio and unemployment in the Netherlands, 1980–2002 (percent of total population)



Source: OECD Labor Market Indicators.

the Dutch labor market in the following years (figure 5.5). While the reforms to monetary and fiscal policies are outside the scope of this chapter, it is pertinent to briefly outline them. Reforms to monetary and fiscal policies consisted of pegging the Dutch guilder to the German deutsche mark starting in 1983 until both currencies were replaced by the euro in 1999. On the fiscal side, the growth of general government expenditure was restrained—it was reduced from 60 percent of GDP in 1982–83 to 45 percent of GDP in 2000 (Eurostat New Cronos Databases). These policies are similar to the policies currently being set for the European Union as a whole—in terms of the common currency and the Stability and Growth Pact (SGP). Thus, improvements in the Dutch labor market did not occur because it followed either an independent or a very expansionary set of monetary and fiscal policies.

Cuts in Wage Growth, Working Time, and Labor-Income Taxes

In 1982, the so-called Wassenaar Agreement was struck among the Dutch government, labor unions, and employers. Under the terms of this agreement, labor unions accepted wage restraint, cuts in social benefits, and increased labor-market flexibility in exchange for an immediate reduction in working hours and, in later years, lower taxes on labor income. Also, the automatic indexation of wages to consumer prices was eliminated, and

employees with part-time work became entitled to full social security coverage.³⁷ In subsequent years, the same three social partners continued to cooperate (along the lines of the Wassenaar Agreement framework) in what became known as the *Dutch Polder Model*, or consensus approach.³⁸ For most of the 1980s and 1990s, a freeze of (and in 1984 a 3 percent cut in) the gross nominal legal minimum wage for Dutch adults above age 23 meant that the gross real legal minimum wage declined by about 20 percent from 1980 to 2000. Similarly, the average real wage growth in the Netherlands was restrained in practice, rising by only about 10 percent over the same 20 years (by much less for production workers, as discussed below). As the real minimum wage was lowered, the gap in wage distribution widened.

However, the above statements must be qualified somewhat. Collective-bargaining agreements cover 75 to 80 percent of the Dutch labor market (OECD 2003i), and the lowest wage scales in these collective agreements have risen in nominal terms so that the actual number of people on the legal minimum wage has declined over time. Full data on the wage distribution were not found, but we know that in 1997 the actual average wage of workers in the lowest wage-scale group in the Netherlands was only 7 percent above the legal minimum wage (Visser and Hemerijck 1997). For Dutch youth below the age of 23, cuts in the minimum wage were even greater than for the average—decreasing significantly for even younger workers. For example, Dutch 15-year-olds from the mid-1980s onward were entitled to only 30 percent of the adult minimum wage. In short, even though the legal wage minimum became less important over this period, the downward real wage pressure on low-skilled workers was substantial. *In fact the wage distribution in the Netherlands actually widened more from 1983 to 1999 than in the United States.*³⁹

Why did the labor unions accept the wage restraints and cuts? The shortening of working hours agreed to with employers provides part of the answer. Another important part of the answer is that cuts by the Dutch government in employees' taxes and social security contributions resulted in a significant increase in disposable incomes, despite low real-gross

37. Six months of employment was required to start accumulating pension rights.

38. It is important to note that consensus was not a new development in Dutch society in the early 1980s—in fact numerous commentators have pointed out the emphasis on consensus throughout Dutch society and history. Nevertheless, the crisis prompted the social partners to imbue it with renewed importance through the Wassenaar Agreement. The Dutch word *polder* refers to a section of seabed converted into land by artificial docks.

39. The wage distribution is measured by the ratio of the wage at the 90 percent decile to the wage at the 10 percent decile. While the Dutch distribution widened more than in the United States, it started at a much lower level than in the United States and remained lower in 1999. Of course the Netherlands is also a smaller and more homogeneous economy than the United States. Data are from the (OECD 2003i).

wage increases.⁴⁰ The International Monetary Fund (IMF) calculated that the real gross wage of the average Dutch production worker increased by only 0.9 percent from 1983–98, while the corresponding real net wage increased by 14.8 percent.⁴¹ Cuts in social security contributions were extended to employers in the early 1990s with a particular focus on low-wage jobs and the long-term unemployed. Hence, for workers hired at close to the minimum wage, employers' social security contributions were cut by 58 percent, which reduced effective labor costs by an average of 10.5 percent. If such a job were given to a long-term unemployed worker (out of work for more than a year), social security contributions would be completely eliminated—bringing the reduction in labor costs to almost a quarter of the total (IMF 1999, 25).

Social Insurance Reforms: Making Work Pay

Wide-ranging changes in the Dutch social security system—aimed at increasing labor supply—were simultaneously implemented with the labor-market reforms described above.⁴² Prior to 1985, an unemployed person with job experience of at least 130 days in the previous year would receive a contribution-financed unemployment benefit (*Werkloosheidswet*, or WW) for 6 months worth 80 percent of the last received wage, followed by 24 months of government-financed unemployment benefits worth 75 percent of the last received wage. After 30 months, the unemployed would be indefinitely eligible for welfare.

In 1985 government-financed unemployment benefits were cut to 70 percent of the last earned wage, and in 1986 the WW was also cut to 70 percent of last earned wage. Then in 1987, the two types of unemployment benefits were combined into a single new contribution-financed type of unemployment benefit as eligibility was tightened and durations cut, especially for younger people. After 1987 all workers with at least 26 weeks of paid employment during the previous 39 weeks would be eligible for 6 months of short-term benefits (*kortdurende uitkering*) at a rate of 70 percent of the legal minimum wage. Because the legal minimum wage was frozen for long periods of the 1980s and 1990s, linking unemployment benefit levels to it constituted a reduction of the benefit level relative to average wages, which increased personal incentives to find work.⁴³

There were, however, supplementary benefits available to workers with lengthy work experience. A salary-related benefit (*loongerelateerde uitker-*

40. Undoubtedly, the severity of the economic situation in the Netherlands in 1982 provided the crucial impetus for the labor unions' agreement.

41. See IMF (1999, figure 3.6) for detailed data.

42. This section draws on IMF data (1999, chapter 3).

43. For detailed statistics, see figure 3.5 in IMF (1999, 25).

ing) of 70 percent of the last earned wage (capped today at €59 per working day) became available for longer durations. The exact duration of unemployment assistance depended on the length of employment, but ranged from 6 months of salary-related benefit with 3 years of employment history to a maximum of 5 years of salary-related benefits with 40 years of employment history.⁴⁴ Overall, however, the reforms represented a very sharp reduction in benefits available to persons under, say, 23 years of age, and an appreciable restriction of salary-related benefit durations even for older workers, relative to the pre-1987 situation.⁴⁵ Van Ours (2003) estimates that the average unemployment benefit replacement rate in the Netherlands declined from 71 percent in 1980 to 56 percent in 2000.

In 1995 a further tightening of eligibility criteria demanded that the unemployed be willing to take any suitable job (*passende arbeid*) they are offered. Article 24(3) in the Dutch Unemployment Benefit Act states that all employment “which is within the worker’s capabilities and abilities” is suitable with possible exceptions made if: the worker’s qualifications are too far above those needed to fulfill the job; the pay is too low in comparison to previous employment; and the commute is too long.⁴⁶ However, the ability of workers to decline alternative employment is gradually scaled back as the period of unemployment lengthens. The longer a person remains unemployed, the fewer the demands he or she can make regarding the qualitative attributes associated with an offered job. Failure to comply with these regulations requires the Dutch social security agency to partially or completely deny benefits to the unemployed.⁴⁷

44. Since the mid-1980s minor changes have been made to the formula of determining a worker’s employment history and the duration of benefits. From 1995 to the present, the exact calculation of employment history has followed a two-step process. First, the individual has to review the five calendar years prior to unemployment to determine how many times wages were continuously received for at least 52 days. Second, the individual has to count the number of calendar years before this five-year period to the calendar year in which he/she turned 18. The two numbers are then added to determine the duration of benefits. For example, with four years of employment history, one is entitled to 6 months of salary-related benefits, increasing to five years with 40 years of employment record. For exact details of the gradually increasing benefit duration in the Netherlands, see the European Commission MISSOC database www.europa.eu.int/comm/employment_social/missoc/2002/nl_part10_en.htm (2004).

45. A two-year follow-up benefit (*vervolguitkering*) of 70 percent of the legal minimum wage is finally available after other types of unemployment benefits expire. For unemployed persons above age 57.5, this follow-up benefit is available until they reach age 65.

46. See European Foundation for the Improvement of Living and Working Conditions, EMIRE database, www.eurofound.eu.int/emire/NETHERLANDS/SUITABLEEMPLOYMENT-NL.html (accessed May 24, 2004).

47. Sanction is required in principle, but in reality the often close relationship between the unemployed and social security agency staff thwarts this automatic cutback. Currently up to two-thirds of benefit recipients are exempted from the job requirement—either statutorily

In 2001, through tax reform, the Dutch government introduced an EITC in an attempt to further alleviate the risk of unemployment and poverty traps⁴⁸ for benefit recipients. A general EITC for all workers was introduced, but cost concerns kept the program small in scale and it therefore had a limited effect on work incentives. For wage earners earning up to 140 percent of the minimum wage unemployment benefit, net replacement rates were brought down by approximately two percentage points, while minimum-wage workers saw reductions in net replacement rates of 2 to 4 percentage points, depending on social circumstances.⁴⁹

The success of the structural supply-side reforms to the Dutch labor market is indicated by the impact they have had on the youth labor market. As we have seen above, many of the reforms were particularly strict for younger workers—a population in which many other eurozone countries are currently experiencing persistent unemployment problems. It is therefore encouraging that the 15- to 24-year-old segment of the Dutch labor market has undergone a similar, if even more pronounced, transformation than seen in the total Dutch labor market.

Organizational Reforms of the Social Insurance System

Starting in 1990, organizational changes were made in the way the social insurance system was administered. These reforms were designed to increase the financial responsibilities faced by firms, reduce the direct influence of employers and employees on the administration of benefits, and introduce market mechanisms into the delivery of social security services in order to align the incentives faced by benefit suppliers and job placement service providers.

New government agencies were created to regulate the collection of social insurance taxes/premiums and the payment of benefits. Previously, companies, unions, and the government had jointly administered this task.

or de facto. See IMF (2002a, 18). Loss of unemployment benefits in the Netherlands does not mean complete loss of income since social assistance guaranteeing sufficient resources (*algemene bijstand*) remains indefinitely available. This assistance varies according to social circumstances, with married or unmarried couples (irrespective of sex) aged 21–65 entitled to 100 percent of the net minimum wage (for example, *algemene bijstand* is subject to taxation), single parents aged 21 to 65 entitled to 70 percent, and single persons aged 21–65 entitled to 50 percent. While special assistance for exceptional needs (*bijzondere bijstand*) is available, loss of unemployment benefits in the Netherlands nonetheless implies a substantial decline in disposable income.

48. Unemployment traps refer to circumstances in which people are discouraged from exchanging social security benefits for work because the net financial gain is either small or negative. Poverty traps refer to circumstances in which people are discouraged from seeking better-paying jobs because the net financial gain is either small or negative. See OECD (2002a, 150).

49. For detailed information, see OECD (2002a, 78–80).

An important purpose of this change was to reduce the incentive inherent in the old system to move the unemployed from the contribution-based UI system to the disability system, which was mostly state funded at that time.

