

# The Impact of Globalisation with Rigid Labour Markets

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# Chapter 3

## Labour markets - institutions and performance

The labour market belongs to one of the most important markets in an economy. In order to absorb adjustment pressure and achieve necessary changes in the economic structure, labour markets need to function appropriately. These adjustments take place via bankruptcies or contraction of less efficient firms and expansion of more efficient or entry of new firms. This necessarily implies hiring and firing of employees and thus demands a high flexibility of labour markets with regard to employment protection. In Germany, for instance, about 8 million people entered into and left unemployment in 2004 alone. This makes up more than 20 percent of total employment. Moreover, it constitutes only a lower bound because direct job changes (without the "detour" via unemployment) are not included here.<sup>1</sup> This impressive figure underlines the importance of employment protection legislation for labour market flexibility.

Adjustment also takes place via changes in (relative) wages. If commodity prices of certain products recede due to low-wage competition from abroad, wages might need to adjust downwards in order to avoid firm bankruptcies. Hence, if labour market institutions prevent market wages from falling below a certain floor, unemployment emerges as a residual adjustment mechanism, and the absorption of exogenous shocks

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<sup>1</sup>Bundesagentur für Arbeit (2006), on request.

cannot take place in a first-best fashion.

Most economic models assume that labour markets function perfectly, that is, full employment always prevails. However, reality tells a different story. Labour markets are far away from being perfect markets, and even in the least regulated labour market, adjustment needs time. In all countries, governments intervene to avoid certain market outcomes. However, these interventions exercise a fundamental influence on market outcome, be it the wage structure, employment and unemployment levels or the duration of unemployment. As this book focuses on the impact of globalisation when labour markets are rigid, it is worthwhile to take a closer look at the degree of labour market regulation in various countries.

It turns out that there are substantial differences across nations. Whereas countries like the UK or the US choose to interfere less with market forces, many continental European states have typically imposed generous welfare states which distort labour supply decisions to a large extent. However, several continental European countries have reduced their unemployment rates over the last decade by both demanding more participation and granting generous welfare benefits at the same time.

This chapter starts with a survey of labour market institutions in OECD countries and Eastern Europe. The second part observes major labour market reforms in selected economies. Finally, we want to link national institutions to labour market performance. We compare labour costs, relative earnings, unemployment and employment trends, the pattern of unemployment and working time across countries.

## **3.1 Labour market institutions**

### **3.1.1 Trade unions and employers' organisations**

A single employee might negotiate her contract with the employer directly. In many cases, however, employees are represented by trade unions that set certain frameworks or negotiate contracts for entire firms or industries. Similarly, a single firm might

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delegate these negotiations to the employers' association. It is obvious that these organisations change the weight of participating parties in the bargaining process and thus might lead to other market outcomes. For instance, powerful trade unions behave as monopolists and set wages above full employment levels. Also, trade unions might protect workers who possess a job by negotiating strict dismissal rules while excluding the unemployed.

The picture concerning trade union membership in Western European countries is mixed.<sup>2</sup> France, Ireland, Italy and Norway have experienced an increase in membership numbers between 1993 and 2003, in some cases very sharply. Many countries remained at their 1993 level, whereas Germany, for example, faced an overall loss of about 4.4 million members between 1991 and 2003 - a reduction of 38 percent.<sup>3</sup> In Greece and the UK, membership receded by about 10 percent between 1993 and 2003. The dissimilar patterns can be explained by varying developments in living standards and unemployment rates in European countries. Additionally, a decline in traditionally highly unionised industries and the rise of lower-unionisation services employment have clearly enhanced this development.

With regard to Eastern European countries, the situation is fundamentally different. Most countries of the former Soviet Bloc experienced a collapse of the old trade union organisations. As trade union membership was compulsory during the communist era, a normalisation process began in which many former trade union members opted out. Polish, Slovak and Bulgarian trade unions lost about 70 percent of their members within ten years. In their 2002 report, *"Industrial Relations in Europe"*, the European Commission ascribed the steep decline in membership numbers to factors such as structural change, rising rates of unemployment, falling living standards and the evolution of small and medium sized companies with a lower or no workers' representation.