In 1996 firms were made legally responsible for employee sick leave payments during the first year of illness. Employer contributions to the disability plan were increased in 1998,⁵⁰ and the employer- and employee-financed unemployment benefits were increased from 8 to 26 weeks. These changes were intended to place stronger incentives for employers and union groups to police misuse of the social insurance programs and to increase their efforts to place people in new jobs.⁵¹

Having taken over the regulation of the social insurance programs, the government then contracted out much of its day-to-day management in 1997. Different agencies, initially set up to cover individual sectors of the economy only, were free to compete for members across sectoral borders and free to employ private companies to deliver social services such as job placement of benefit recipients. Competition introduced market forces into social service delivery, and also facilitated a targeted response by a region or sector to particular problems. For example, additional incentives could be given to private companies able to place laid-off workers from an area hit by company closings or restructuring.

Qualifications to the Dutch Labor-Market Miracle

Labor-market reforms in the Netherlands have increased the employment rate and reduced the unemployment rate. But this overall success has some qualifications.

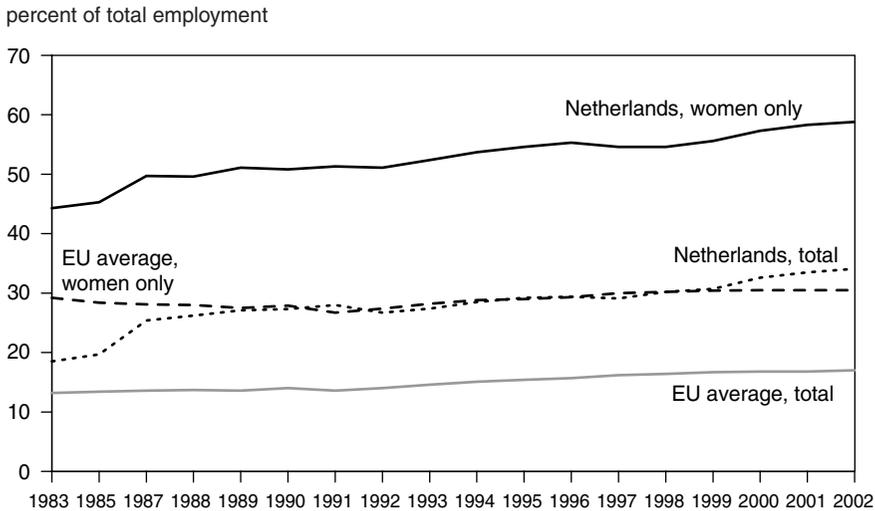
First, the Netherlands has experienced a high and rising incidence of part-time work. Figure 5.6 illustrates that the Netherlands has approximately twice the share of part-time employment in total employment than the European Union as a whole. Part-time jobs are very common among Dutch women, associated with a near doubling of female employment (full- and part-time) from 34.4 percent in 1980 to 65.1 percent in 2002.⁵² This increase to some degree represents catch-up from a traditionally low female participation rate in the Dutch workforce. The availability of part-time work is beneficial to many employees, and, according to the OECD, most part-time employment is voluntary. However, the preva-

50. The impact on total company wage costs was offset by decreases in other taxes and social security contributions.

51. These changes may also have discouraged employers from hiring anyone likely to become sick or disabled—known as the “adverse selection” problem in insurance provision.

52. Data drawn from OECD (2003i).

Figure 5.6 Part-time employment of total population and women, Netherlands and EU average, 1983–2002 (percent of total employment)



Source: OECD (2003i).

lence of part-time work may also reflect unavailability of adequate child-care facilities and the lack of incentives for full-time employment.⁵³

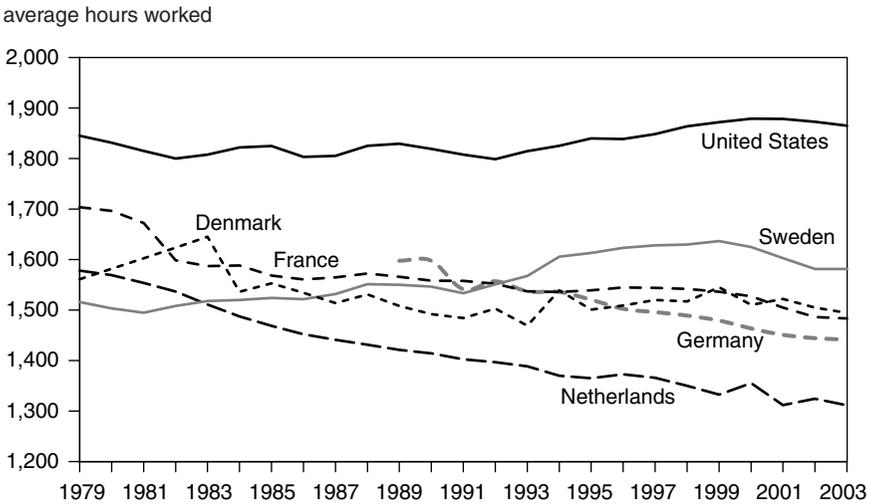
As figure 5.7 illustrates, the dramatic increase in Dutch labor-force participation has gone hand in hand with a steep slide in average hours worked per employee in the Netherlands after 1980. The prevalence of part-time work is partly to blame for this decline, but a reduction in the full-time workweek⁵⁴ also plays a part. Today, the average workweek per employee in the Netherlands is the lowest in the OECD.⁵⁵ This has consequences for economic growth and limits the tax revenue generated by rising employment levels. The increase in employment since the early 1980s

53. See OECD (2002a, 149). In 2000, the right to work part-time became legal. Employees with more than 12 months of employment can ask their employers to adjust the number of contractual working hours to less than 35, unless compelling business reasons prevent it. Social partners cannot divert from these rules in collective-bargaining agreements, and rejections based upon compelling business reasons are subject to the jurisdiction of Dutch labor courts. Companies with fewer than 10 employees are exempt. See Bertelsmann Foundation (2000, 32–33).

54. The reduced full-time workweek was first initiated with the 1982 Wassenaar Agreement and continues today with the collective-bargaining agreement average of 37 hours per week.

55. See data from University of Groningen and the Conference Board (2004).

Figure 5.7 Average annual hours worked, select countries, 1979–2003



Source: University of Groningen and the Conference Board (2004).

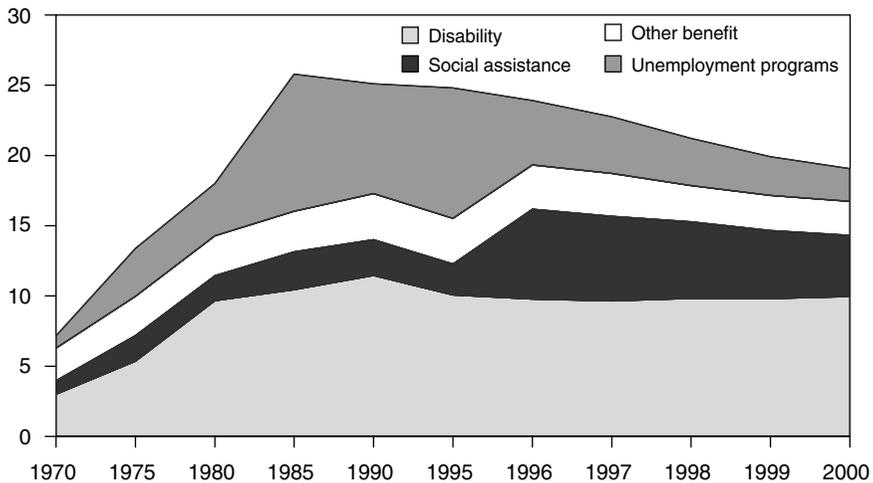
has been achieved in part by redistributing existing work rather than by the creation of new job opportunities.

Naastepad and Kleinknecht (2002) link the relatively low Dutch labor-productivity growth in the 1980s and 1990s to the rapidly increasing Dutch employment. As we noted before, it is not necessarily bad if labor productivity in some European economies is lowered by increasing employment. But there are certainly ways in which productivity could be increased by better business operations in the Netherlands (many of the same barriers to productivity have been highlighted in Britain, France, and Germany), thereby combining higher productivity and higher employment.

Second, while many new jobs have been created, particularly in the rapidly expanding service sector, a significant number of those who lost their jobs left the workforce altogether rather than being induced to look for and find other work. These individuals entered income transfer programs other than UI—principally disability and early retirement programs. Figure 5.8 illustrates that the total share of people on social benefits in the Netherlands reached more than 25 percent in the mid-1980s, before declining slowly in the following years as a result of declining unemployment and stricter eligibility criteria for disability and social benefits. A part of the decrease in the Dutch unemployment rate is thus clearly a result of the increase in the number of persons outside the labor force. The idea that the Netherlands has been able to achieve *full employment* again is therefore questionable.

Figure 5.8 Unemployment benefit recipients in the Netherlands, 1970–2000

percent of sum of employed and benefit recipients



Note: Because of administrative reform in 1995, a significant number of people were moved from unemployment programs to passive social assistance in 1996.

Source: Dutch Ministry of Social Affairs and Employment, cited in OECD (2002a, 26–27).

The disability issue has shown itself to be extremely difficult to manage. In both 1985 and 1993, the Dutch government attempted to reform the disability system. In 1985, disability benefits were reduced from 80 percent to 70 percent of the last earned wage. To qualify for full disability, a person had to be at least 80 percent incapacitated. If a person was less than 80 percent incapacitated, the benefits were reduced proportionally and supplemented by unemployment benefits (the duration of these benefits expired as outlined earlier) if he/she were unable to find a job.⁵⁶ In 1993 disability benefits for new claimants were sharply reduced. The duration of full benefits (70 percent of last earned gross wage) were reduced to a maximum of 6 years for those age 58 and above and gradually declining to only 6 months for those at age 32. After these benefits expire a lower level of benefits is subsequently provided, which is calculated based on age and salary previously earned. Eligibility requirements were also tightened. The reference point for calculating disability became the ability to perform any paid job—regardless of the applicant’s skill level or experience.

56. For additional detail, see IMF (1999, 27) and European Commission MISSOC database www.europa.eu.int/comm/employment_social/missoc/2002/nl_part5_en.htm (accessed May 25, 2004).

Third, a radical step was taken: All disability beneficiaries under the age of 50 were individually reexamined.⁵⁷ While these three steps did temporarily stem the rise in the fraction of disabled claimants, toward the end of the 1990s the fraction started to rise again, especially as more claims were accepted on psychological grounds (OECD 2002a, 85).

Van Ours (2003) uses 2001 statistical evidence to show that the share of disability recipients among women is slightly higher than among men for younger age groups (25–44 years of age), whereas the share of male recipients is twice as high as for females in some subcategories (55–64 years of age) for older workers (45–64 years of age). This finding supports the conclusion that *nondisability-related forces* heavily affect enrollment in Dutch disability programs—for example, the recent rise in female disability recipients may be linked to the easing of psychological eligibility criteria.⁵⁸

Overall, the reforms to the disability program meant that *the share of disabled in the total labor force* stabilized. However, since the labor force increased substantially with the rise in employment, this stable share implies a large (nearly 30 percent) absolute increase in the number of disabled—from 608,000 in 1980 to 794,000 in 2000. The disability rate in the Netherlands today remains more than twice the rate found in otherwise comparable European countries, such as France or Germany.⁵⁹

Acknowledging this, the Dutch government in 2003–04 initiated a series of further reforms to come into effect in 2006. The main aims of these are to further tighten the medical definition of full disability and restrict such to permanent cases (WAO—*Wet arbeidsongeschiktheidsregeligen*). Simultaneously, a new return-to-work scheme (WGA—*Werkhervatting Gedeeltelijk Arbeidsgeschikten*) for people not fully or permanently disabled strives to mobilize the “residual labor supply” in this group. They are to be coaxed into returning to the labor market through a combination of wage subsidies and stricter eligibility criteria. On the face of it, these proposals seem encouraging, but the devil is frequently in implementation, so their effect cannot be fully gauged as of yet.⁶⁰

Lessons Learned

The Netherlands illustrates that determined, coordinated, and sustained government action on several fronts can, in the words of C. Maxwell Watson (IMF 1999, 2), “change the rules of the game in the labor market . . .