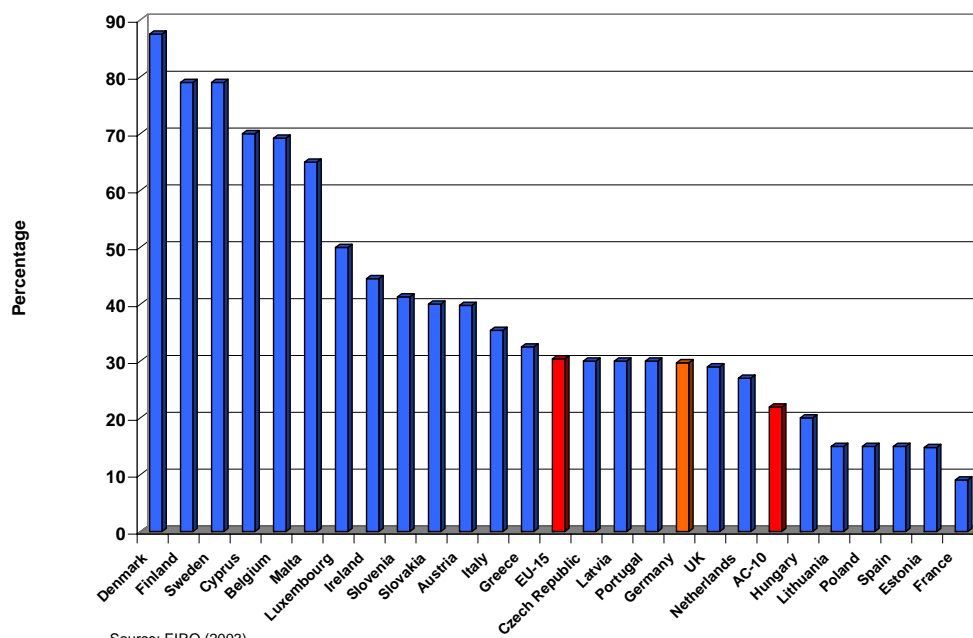
A glance at trade union densities in Figure 3.1 allows further insights. The ratio describes the absolute number of members relative to total employment. In 2002,

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<sup>2</sup>According to EIRO (2004a).

<sup>3</sup>Deutscher Gewerkschaftsbund, by request 2005, own calculations.

Figure 3.1: Trade union density in the EU, 2002



the Nordic countries Denmark, Finland and Sweden exhibited highest densities with about 80 to 90 percent of all employees being represented by a trade union. Germany ranks slightly below the EU-15 average with 29.7 percent. With regard to the new EU members, Malta, Cyprus, Slovenia and Slovakia are the only countries ranking above the EU-15 average. All others feature lower relative membership. As a reference value, the trade union density in the US amounted to 13.2 percent in 2002 - at the lower edge of this distribution.<sup>4</sup>

The trade unions' counterpart in the social dialogue are the employers' organisations. Basically, there are bodies representing employers' interests and bodies representing business and trade interests. Several countries have installed a single organisation for both parts, whereas some countries, like Germany, have two single organisations. Another feature is the separation of representation by sectors such as industry, services and agriculture.<sup>5</sup>

<sup>4</sup>EIRO (2003).

<sup>5</sup>As in Finland, Greece or Portugal. For further details, see EIRO (2002).

In contrast to the long tradition of company representation in Western Europe, the new EU member states had to start this process from the beginning because the communist regime only allowed state-owned enterprises. As everything was decided by government authorities, there was no need for own representative bodies. The transition crises substantially hampered the development of employers' organisations. As big companies went bankrupt and were replaced by many smaller firms, coordination became much more difficult. The European Commission (2003a) estimates that 30 to 40 percent of industrial enterprises are represented by an organisation, but only 2 to 5 percent of all firms. Due to history and tradition, these young organisations lack a strong influence in the social dialogue. Although trade unions and employers' organisations intend to discuss labour market issues within their spheres autonomously in the future, the governments currently still play a central role in negotiations.<sup>6</sup>

### 3.1.2 Bargaining systems

The size of trade unions and employers' organisations provides a first impression of the distribution of power in the bargaining process. Yet, how this process is organised is another story. The degree of centralisation and the extent to which collective bargaining results apply to firms and employees - the so-called coverage rate - are crucial ingredients. Both a large coverage and a high degree of centralisation might be detrimental for labour market flexibility. Negotiating wages on the national level makes it more difficult to account for differences between regions or firms. Consequently, wages might be too high for low productivity firms and cause bankruptcy.

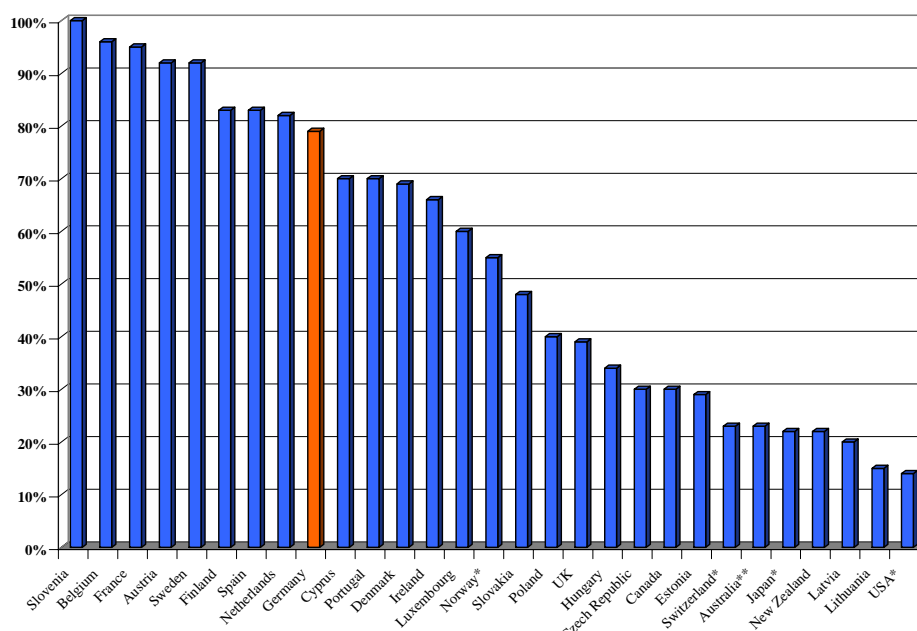
Figure 3.2 shows collective bargaining coverage in percent of total employment for OECD- and new EU-member countries. Not surprisingly, the United Kingdom and the United States can be found at the lower end of the scale with 36 and 14 percent, respectively, whereas continental European countries are earmarked by comparably high coverage rates.<sup>7</sup> The Nordic countries Sweden and Finland, as well as Belgium,

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<sup>6</sup>Funk and Lesch (2004).

<sup>7</sup>The coverage rate has been decreasing in Germany over the last years and is much higher in Western Germany, IAB (2002). See also Ochel (2001) for cross-country time series.

Figure 3.2: Collective bargaining coverage, 2000



Source: European Commission (2003a) for EU countries; EEAG (2004) for non-EU countries. \*1996-98, \*\*2001

France and Austria, exhibit highest coverage above 80 percent of total employment. Germany also ranks in the upper part of the distribution with 79 percent. The new Eastern European member states are instead more comparable to the Anglo-American pattern. Only Slovenia is the exception as the leader of the ranking.