57. For additional details, see IMF (1999, 27) and European Commission MISSOC database www.europa.eu.int/comm/employment_social/missoc/2002/nl_part5_en.htm.

58. The high female disability reciprocity rate for younger workers (25–44 years of age) may also be related to the rapid rise in female labor-force participation since 1982. However, the male labor-force participation rate in this age group remains higher than for females.

59. Data drawn from OECD (2002b).

60. For additional information, see OECD (2004d).

[through] chemistry, but no alchemy.” As van Ours (2003, 17) puts it in his conclusion, “Labor market developments in the Netherlands were not a miracle but above all related to the restructuring of inefficient labor-market institutions.” Thus, the interaction of several labor-market-related reforms proved a powerful stimulus to job creation without endangering the nucleus of the Dutch welfare state. The example of the Netherlands shows how an economy can start a positive cycle in which payroll taxes and unemployment benefits are cut, and work incentives and employment increase.

The drop in hours per employee and the growth of early retirement and disability programs are important qualifications to this finding. Dutch policymakers clearly attempted to control social programs but were unwilling to do more because of the potential political fallout. The Wassenaar Agreement was achieved with fairly peaceful labor relations.⁶¹ Any agreement would have been more difficult without alternative social support programs for laid-off workers to move into as UI benefits were cut back. The Netherlands decided to preserve its tradition of social cooperation even though it limited the effectiveness of labor-market reforms in terms of increasing the number of hours worked in the economy.

Sweden: Reforming under Fiscal Distress

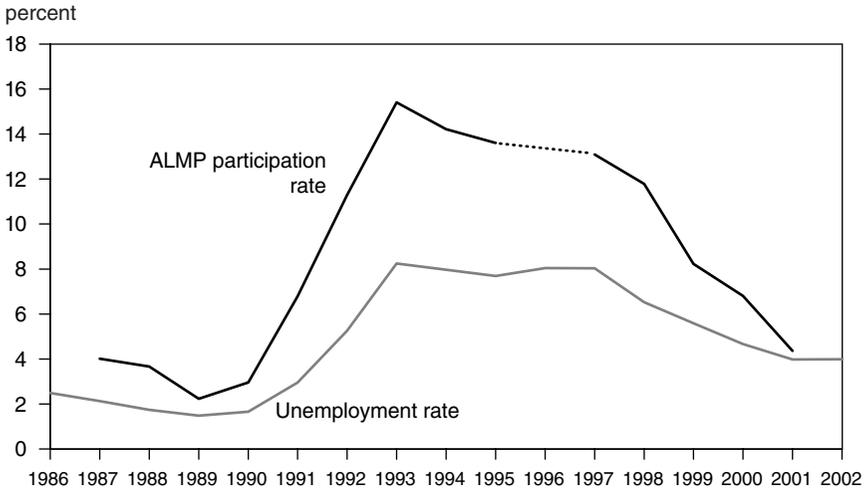
In the early 1990s Sweden suffered its steepest recession since the 1930s with real GDP declining more than 1 percent each year from 1991–93 and open unemployment more than quadrupling in 3 years to about 8 percent of the labor force in 1993 (figure 5.9)—an unprecedented level for that economy. This caused an unparalleled fiscal crisis in Sweden with the general government deficit peaking at 12 percent of GDP in 1993 and gross general government financial liabilities nearly doubling to 83 percent of GDP from 1990–94.⁶² Desperate times called for desperate measures, and successive Swedish governments throughout the 1990s implemented a series of economic reforms, even through changes in the political parties in power. These reforms not only engineered a remarkable fiscal turnaround of government finances, but also laid the foundations for a robust pickup in employment. Unemployment by the end of the 1990s had halved to 4 percent, considerably lower than in other major European economies.

The great bulk of the fiscal consolidation in Sweden occurred through cuts in government expenditure after 1993. Figure 5.10 shows the decline

61. The European Industrial Relations Observatory (EIRO) lists the Netherlands as having the fourth lowest level of strike activity in Europe (after Slovakia, Austria, and Germany) in the late 1990s.

62. All data from OECD (2003a).

Figure 5.9 Sweden's open unemployment and participation rate in ALMPs^a (OECD Program 910), 1986–2002



ALMPs = active labor-market programs

a. Unemployment rate is percent of labor force; ALMP participation rate is percent of active labor force.

Source: OECD (2003i).

in government outlays, declining by 15 percentage points of GDP from 73 percent of GDP in 1993 to 58 percent in 2002. Of course spending at 58 percent of GDP is still very high even by European standards, with government outlays still roughly 10 percentage points above the eurozone average in 2002.⁶³

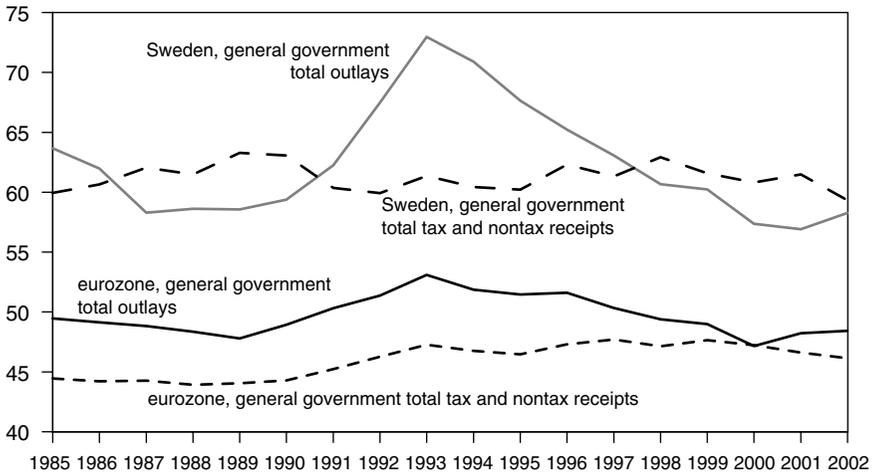
Even though taxes remain very high,⁶⁴ the 1990s reforms have remarkably improved the sustainability of Swedish government finances, with the cyclically adjusted general government balance improving from -6 percent of GDP in 1991–95 to +3 percent in 2000 (and it remained positive at +0.7 percent in the latest available data from 2003) (European Commission 2004a). According to the IMF a little less than half this improvement came from a reduction in government transfers to households, while the remainder arose from cuts in government transfers to business, which had been reduced by 75 percent of their 1993 absolute value by 2000.

63. Similarly, the OECD (2004c) ranks Sweden first in terms of social expenditure in 1998 with total social expenditure at 30.98 percent of GDP.

64. The OECD (2003h) ranks Sweden—at 50.6 percent—as having the highest total tax revenues as a share of GDP in 2002 of all surveyed countries in its 2003 revenue statistics.

Figure 5.10 General government revenues and expenditure in Sweden and the eurozone, 1985–2002

percent of nominal GDP



Source: OECD (2003i).

In 1997 Sweden implemented medium-term government expenditure constraints that stipulated a combination of a 2 percent of GDP government structural surplus target set three years ahead and central government expenditure ceilings. Starting in 2000 a balanced-budget requirement for local governments required a reversal of any deficits on current spending within two years. Thus, even though Sweden remains outside the eurozone, the fiscal policies it has followed are actually tougher, but more flexible, than those required by the SGP.⁶⁵

We turn now to a description of how Sweden reduced transfers to households by up to 5 percent of GDP while improving employment. The Swedish reforms can be separated into four main areas: unemployment benefits, active labor-market programs (ALMPs), sickness and disability benefits, and comprehensive tax reform.

Unemployment Benefits: Cuts and Conditionality

There is a two-tier UI benefit program in Sweden. Most of the unemployed receive earnings-related benefits (*inkomstbortfallsförsäkring*) available to members of UI funds, which are administered by the labor unions in each sector of the economy.

65. See also IMF (2001a, 14–15).

Control of the UI funds serves as a powerful recruitment tool and has contributed to Sweden's very high union membership levels for both blue- and white-collar workers. It also meant that reforming the unemployment benefit system was politically very contentious in Sweden. Nevertheless, substantial changes were made to benefit levels, duration, and eligibility.

Before 1991, Swedish unemployment benefits were 90 percent of reference earnings (previous daily average earnings). In 1991, benefits were reduced to 80 percent of reference wages, before being temporarily lowered to 75 percent in 1996. A year later, the benefits were raised again to the current (and 1991–96) level of 80 percent. One study suggested that unemployment in Sweden is quite sensitive to the level of UI benefits. Carling, Holmlund, and Vejsiu (2001) estimate that the 1996 replacement rate reduction from 80 to 75 percent led to a 10 percent increase in transition out of unemployment.

The rather high replacement rates for the Swedish UI system do not apply to all workers, because benefit levels are capped. Data for benefit-cap levels in earlier years are not available, but the current cap is €73 (680 Swedish kroner) per day during the first 100 days with benefits. This cap is estimated to limit payouts for approximately 45 percent of recipients. The current cap is a significant increase compared with the €62 (580 Swedish kroner) per day level prevailing prior to July 2001 (Thakur et al. 2003, 54).

Until 2001, the duration of unemployment benefits was essentially indefinite, as eligibility spells could be extended through participation in public works or training programs (the ALMPs). The adverse effect this created for work incentives was widely noted (IMF 2001a; Calmfors, Forslund, and Hemström 2001), and in 2001 the new "Activity Guarantee" plan limited UI benefit duration to 300 days initially and extendable for another 300-day period provided that the recipient participated in one ALMP at least 70 hours per month for 6 months.

Once the unemployment-benefit eligibility is exhausted, the unemployed person needs at least 12 months of full-time employment—with membership in a UI fund—to requalify for earnings-related UI benefits. The 12-month membership rule reflects a substantial tightening in eligibility requirements prior to 1991 when only 4 months was required.

The limits and restrictions on the main UI benefit program are mitigated by the second-tier UI program, which provides a lower flat-rate basic allowance (*grundförsäkring*). This program only requires that a person be employed for at least 6 months and at least 70 hours per month. Other rules include a five-day waiting period (initiated in 1991) before payment and a nine-week penalty if a worker leaves a job without a valid reason.

The UI programs in Sweden do not simply hand out benefits without strings attached. In fact, the requirement for recipients to accept positions has been strengthened recently: Since 2001 beneficiaries have been required to cooperate with the unemployment agency to create an individ-

ual action plan (IAP),⁶⁶ which makes it clear that individuals must accept suitable job offers. The IAP also describes the possible ALMPs the unemployed will be required to participate in. Failure to comply with the IAP or take up suitable employment leads to automatic sanctions in three progressive “steps”: A first-time refusal leads to an 8-week 25 percent reduction in benefits; a second refusal leads to an 8-week 50 percent reduction; and a third refusal completely halts benefits for 8 weeks.

Overall, there has been a significant tightening of the Swedish UI program over the 1990s, in terms of benefit levels, duration, and eligibility. Some reforms since 1991 have subsequently been reversed, but the net effect has been a considerable reduction in the availability of unemployment benefits.

That said, it is notable that persons who lose UI benefits do not lose income support altogether in Sweden. A low basic level of income is guaranteed through social assistance (*socialbidrag*). In 2003 this was a flat-rate basic amount of €271 (2,520 Swedish kroner) per month for singles and €492 (4,570 Swedish kroner) for couples. This basic amount can be—and is—supplemented by additional benefits for children as well as commuting by any household member, trade union membership (including the UI fund), housing, and other “needs.” There are no limits on the length of time for which these additional benefits can be received.