The degree of centralisation differs markedly between countries. Bargaining takes place on the national level in Belgium, Finland and Ireland. For most EU countries, however, the sector is the dominant level. In the UK and in the US, negotiations even take place on the company level. The recent trend in many EU member states indicates a tendency towards a more decentralised wage formation. Italy and Denmark serve as good examples.<sup>8</sup> However, decentralisation of wage bargaining as in the United Kingdom does still not seem to be in reach for continental Europe. The situation in Eastern Europe again looks similar to the UK and the US. Here, wages are also negotiated on the enterprise level in most cases. Slovenia and Slovakia are the exceptions with pay setting at the sectoral level. Tables 3.1 and 3.2 provide a detailed overview.

<sup>8</sup>European Commission (2003), p. 77.

Table 3.1: Summary characteristics of national wage formation systems in EU-15

	Trade union density, 2000	Collective bargaining coverage, 2000	Duration of agreements	Bargaining level (dominant form)
Austria	30 %	92 %	1 year	sectoral
Belgium	69 %	96 %	2 years	national
Denmark	88 %	69 %	4 years	national/ sectoral
Finland	79 %	83 %	2 years	national
France	9 %	95 %	1 year	company
Germany	30 %	79 %	2 years	sectoral
Greece	33 %	n.a.	2 years	sectoral
Ireland	45 %	66 %	2 years	national
Italy	35 %	n.a.	varying	sectoral
Luxemb.	50 %	60 %	varying	sectoral/ company
Netherl.	27 %	82 %	varying	sectoral
Portugal	40 %	70 %	1 year	sectoral
Spain	15 %	83 %	3 years	sectoral
Sweden	79 %	92 %	3 years	sectoral
UK	29 %	39 %	varying	company

Source: European Commission (2003a), Table 27. Trade union density for Portugal refers to 1998, for Germany and Italy to 1999; collective bargaining coverage for Ireland and Luxembourg based on estimates from national experts.

Table 3.2: Summary characteristics of national wage formation systems in new EU member countries

	Trade union density, 2000	Coll. bargaining coverage, 2000	Bargaining level (dominant form)
Cyprus	70 %	65-70 %	sectoral
Czech Republic	30 %	25-30 %	company
Estonia	15 %	29 %	company
Hungary	20 %	34 %	company
Latvia	30 %	<20 %	company
Lithuania	15 %	10-15 %	company
Malta	65 %	n.a.	company
Poland	15 %	40 %	company
Slovakia	40 %	48 %	sectoral
Slovenia	41 %	100 %	sectoral

Source: European Commission (2003a), Table 27.

The evaluation of the new EU member states' pay setting systems is not unambiguous in the literature. The European Economic Advisory Group (2004) finds a high conformity with the less regulated Anglo-Saxon system. Kohl and Platzer (2003) suggest a unique Central Eastern European industrial relations model, whereas Belke and Hebler (2002) instead group the CEECs to continental Western European countries like Germany and France. However, Belke and Hebler also incorporate unemployment benefits and dismissal rules which have already converged towards the high European regulation level.<sup>9</sup>

### **3.1.3 Minimum wages and implicit wage floors**

The outcome of wage negotiations can be restricted by wage floors. The majority of EU countries has installed statutory minimum wages. The US serves as another prominent example. Concerning the theoretical implications, it depends on the market structure whether minimum wages reduce or increase employment. With monopsonistic markets, a minimum wage above the prevailing market level might well increase unemployment and reduce the surplus of the monopson. Thereby, welfare rises. A prominent representative of this view is Alan Manning (2003a and 2003b). The main argument states that the division of labour has become so specialised that many firms within their segments in fact behave as monopsonists. However, an economy is made up of many sectors that are characterised by different productivities and hence, different wages. Therefore, a minimum wage that might have positive effects in one sector could be too high for a low-productivity branch and exacerbates detrimental effects. Another argument against this view says that minimum wages are only relevant for the low-skilled workers in the lowest part of the wage distribution. As specialised skills do not play a role here, one can assume that labour markets can rather be described by the perfect competition model. Then, the market clearing wage implies a Pareto optimum and setting a statutory minimum above this level unavoidably creates unemployment and welfare losses.