ALMPs: A Swedish Tradition Overdone?

For many years Sweden has had extensive ALMPs. For as long as international comparable data are available⁶⁷ Sweden has been at—or near—the very top in terms of expenditure on ALMPs. Calmfors, Forslund, and Hemström (2001) describe how the original intent of these programs in the 1950s was to increase labor-skill levels and mobility, but that since the 1960s the emphasis increasingly shifted toward counteracting all types of unemployment—including cyclical unemployment. These programs became an alternative form of income support, and, indeed, there was a sharp rise in ALMP participation during the early 1990s recession (figure 5.9). In fact, most of the ALMP support during that time came in the form of subsidized employment—predominantly public employment,⁶⁸ which

66. These IAPs bear some resemblance to the PAP/PARE (*plan d'action personnelle/plan d'aide au retour à l'emploi*) program introduced in France in 2001 and the Job-AQTIV (German acronym: A = Activate, Q = Qualify, T = Train, I = Invest, and V = Mediate) format introduced in Germany in 2002. However, the level of sanctions against the unemployed for non-compliance is greater in Sweden.

67. OECD Labor Market Indicators data go back to 1985.

68. Data drawn from OECD (2003i). The vast majority of Swedish “Youth Measures” are of similar characteristic and should—for this purpose—be included in the functional category “subsidized employment.”

directly lowered the unemployment rate as measured by official statistics. However, participants in education-type ALMPs are considered unemployed in official statistics (Thakur et al. 2003, 61). Hence, the true level of unemployment in Sweden in the mid-1990s was likely significantly above the official open rate of about 8 percent shown in figure 5.9.

Calmfors, Forslund, and Hemström (2001) surveyed a range of empirical micro- and macroeconomic studies of the effect of ALMPs. They concluded that the Swedish ALMPs were not particularly efficient overall and should not be copied outright if a country's goal is ultimately to increase *private* employment. ALMPs in Sweden did succeed in lowering open unemployment, but they did so with serious "crowding-out effects" that reduced other employment. Subsequently, in 2002 Sweden's employment-to-population ratio had not yet recovered to precrisis levels, although the ratio is very high relative to other European economies. Using ALMPs in response to a sharp cyclical slowdown was problematic because the sudden surge in participation⁶⁹ made it difficult to find economically valuable activities for all participants. However, the Swedish experience does not rule out positive results from ALMPs under different macroeconomic circumstances (see the next section on Denmark for an example).

Sickness Benefits and Disability: An Enduring Swedish Addiction?

Sweden has traditionally had very generous sickness and disability benefits. In 1991 sickness-benefit replacement rates of close to 100 percent were available for an indefinite period.⁷⁰ Figure 5.11 illustrates that by the end of the 1980s expenditure on both sickness and disability cash benefits had reached 4.7 percent of GDP, and in figure 5.12 is it evident that absenteeism rose almost continuously after the introduction of sickness benefits in 1955. As awareness of the problems associated with worker absenteeism became widespread, and the fiscal situation deteriorated in 1991, the new center-right government introduced reforms in September 1991. The new rules included a one-day waiting period before benefits were provided. Also, employers now had the burden of paying benefits for the first 14 days of a person's illness or disability. Furthermore, eligibility criteria were tightened, and benefits were cut to 75 percent of wages.⁷¹ Prior

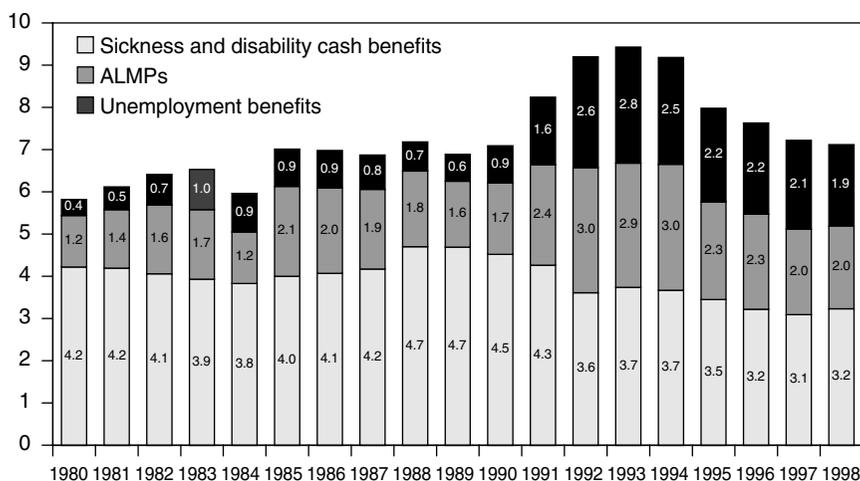
69. Figure 5.11 shows that expenditure on ALMPs in Sweden almost doubled from 1.6 percent of GDP in 1989 to 3.0 percent of GDP in 1992.

70. See IMF (2001a, 40) for a detailed breakdown of historical sick leave compensation. Traditionally, compensation varies with the number of days one is absent and is capped at a certain fixed level. As such, only low-wage recipients will face an actual net replacement rate of 100 percent, whereas recipients with higher incomes will—due to the cap—face lower net replacement rates. See the Swedish National Social Insurance Board (*Riksförsäkringsverket*), www.rfv.se/forsak/belopp/docs/aktbel03.pdf (accessed October 29, 2003), for detailed maximum benefits in 2003.

71. Eligibility for disability for elderly unemployed persons covered by "nonmedical labor market considerations" (i.e., healthy workers "parked" on disability pensions) was also eliminated in 1991.

Figure 5.11 Select social expenditures in Sweden, 1980–98

percent of nominal GDP



ALMPs = active labor-market programs

Source: OECD (2002b).

to this reform all employers had paid a flat amount for sickness and disability insurance regardless of the extent to which their own employees drew benefits, which limited the incentive for employers to require employees to verify sickness.

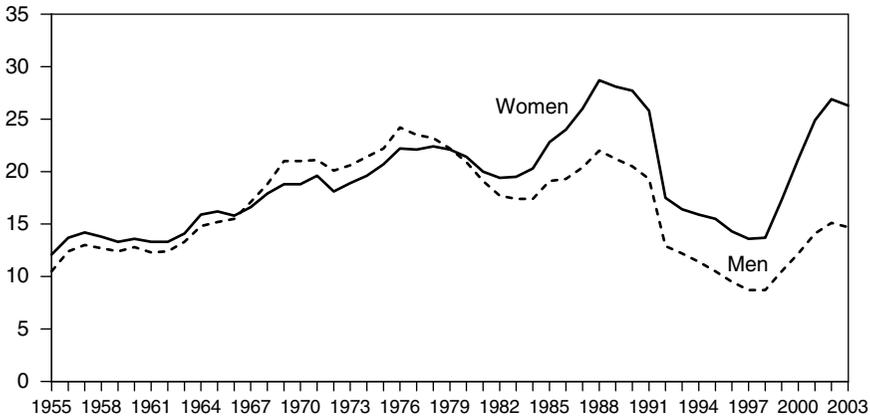
In 1995 eligibility criteria were tightened again. A physician’s certificate was required after the seventh calendar day of sickness while long-term cases required a more thorough medical examination. In 1998, sickness benefits were raised to 80 percent of wages and remained at this level until July 2003, when they were again reduced, to 77.6 percent of wages. At the same time, employer-covered sick days were extended from 14 to 21. In figure 5.11 it is evident that the tightening of eligibility criteria and benefit levels did have an effect on expenditure, which fell to 3.2 percent of GDP by 1998.⁷²

The most recent reforms are a direct result of the strong rebound in the number of sickness benefit recipients after 1997, which is clearly illustrated in figure 5.12. In 2003, the OECD estimates that sick leave alone kept 270,000 full-time-equivalent workers away from work for the full year. This is more than total unemployment at 259,500 in 2003 (OECD 2004e; Eurostat 2004a). The sharp increase in beneficiaries reversed the

72. One can expect sickness levels and the number of people on disability to be cyclical only to a limited degree, so the decline in expenditure from 1990 to 1998 can primarily be attributed to the tightening of eligibility criteria and benefit levels. Unfortunately, data do not go beyond 1998.

Figure 5.12 Sweden's sick leave, men and women, 1955–2003

annual paid days of sick leave
per insured person



Note: Sickness benefits began in Sweden in 1955. Data are only for sickness benefits paid by National Social Insurance Board. Data do not include sickness benefits paid by employers during the first 14 days of sickness, implemented in 1992 (and extended to 21 days in July 2003). From 1998 onward, recipients of disability pensions are excluded from denominator.

Source: Swedish National Social Insurance Board, *Riksförsäkringsverket*.

decline experienced in the first half of the 1990s.⁷³ Several explanations for this strong procyclical rebound have been suggested. Aronsson and Walker (1997) estimate that procyclicality has been present in Swedish sickness benefit claims since the 1960s. They suggest that work-related stress and compositional effects of the workforce affect sick leave, and that the last hired are more prone to falling ill. Based on other Swedish evidence, Johansson and Palme (2003) suggest that sickness benefit claims are responsive to the incentive structure of the system. Henrekson and Persson (2004) estimates that the 5 percentage point increase in sickness benefit replacement rates in 1998 (from 75 to 80 percent) accounted for a 30 percent increase in Swedish claims.

Since there is no limit to the duration of sickness benefits (*sjukpenning*) in Sweden, the distinction between sickness benefits and a full disability pension (*sjukbidrag/förtidspension*) is blurred. Both types of benefits expire at the age of 65 when individuals then become eligible for an old-age pen-

73. The rebound in sick leave after 1998 shown in figure 5.12 is staggering, since the first 14 days of sick leave paid for by the employer after 1998 are not included in the data from the Swedish National Social Insurance Board. Such a rebound inevitably questions the effect of shifting the burden of financing the initial 14 days directly to employers, since only a rise in the number of people on sick leave for prolonged periods (more than 14 days) could have caused the post-1998 increase. It seems that the effects of employer surveillance/policing of employee sickness would be extremely limited for longer periods of absence.

sion (*ålderspension*). The main difference comes in the calculation of benefit levels.⁷⁴ It is hard to make a clean comparison of benefit levels in the programs because of the system's complexity. There are different degrees of disability, which affect the amount and type of benefit paid. The benefits of the two programs are taxed differently, and disability beneficiaries receive additional allowances over and above the basic benefit level.⁷⁵ However, it would be fair to say that Sweden's sickness benefits are very generous in absolute terms and in comparison with its disability pensions.

Given the generosity and extended duration of Sweden's sickness benefits, this means that a number of people who would be classified as disabled in other European countries are counted as "sick" in Sweden. Therefore, the permanent level of withdrawals from the Swedish labor market through the combination of sickness benefits and disability pensions will likely be somewhat higher than the already high level indicated by international comparative statistics such as the OECD.

Comprehensive Tax Reform

In 1991, Sweden implemented a comprehensive tax reform. The existing system had tax rates that were extremely high on upper-income levels (very high marginal tax rates) combined with tax breaks or deductions that allowed certain forms of income to avoid taxation or be taxed at a lower rate. The main goal of the reform was to lower the highest tax brackets while eliminating tax breaks and deductions (broadening the tax base while lowering marginal tax rates). In addition, there was an effort to move toward taxing consumption and capital income, while lowering the taxes on labor income. Overall the reform was designed to be revenue neutral. A negative revenue impact of 6 percent of GDP (or more) was also expected from the cuts in income tax rates. This was to be offset one-third by new taxes on capital, one-third by broadening the base of the standard 23 percent value-added tax (VAT), one-sixth from the elimination of tax loopholes, and the remainder from revenue gains generated by higher output associated with incentive improvements.⁷⁶

A large group of full-time employees benefited from the 24 to 27 percentage point drop in the top income tax rate (although the top rate was

74. Differences in determining personal eligibility also occur, since eligibility for disability pensions generally requires a one-time assessment by a medical practitioner employed by the National Social Insurance Board, while sickness benefits may require periodic medical examinations.

75. See Swedish National Social Insurance Board (*Riksförsäkringsverket*), www.rfv.se/forsak/famba/sgi/index.htm (accessed October 30, 2003) for details regarding the calculation of sickness benefits and www.rfv.se/forsak/pension/alder/analys/index.htm (accessed October 30, 2003) for details regarding the disability program.

76. For a detailed analysis of the Swedish tax reform, see Agell, Englund, and Sodersten (1996) and IMF (2001a).

still high at 51 percent). Subsequent estimates indicate that this drop led to an increase in labor supply of up to two percent (see Agell, Englund, and Sodersten 1998; Blomquist, Eklöf, and Newey 2001). However, ensuing estimates also indicate that the reform did not achieve revenue neutrality and, indeed, was underfunded by about 4 percentage points of GDP (Thakur et al. 2003, 16). Thus, while the tax reform plan had a direct, positive effect on the labor supply, it also aggravated the fiscal crisis in Sweden in the years following implementation in the early 1990s.

Lessons Learned

Despite the problems and issues that remain, the overall nature and effect of the Swedish labor-market and tax reforms that started in 1991 are clear: lower (but still) generous benefit levels available for shorter durations and lower marginal tax rates on labor income. These reforms have contributed to significant improvements in unemployment and a rebound in labor-force participation. Crucially, the employment increase has not been accompanied by a steep decline in average hours worked per employee, as was the case in the Netherlands (see figure 5.7).

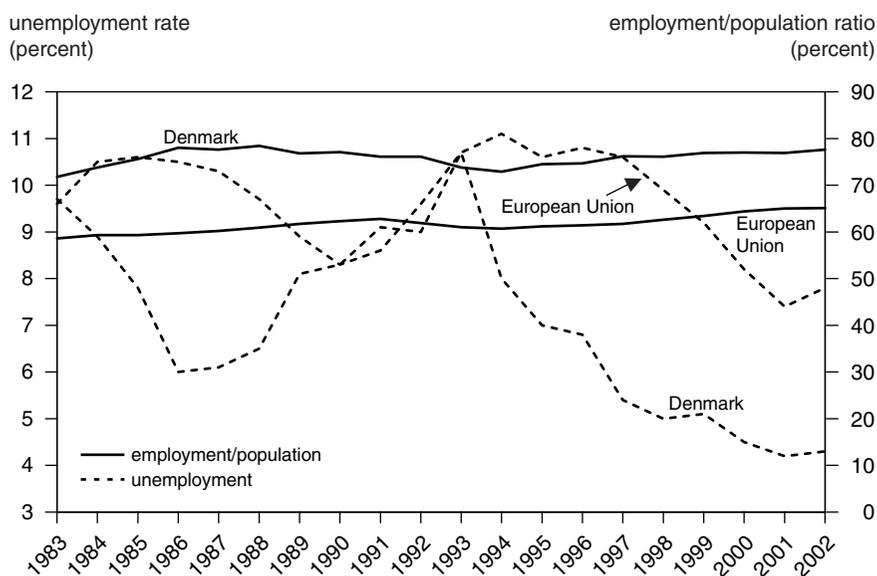
On the negative side, Sweden also illustrates what can happen if labor-market reforms are not comprehensively implemented. The surge in sickness benefit claims after 1998 appears linked to the stricter unemployment benefit rules. As people were denied UI benefits or unwilling to meet the stiffer requirements for eligibility, they shifted to the sickness benefit program.

Denmark: Toughening the Welfare State

In 1993, unemployment in Denmark reached a historic peak of 309,000 persons (or 10.7 percent of the labor force) who included approximately a quarter of long-term unemployed.⁷⁷ This made it evident to decision makers that the existing Danish labor-market model was no longer financially viable nor delivering an acceptable outcome for the unemployed. As a result, the ruling leftist social-democratic government implemented a series of reforms in the labor market during the 1990s that successfully decreased unemployment to below US levels, while increasing an *already high* labor supply. Figure 5.13 illustrates the development of unemployment rates and employment/population ratios in Denmark, the European Union, and the United States.

77. Data drawn from OECD (2003i). Long-term unemployed are defined as persons unemployed for more than 12 months, which, in absolute numbers, were 77,100 in 1993.

Figure 5.13 Unemployment and employment to population rates in Denmark and the European Union, 1983–2002



Source: OECD (2003i).

The condition of Denmark’s labor market benefited from a strong cyclical recovery in 1994 with real GDP increasing 5.5 percent—up from being flat in 1993.⁷⁸ But over the period as a whole, employment growth was not driven just by demand growth. Danish real GDP growth from 1995 to 2002 was a moderate 2.4 percent a year, which is comparable to the 2.3 percent recorded for the European Union as a whole (although better than either Italy’s 1.9 percent or Germany’s 1.4 percent growth over the same period). The job-rich growth that occurred in Denmark reflects a substantial difference compared to the European Union as a whole, as figure 5.13 illustrates.

The Danish labor market was revamped through a series of initiatives, which were accompanied by critical periodic parliamentary reviews of these initiatives from 1994 through 1999.⁷⁹ The reforms had four main elements: decentralization and individualization; shortening the duration of unemployment benefits; the right and duty to be active while unemployed; and measures to improve youth employment.

78. All real GDP data from the OECD Economic Outlook (OECD 2003a).

79. The main delivery vehicles were the 1994 Labor Market Reform Package and the Annual Financial Acts (1995 through 1999). See Danish Ministry of Labour (1999, chapter 1).

Decentralization and Individualization

With the 1994 labor-market reforms, the priority of specific policy decisions was delegated to local regional labor-market boards,⁸⁰ although subject to an overall framework laid down by the Ministry of Labor. The aim was to incorporate local needs, knowledge, and expertise when allocating resources for the community. For example, local labor-market boards could select for special programs target groups of unemployed persons considered at risk of becoming long-term unemployed. Similarly, the local boards could identify sectors with shortages of skilled labor (that could create growth bottlenecks), and then take steps to overcome these shortages.

Simultaneously, individual action plans (IAPs) between the unemployed and the public employment agencies were introduced.⁸¹ The IAPs were intended to reflect the needs of both the individual and local employers. However, to resolve possible conflicts between the two sides, the Finance Act of 1995 explicitly states that *the wishes of the unemployed in connection with the drawing up of action plans should not stand in the way of the labor needs of enterprises*⁸²—in other words, the wishes of the unemployed are overruled by the needs of local labor demand.

Shortening the Duration of Unemployment Benefits

Unemployment benefit levels in Denmark are generous for low- and moderate-income workers. They are set at 90 percent of the average of the preceding 12 weeks' wages⁸³ but are capped at a fairly low level (currently €400 or 3115 Danish kroner/week). The UI benefit levels have not been cut with the labor-market reforms, in part because employment protection legislation in Denmark is less stringent than in the rest of Europe (figure 5.14). Company restructuring and job cuts are easy, but laid-off workers have access to generous compensation. Thus, Denmark attempts

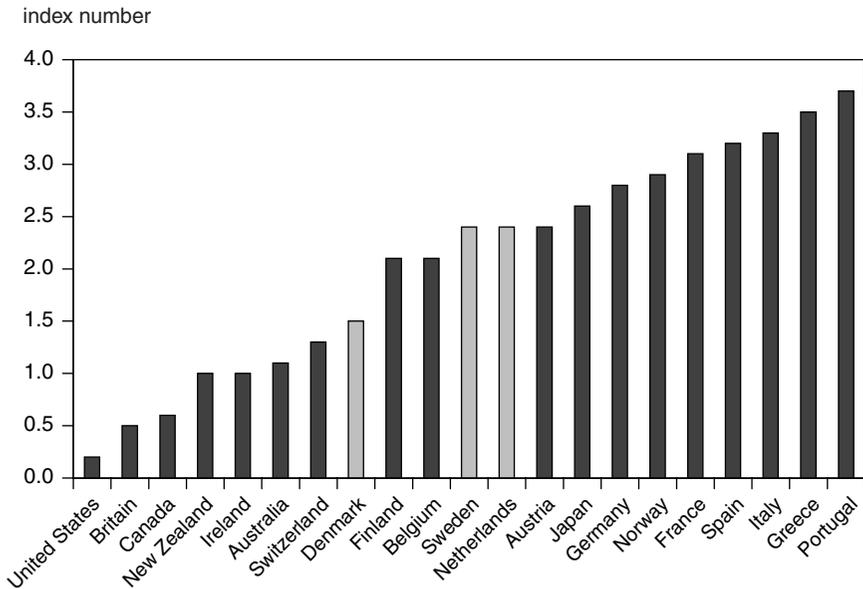
80. Local labor-market boards consist of representatives from private employers and local authorities as well as workers.

81. These IAPs bear some resemblance to the PAP/PARE (*Plan d'Action Personnelle/Plan d'Aide au Retour à l'Emploi*) program introduced in France in 2001 and the Job-AQTIV (German acronym: A = Activate, Q = Qualify, T = Train, I = Invest, and V = Mediate) program introduced in Germany in 2002 (mentioned earlier). However, the level of sanctions against the unemployed for noncompliance in Denmark—as in Sweden—is substantially higher.

82. Wording is from the Danish Government's Financial Act of 1995, which was reproduced in Danish Ministry of Labour (1999, 14).

83. Access to unemployment benefits is granted after membership in an unemployment insurance fund for 12 months. Benefits are financed by the state and through flat-rate contributions by salaried workers and nonwage earners to a labor-market fund. However, as employee contributions to the labor-market fund are tax exempt, in effect the vast majority of funding for unemployment benefits is provided by the state. As is the case in Sweden, labor-market funds in Denmark are administered by labor unions with similar effects on union recruitment potential and political controversy of reforms to the system.

Figure 5.14 Overall employment protection legislation indicator, 1998



Source: OECD (2001e).

to combine income security with a flexible economy—“flexicurity.” Many higher-wage workers are also covered by contracts—negotiated by white-collar unions—that provide a generous severance payment if they are laid off. Thus, both the generosity of the benefit levels and the costs of restructuring are likely greater than implied by the UI-benefit cap found in the union-run UI program and by the regulatory ease of firing.

While levels of unemployment benefits (as a percent of prior wages) have not been changed since 1994, the duration for which they are available has been cut by half to a (still generous) maximum of four years. Moreover, as of 2000, the unemployed are required to participate in training or job placement programs for the last 36 months of the four-year benefit duration period. Prior to 1994 it was possible for persons to requalify for UI benefits by participating in training or other programs, but this possibility was eliminated. By 1996 only 52 weeks of unsubsidized employment entitled an unemployed person to new unemployment benefits. The rule was changed to ensure active labor-market training would target a return to employment, rather than being just a means to continued eligibility for unemployment benefits.⁸⁴

84. See OECD (2004g) for the most recent changes in legislation in Denmark and elsewhere.

The Right and Duty to Be Active while Unemployed

Although government-sponsored training programs in Sweden and in the United States have not been very successful, indications suggest the Danish programs have worked relatively well. Denmark has traditionally spent lavishly on both passive and active programs. Both businesses and unions are supporters of the programs, and potential employers even provide information regarding the skills they seek in potential employees. The programs have obtained high job placement rates for graduates.⁸⁵ The programs, which are subject to review, are credited with reducing the structural unemployment level in Denmark by 3 to 4 percentage points, as well as raising the skilled-labor supply and thereby avoiding bottlenecks and contributing to moderation in wage increases.⁸⁶

Another important aspect of the Danish labor-market training programs is that they are not limited only to the unemployed, for whom participation is mandatory. Instead they are an integral part of an extensive program of continuing vocational training opportunities available to all Danish workers, thus ensuring knowledge of the skill requirements of the labor market.⁸⁷ Figure 5.15 illustrates that there was a near doubling of resources given to labor-market training from the mid-1990s on. The additional resources significantly expanded labor-market training programs, to the point that more than 10 percent of both unemployed and employed workers had participated in a program for at least a short period (figure 5.16). Although this labor-market approach is very expensive it does appear to have some significant positive benefits and the money has not been wasted.

The opportunities for the unemployed in Denmark to upgrade their skills are regarded as *a right of the unemployed* to improve their employability. However, it is simultaneously considered the *duty of the unemployed* to engage in ALMPs, and strict rules are in place to ensure participation. As we saw earlier, all unemployed have an IAP, which will often spell out what active training or job placement activities the unemployed will par-

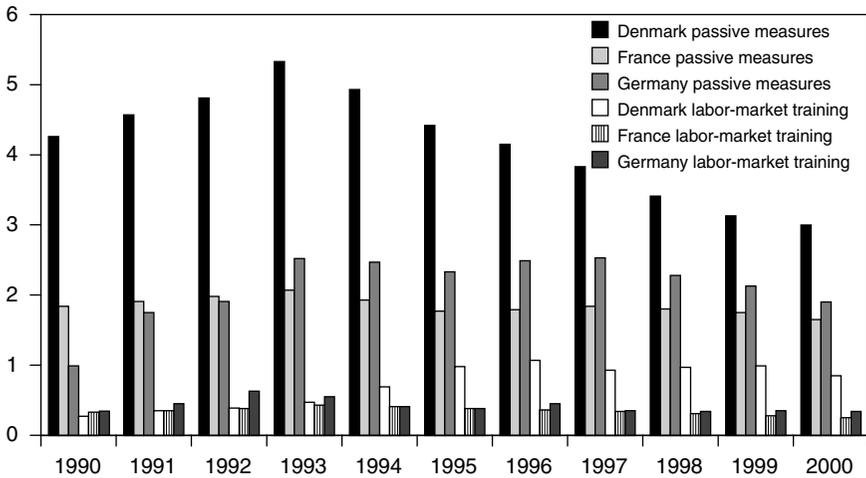
85. Follow-up studies by the Danish Ministry of Labour indicate that from 1996–97, 46 percent of all people unemployed or activated under the ALMPs in the UI benefit system found full-time employment, and 95 percent of these had, at some point during this period, left unemployment, ALMPs, or training-leave programs. Similarly, the increase in outflows from unemployment benefits and ALMPs among long-term unemployed (more than two years of unemployment) has been significantly higher than found among short-term unemployed. See Danish Ministry of Labour (1999, chapter 2).

86. See Danish Ministry of Labour (2000, chapter 8). It must be emphasized that “participation in labor-market training” does not require long-term, full-time training, but can entail participation in short training activities.

87. In its 2002 survey of continuing vocational training Eurostat finds that Danish companies have the highest investment in training programs of all countries in the survey at 3 percent of labor costs (Eurostat 2002, cited in Employment Taskforce 2003, 51).

Figure 5.15 Passive measures and labor-market training expenditures, select countries, 1990–2000

percent of GDP



Source: OECD (2003i).

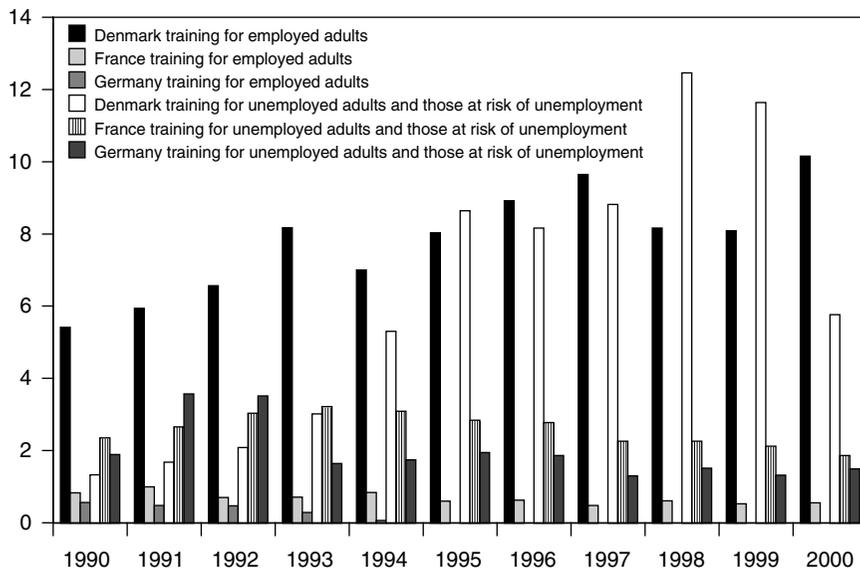
ticipate in. If an unemployed person rejects an *activation offer* (i.e., either a job or a training opportunity) during the four years of unemployment benefits, unemployment benefits are immediately and completely terminated.⁸⁸ The unemployed also have the *duty of availability to the labor market*, which means that they must be able to take up *suitable employment* with one day's notice⁸⁹ or face the complete loss of benefits. *Suitable employment* in Denmark is defined as any job that the unemployed can fulfill immediately or after a short training period within his or her field (Retsinfo 2003). Furthermore, an unemployed person must accept up to four hours of daily transportation time by public transport to get to and

88. The loss of unemployment benefits in Denmark does not entail complete loss of income as social benefits guaranteeing sufficient resources are indefinitely available. However, since these social benefits are fixed at a level of 60 percent of the maximum unemployment benefits (80 percent for parents), the loss of unemployment benefits may lead to an immediate 40 percent decline in income. Furthermore, maximum indefinite benefits are dependent on recipient participation in locally determined activation measures, and unjustified failure to participate automatically leads to a reduction in indefinite benefits (in proportion to absence) up to a total of a 30 percent reduction. See European Commission MISSOC database, www.europa.eu.int/comm/employment_social/missoc/2002/dk_part11_en.htm (accessed October 27, 2003).

89. "Passive availability" is also required, which means that unemployed persons participating in ALMPs must leave the program and take an available job if it cannot be filled by another unemployed person.

Figure 5.16 Active labor force enrolled in labor-market training, select countries, 1990–2000

percent of active labor force



Source: OECD (2003i).

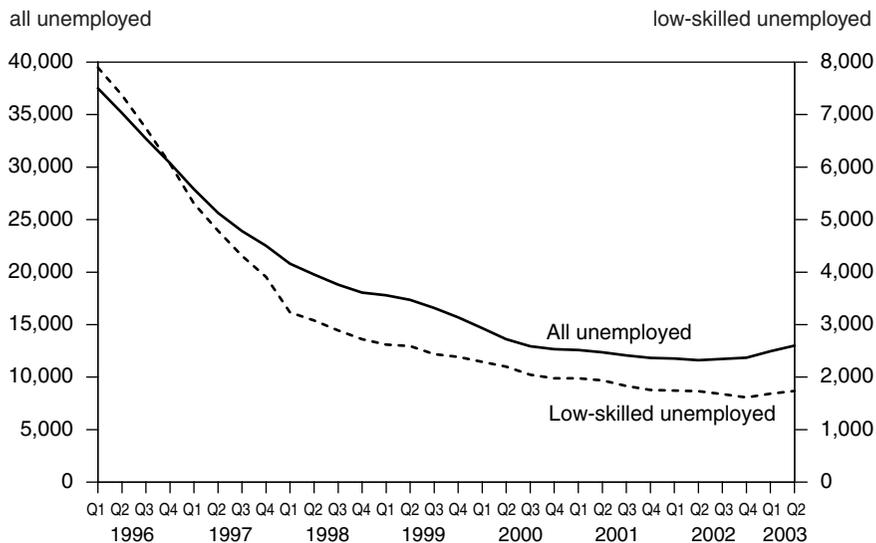
from work.⁹⁰ As such, the high level of unemployment benefits and the extensive opportunities for acquiring new skills come with significant requirements designed to return people to the workforce and to increase the flexibility of the labor market.

Measures to Improve Youth Employment

Similarly to the Netherlands, after 1996 Denmark enacted a number of policies initially targeted toward low-skilled unemployed youth and subsequently encompassing all unemployed youth. Any unemployed persons under the age of 25—apart from all the requirements listed earlier—have the right and duty to enter into ALMPs after only six months without a job. Unlike the situation for adults, the level of their unemployment benefits was cut by 50 percent. The severe cut in the unemployment benefit levels was intended to encourage the youth to quickly enroll in education or

90. If the unemployed person possesses an upper-secondary or tertiary education, he or she must accept a job offer irrespective of the commute. We also want to emphasize that Denmark is a very small country where all higher education is provided free of charge by the government.

Figure 5.17 Youth unemployment in Denmark, 1996–2003



Note: Youth is defined as those 16 to 24 years of age. Unskilled defined as members of unemployment funds affiliated with the *Kvindeligt arbejderforbund Danmark* (KAD) and *Specialarbejder i Danmark* (SID) unions.

Source: Danish Statistical Agency, <http://www.statistikbanken.dk/>.

training programs rather than remain unemployed.⁹¹ Figure 5.17 suggests that these measures have been extraordinarily effective and have brought levels of youth unemployment in Denmark down by about two-thirds from 1996 to 2003—and even more among low-skilled youth. As a result, youth unemployment in Denmark is now among the lowest in Europe.

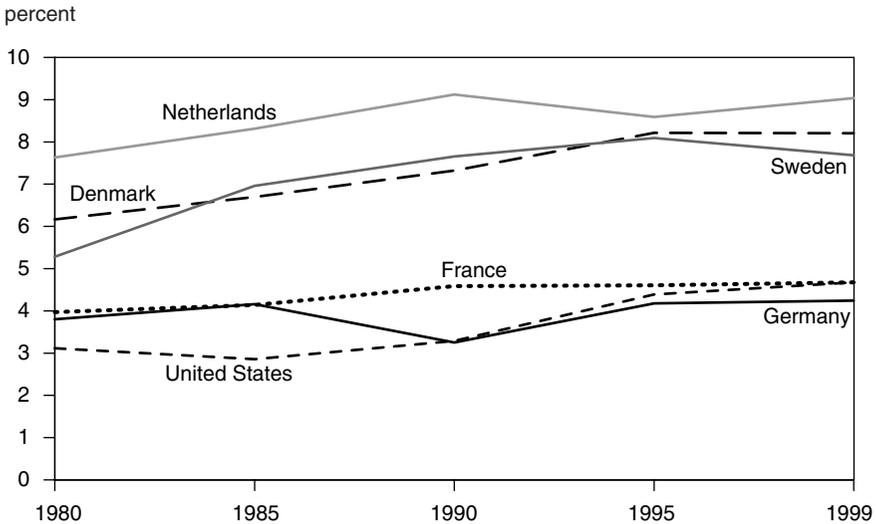
Qualifications to the Success of the Danish Labor-Market Reforms

The Danish labor-market model remains very expensive despite successfully lowering unemployment by the end of the 1990s. The system cost about 5 percent of GDP even with a strong economy (and low unemployment) and would presumably be much higher if unemployment were to rise for cyclical reasons.⁹² Such high costs may not be justified as a social investment on pure economic grounds, and the political consensus needed to sustain the model also may not last. The high cost also makes it harder to offer the Danish model as one other countries should emulate.

91. With the 50 percent cut, the level of unemployment benefits became comparable to the level of state grants available to all Danish citizens enrolled in higher education.

92. On the other hand, as noted above, some of these program expenses also benefit workers by enhancing their job skills.

Figure 5.18 Disability benefit recipiency rates in the 20- to 64-year-old population, select countries, 1980–99



Source: OECD (2002c).

Just as in the Netherlands and Sweden, Denmark has in recent decades experienced continued increases from an already high level in the number of citizens receiving disability pensions (figure 5.18). By the late 1990s Denmark had one of the highest rates of such *working-age inactives* in the OECD. Denmark has also seen a decline in the average hours worked, putting it again among the lowest in the OECD. Therefore, Denmark has not increased total hours worked as much as employment.

Lessons Learned

Denmark shows that it is possible to maintain very high levels of unemployment benefits and still achieve a very low unemployment rate, a high employment rate, and labor-market flexibility. Their success is based upon a combination of work incentives and a very extensive and expensive program of active labor-market measures. Increased employment required that unemployment benefits and training opportunities have the necessary incentive structure in order to lure the unemployed toward regular employment. Denmark imposed severe sanctions (immediate and complete loss of benefits) even for minor noncompliance with IAPs, and also demanded strict availability requirements to ensure the unemployed person's readiness and willingness to enter the workforce with little or no advance notice. Essentially, the program placed the needs of local enterprises (labor demand) above the needs of the unemployed. It also em-

phasized the belief that the unemployed are not helpless—they are expected to help themselves as well.

Overall Lessons from Labor-Market Reforms

National labor markets and social security systems are complicated. It is often hard to figure out why they work the way they do and even more difficult to compare across countries. Yet, some overall lessons can be drawn from the experiences of the Netherlands, Sweden, and Denmark. First and foremost, their experiences illustrate that policy changes do make a difference, trends can be reversed, rising curves can be broken, and the unemployed can return to work. Politically hard decisions cannot be dismissed on the grounds that labor-market reforms would be ineffective in a European context.

Unemployment benefit levels and duration—especially for youth—will have to be cut in many European countries, and eligibility requirements will need to be significantly tightened. Simultaneously, payroll taxes should be lowered, particularly for low-wage jobs, since employment must not only support the worker but also be affordable for the employer. Finally, the threshold to disability pensions and other permanently inactive options for the working-aged must be raised to (or maintained at) a level that puts the benefits outside the reach of the average worker.

Yet the Dutch, Swedish, and Danish experiences also illustrate a number of other important lessons: Fairly generous unemployment benefits can still be provided, but not long term nor without stricter requirements such as adherence to an IAP with the threat of severe penalties for non-compliance. Also, active labor-market policies, if implemented with the correct incentives and incorporating local expertise, can effectively increase employment, although at substantial budget costs. Successful labor-market reforms are generally a result of simultaneous changes in multiple regulations. For example, if separate parts of a social security system are reformed independently, beneficiaries will simply move from one program to another to continue receiving benefits and to avoid changing their behavior.

In July 2003, the European Council (2003) agreed upon new *Guidelines for the Employment Policies of the Member States*. In specific guideline number 8, entitled *Make Work Pay Through Incentives to Enhance Work Attractiveness*, the European Council states that:

Whilst preserving an adequate level of social protection, Member States will in particular review replacement rates and benefit duration; ensure effective benefit management, notably with respect to the link with effective job search, including access to activation measures to support employability, taking into account individual situations; consider the provision of in-work benefits, where appropriate; and work with the view to eliminating inactivity traps.

In particular, policies will aim at achieving by 2010 a significant reduction in high marginal effective tax rates and, where appropriate, in the tax burden on low-paid workers, reflecting national circumstances.

The implementation of such a guideline at the national level in all EU countries would result in a move toward the principles for reform set out in the first half of this chapter. Both draw attention to the problem with indefinite benefits, as well as, for low-wage workers, the problems associated with high payroll taxes and benefit levels. In fact we find the degree of overlap between our principles of social policy reform and the European Council guidelines heartening and urge progress in implementation of the latter. Implementing the guidelines would further diffuse the lessons of the Dutch, Swedish, and Danish experiences presented in this chapter. If these lessons can be applied throughout the European Union, they will substantially increase employment in the region without destroying the existing European tradition of helping those who lose their jobs.

Appendix 5.1

The Nonobserved Economy, Undeclared Work, and European Economic Reforms

To accurately measure the whole economy, GDP should encompass even the nonobserved economy (NOE). The NOE includes activities in five distinct categories:⁹³

- 1) Underground Production, which according to the 1993 System of National Accounts (SNA) (Para 6.34) covers “certain activities that may be both productive in an economic sense and also quite legal (provided certain standards or regulations are complied with) but deliberately concealed from public authorities for the following reasons:
 - a) To avoid the payment of income, value-added, or other taxes;
 - b) To avoid the payment of social security contributions;
 - c) To avoid having to meet certain legal standards, such as minimum wages, maximum hours, safety, or health standards; and
 - d) To avoid complying with certain administrative procedures, such as completing statistical questionnaires or other administrative forms.”
- 2) Illegal Production, which, according to the 1993 SNA (Para 3.54), if it fits “the characteristics of transactions—notably the characteristic that there is mutual agreement between the parties—are treated the same way as legal actions.”
- 3) Informal-Sector Production, which according to the 15th International Conference of Labour Statisticians Resolution Paragraph 5(1), describes the following:

The informal sector may be broadly characterized as consisting of units engaged in the production of goods or services with the primary objective of generating employment and incomes to the persons concerned. These units typically operate at a low level of organization, with little or no division between labor and capital as factors of production and on a small scale. Labor relations—where they exist—are based mostly on casual employment, kinship, or personal and social relations rather than contractual arrangements with formal guarantees.
- 4) Household Production for Own Final Use, which includes production of crops and livestock as well as production of other goods, such as own final use of cloth, home construction, imputed rents of owner-occupiers, and services of paid domestic servants.

93. See OECD, ILO, IMF, and CIS STAT (2002, chapter 3) for a detailed description of the NOE.

- 5) Production Missed Due to Deficiencies in Data Collection, which covers data deficiencies arising from enterprises' undercoverage, nonresponse, and underreporting.

The NOE—especially categories three through five, which can represent a very large part of GDP—is an issue for developing countries. On the other hand, these three categories are unlikely to significantly affect the developed European (and US) economies examined in this book.

Category two of the NOE, which focuses on illegal activities, will invariably differ across legal jurisdictions, since what is legal in one country may be illegal in another—abortion,⁹⁴ alcohol production,⁹⁵ prostitution,⁹⁶ gambling, and drug use spring to mind. Given the general similarity of criminal laws and well-developed law enforcement in the EU countries and the United States, however, these activities are unlikely to yield significant differences in their GDP estimates.⁹⁷

Only category one, underground production, is substantially large enough to appreciably affect GDP in the EU countries and the United States. Therefore, only this category is of interest to us in the context of this book.

Underground Production in the EU Countries and the United States

It is inherently difficult to estimate the extent of underground activity when its participants are specifically trying to avoid being measured and taxed. Statisticians and economist have devised several techniques in “guesstimating” the required adjustment to GDP from underground production. The most utilized method is the so-called currency demand model, which has several forms but whose basic tenet is cash-based transactions. Thus, any changes in the cash/deposit ratio that are unexplained by other economic factors such as interest rates, changes in payment habits (often technology-induced via ATMs, for example), or income levels, are

94. Abortion, for instance, became legal in Italy only in 1978 and was subsequently included in household expenditures. Abortion is still illegal in Ireland, however. See OECD, ILO, IMF, and CIS STAT (2002, 39).

95. In some Islamic countries the production and consumption of alcohol is forbidden.

96. Prostitution was legalized in the Netherlands in 2000, and Dutch prostitutes currently pay 19 percent value-added tax (VAT). Similarly, since 2002 German prostitutes have been able to receive social benefits in exchange for paying taxes. The US state of Nevada has also recently legalized and taxed prostitution.

97. National estimates from the three Baltic countries as well as Poland, the Slovak Republic, and Britain for illegal value-added taxes from drugs, prostitution, fencing, smuggling, and audiovisual counterfeits all range below 1 percent of GDP. Bulgarian estimates of household expenditure on drugs range from 1.8 to 2.4 percent of household consumption. Only Bulgaria, the Czech Republic, Estonia, the Slovak Republic, and Britain make allowances for illegal activities in their GDP estimates. See UNECE (2003).

taken to indicate a change in the size of underground production.⁹⁸ However, additional assumptions regarding the size of underground activities at a given point are required—usually zero in an early base year—for the change in those activities to be computed in the model.

Other methods of computing underground production in GDP are available. In *commodity flows*, estimates of gross output and value added are approximated by markups—most commonly power usage or labor—to flows of commodities into production. *Household surveys* are also used and provide information about the location of respondents' expenditures (street stalls versus supermarkets), time of use, and occasionally respondents' assessment of how frequently they and others engage in underground production. Tax audits have also often been used.

It is important to note that the underground economy is almost wholly concentrated in particular sectors of a developed economy such as construction (home repairs), household services (cleaning and child care), retail trade, taxis, trucking, and restaurants. In other parts of developed economies—for instance, power generation, heavy industry, finance, and rail and air transportation—there is essentially no underground activity.

While many different estimates on the size of underground production in developed economies exist, of most consequence is whether or not official GDP estimates make explicit allowances for underground production. It may surprise some to know that within the European Union, the *markup* to official GDP from underground production ranges from 0 in most countries to 15 percent in Italy.

Schneider (2002) estimates the size of the underground economy in advanced economies using the currency-demand model, and figure 5A.1 illustrates his results. The European Commission in 2004 sanctioned a report on undeclared work in the enlarged European Union (Renooy, Ivarsson, Van der Wusten-Gritsai, Meijer 2004). This report lists the result of available official statistical agency work on the issue. These estimates are also shown in Figure 5A.1. Lastly, the figure shows the extent to which some countries mark up their official GDP estimates for the underground economy.⁹⁹ Schneider's estimates seem very high for some countries. Since underground activities are concentrated in only parts of the economy, it is difficult to understand how Greece or Italy could estimate a nearly 30 percent increase in total GDP. The underground share of the *susceptible sectors of the economy* would have to be unrealistically high.¹⁰⁰ The basic issue is that a variety of reasons may have increased cash transactions in some economies,

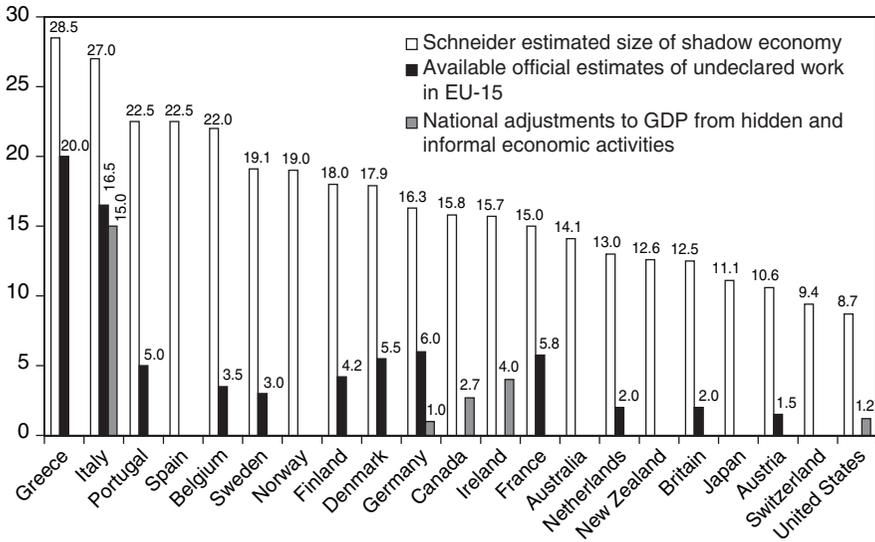
98. For surveys of the NOE and use of currency-demand models, see Schneider and Enste (1998 and 2000) and Schneider (2002). Note that currency-demand models are not restricted to "measuring" underground production but, in principal, cover the total NOE.

99. The term *shadow economy* in figure 5A.1 is the phrase used by Schneider. For the purposes of this appendix, it is synonymous with *hidden and informal economic activities* as well as *underground production* and *undeclared work*.

100. See OECD (2002g, 7) for elaboration of this point.

Figure 5A.1 Underground activities in OECD countries, 2001–02

percent of nominal GDP



OECD = Organization for Economic Cooperation and Development

Sources: Schneider (2002), UNECE (2003), and Renooy, Ivarsson, van der Wusten-Gritsai, and Meijer (2004).

so the size of underground activities cannot always be directly linked to an increase in GDP.¹⁰¹

The much lower official estimates of undeclared work in the EU-15 seem to concur with our assessment of Schneider’s estimates. However, Renooy, Ivarsson, van der Wusten-Gritsai, and Meijer (2004) lists values between 8 and 30 percent of GDP for undeclared work for the 10 new EU members, values not vastly different from Schneider’s estimates for rich OECD members. The adjustments made to official GDP data in figure 5A.1 to account for underground activities are not comprehensive. The adjustments only represent the respondents to the 2001–02 UNECE survey, the *Inventory of National Practices in Estimating Hidden and Informal Economic Activities for National Accounts*, and may consequently miss some national corrections altogether. Also, the UNECE survey covers only explicit adjustments for *Hidden and Informal Economic Activities* and may therefore also not report implicit coverage of activities particular to the method of calculation of particular sectors itself.

For example, in Germany rents are calculated through the housing stock—broken down by size and other characteristics—into rent per square

101. In the United States, it is not certain how much currency is used in the domestic economy. US dollars are widely used around the world.

meter. Whether such income is declared for tax purposes (and thus official as opposed to underground) is immaterial to the calculation of this part of GDP (UNECE 2003, 109). It seems likely that the actual extent of underground activities is smaller than indicated in figure 5A.1, and the degree to which these are captured in official GDP estimates is greater than is shown.

Nonetheless, the countries in figure 5A.1 with high underground activity often also have high unemployment rates, which suggests that such activity may be important to the economy overall. After all, the sustained level of high unemployment in some European countries may simply mask a situation where many of the officially unemployed are in reality employed in the underground economy.

Undeclared Work in the European Union

Unsurprisingly, the European Commission has engaged in considerable effort to measure the scope of *undeclared work*¹⁰² and has proposed national and EU policies to solve this problem (European Commission 1998; Mateman and Renooy 2001; Employment Task Force 2003; and Renooy, Ivarsson, van der Wusten-Gritsai, and Meijer 2004). Following the meeting of the European Council on July 22, 2003, the guidelines for the employment policies of the member states (European Council 2003) explicitly included the following references to undeclared work:

Undeclared work is taken to mean any paid activities that are lawful as regards their nature but not declared to public authorities. Studies estimate the size of the informal economy on average between 7 percent and 16 percent of EU GDP. This should be turned into regular work in order to improve the overall business environment, the quality of work of those concerned, social cohesion, and the sustainability of public finance and social protection systems. Improving knowledge about the extent of undeclared work in Member States and the European Union should be encouraged.¹⁰³

The Council also recommended implementing specific guidelines:

Member States should develop and implement broad actions and measures to eliminate undeclared work, which combine simplification of the business environment, removing disincentives and providing appropriate incentives in the tax and benefits system, improved law enforcement, and the application of sanctions. They should undertake the necessary efforts at national and EU level to measure the extent of the problem and progress achieved at national level.¹⁰⁴

The European Commission has collected a good deal of information about underground activity, and it is summarized in table 5A.1. Despite

102. Conceptually, *undeclared work* almost completely overlaps with the OECD concept of *underground production*, which serves to demarcate the focus of the analysis.

103. Opinions of the Employment Committee (19).

104. Specific Guidelines (9) to Transform Undeclared Work into Regular Employment.

Table 5A.1 Undeclared work in the European Union and select labor-market statistics

Country	Characteristic of the undeclared worker	Principal sector of undeclared work	Labor-force participation rate, 15- to 24-year-olds, 2001 (percent)	Labor-force participation rate, 25- to 64-year-old women, 2001 (percent)	Total tax wedge 2000 ^a (percent)
Austria	One-tenth of all working-aged people have a sideline activity. The focus has been on illegal employment of foreign labor.	40 percent in building and craft, 16 percent in other trade and industrial enterprise (auto repair, machinery, etc.), 16 percent in service sector, 13 percent in entertainment business, and 15 percent in other trades and services (remedial training, hairdressing, baby-sitting)	55.0	64.8	34.6
Belgium	Semi- or low-skilled workers, male, young people	Catering, retail trade, construction, textile sector, traffic/transport, household services (private cleaning, etc.), agriculture (e.g., fruit picking)	33.6	60.0	49.3
Britain	Job holders (including self-employed), and to a lesser extent casual/seasonal workers, unemployed, benefit claimants, and illegal immigrants	Agriculture; community, social, and personal services (e.g., cleaning); construction; tourism, hotel, and catering, fashion and clothing manufacture	68.2	69.9	24.6
Denmark	Skilled and unskilled workers, students, men (twice as frequent as women). There is a geographical divide (cultural—young skilled males living outside Copenhagen)	33 percent in construction sector, 50 percent in private service sector (baby-sitting, cleaning, car repairs, gardening, etc.)	67.2	77.0	39.2
Finland	Younger skilled males	Construction, hotels/restaurants, retail trade (including car repairs), and real estate services	50.4	77.4	40.8

France	Unemployed, illegal immigrants, self-employed, and job holders	Construction (25.5 percent), community, social and personal services (24.4 percent); retailing (20.3 percent), catering (hotel/cafe/restaurant) (14.7 percent); transport (8.4 percent), agriculture (8.4 percent), textile industry (3 percent)	29.9	70.4	40.8
Germany	Old-age pensioners, students, illegal immigrants, unemployed, self-employed, job holders	Agriculture; community, social, and personal services (e.g., cleaning, care); manufacturing and construction	51.1	67.1	43.7
Greece	Illegal/legal immigrants; old-age pensioners; women/home workers; young seasonal workers	Sectors with home working possibilities (textile), hotels/restaurants/tourism, services, household services, and transport	36.2	52.4	35.2
Ireland	Students, double workers; no illegal immigrants	Building, construction, and distribution	50.1	59.7	21.8
Italy	Students, illegal immigrants, unemployed, self-employed, job holders	Agriculture; community, social, and personal services; manufacturing; construction/building; transport; retailing	37.6	50.2	43.5
Netherlands	Students, unemployed, self-employed, and job holders	Agriculture; community, social, and personal services (e.g., cleaning, care); and construction	71.1	65.2	40.0
Portugal	Illegal immigrants, women, and unregistered workers	Construction, textile sector, and retail trade	47.1	70.3	29.0
Spain	Unemployed, and illegal immigrants	Agriculture; community, social, and personal services, and manufacturing	46.8	54.1	34.0
Sweden	Job holders, and to a lesser extent the unemployed	Community, social, and personal services; construction; and transport	54.3	81.5	44.8

APW = average production worker

job holders = employed in a formal job

double worker = workers with multiple jobs

a. Married couples with two children, principal earner 100 percent of APW and spouse 67 percent of APW.

Sources: European Commission (1998); Mateman and Renooy (2001); OECD (2003).

considerable detailed country differences, table 5A.1 contains some possible trends:

- In several countries (Belgium, Greece, and Italy) with very low (less than 40 percent) labor-force participation rates among youth between 15 and 24 years of age, young people and students are identified as frequently engaging in undeclared work.
- In several countries (Greece, Italy, and Spain) with very low labor-force participation (less than 55 percent) among females, economic sectors with traditionally very high levels of female employment such as household services and community as well as social and personal services are identified as sectors with high degrees of undeclared work.
- In many countries, frequently those (France, Germany, Italy, the Netherlands, and Sweden) with very high total-tax wedges (at or greater than 40 percent), existing job holders characteristically engage in undeclared work.

Keep in mind that the country differences illustrated in table 5A.1 do not rule out a connection between undeclared work and nonparticipation in the official labor force by some groups—especially youth and women in some countries. Yet, table 5A.1 also reveals that *the overwhelming part of undeclared work in Europe is conducted by persons already in employment—not by people outside the labor market* (except in some countries with large illegal immigrant populations). Thus, the belief that undeclared work, on average in Europe, reduces the importance of low labor-force participation and high unemployment rates by serving as a *substitute* for official jobs, must be dismissed in the face of these available facts. Rather, with job holders supplying most of the undeclared work in Europe, it seems likely that the decline in (official) hours worked (figure 5.7) may in fact be somewhat overstated.

The Development and Origins of Underground Production and Undeclared Work

Given the huge degree of uncertainty regarding estimates of undeclared work, time trends are also difficult to gauge. Yet, in 2001 the European Commission states explicitly that: “Nevertheless, most experts do agree that the amount of undeclared work is growing all over Europe” (Mateman and Renooy 2001).¹⁰⁵

In virtually all studies of underground production and undeclared work, a positive link between increases in taxes and social security con-

105. See also Schneider (2002) for estimates and a survey of the literature reaching the same conclusion.

tributions and increases in the informal economy has been established (Schneider 2002, section 4). This is true for empirical studies from all parts of the European Union as well as other OECD countries. Table 5A.1 also lends credence to the link as high total-tax wedges frequently seem to drive job holders into underground production. In some sectors high labor costs prohibit hiring workers in the official economy, but make it economically feasible in the underground one.

In addition to the tax wedge, general regulatory intensity—notably in the labor market—is an important factor in increasing undeclared work, especially when it tightens restrictions on immigrants (Schneider 2002, section 4). Thus, Johnson, Kaufmann, and Shleifer (1997) estimate that a one-point increase in regulatory intensity (in a range from 1 to 5) leads to an 8.1 percent increase in a country’s underground activity.

The factors included in this appendix are not an exhaustive list of the origins of undeclared work in Europe. Other country-specific issues, such as cultural acceptance of undeclared work and immigration, likely play significant roles. Nonetheless, the unambiguous finding in the literature that links high tax wedges and excessive regulation to increased underground production is an important consideration for the reforms suggested for Europe in this book.

The Effect of Suggested European Economic Reforms on Undeclared Work

The economic reforms that we suggest in this book—aimed at liberalizing product and labor markets and lowering nonwage labor costs—would have an effect on undeclared work.

Lowering payroll taxes would decrease personal incentives for individuals to supply undeclared work. Limiting poverty and employment traps would also reduce undeclared labor supply, while reducing social security contributions (particularly for low-wage jobs) would reduce the demand for undeclared work, as would general liberalization of labor-market regulation.

Increasing work incentives by cutting benefit levels and increasing job search requirements to sustain eligibility for benefits may lead some people to move into the underground economy rather than attempt to find official employment.

On balance, however, we believe that the proposed reforms will lead to better product and labor markets, which in turn will reduce the existing network of underground production and undeclared work in Europe.