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<sup>9</sup>For a summary, see Funk and Lesch (2004).

Apart from minimum wages, benefit payments can cause similar effects. Social security payments define workers' reservation wages and thereby create an implicit wage floor. Assuming perfect labour markets for low-wage workers, policy makers generally face a fundamental trade-off when setting rules in this field. A more generous benefit system or a higher minimum wage are intended to compress the income distribution, that is more equality, but *pari passu* might reduce incentives to either employ workers or for workers themselves to supply labour, that is less efficiency. While minimum wages refer to the demand side, social benefits have an impact on the supply of labour. Both aspects will be discussed in the following section.

### Minimum wages

Within the enlarged European Union, 18 out of 25 countries have introduced a statutory minimum wage – nearly all of the new members (except for Cyprus) and nine of the old member states.<sup>10</sup> Also the United States, usually not recognised as having regulation in place, have protected the low-skilled by a statutory wage rate set on the federal level. With regard to levels, Luxembourg, for instance, guaranteed the highest minimum wage (1,237 €) whereas Lithuania established the lowest (281 €) in 2004. The statutory minimum wage in the US amounted to 727 € and in the UK to 1,083 €. France, the Netherlands and Belgium are ranked just below Luxembourg. However, if one corrects for purchasing power, the gap between the highest and the lowest minimum wages shrinks significantly.<sup>11</sup>

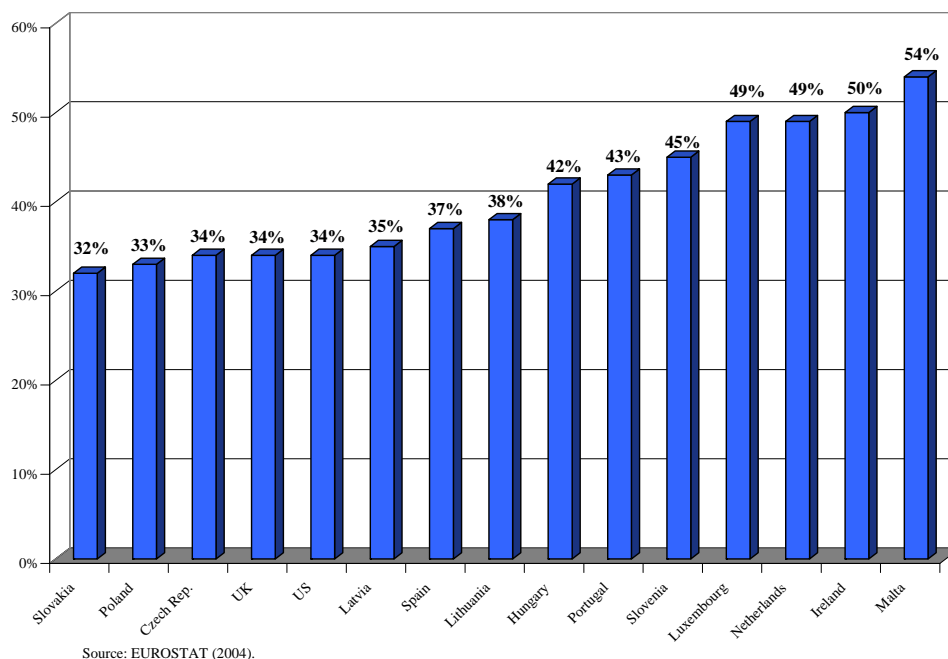
As all these economies are characterised by different average wages, the absolute numbers do not provide an insight into whether statutory minimum wages can potentially be binding for a large fraction of the work force. Figure 3.3 reports minimum wages as a percentage of average monthly gross earnings in industry and services. It is evident that the guaranteed minimum pay is relatively low in Eastern European countries, the UK and the United States (30-40 percent), while it is 49 percent in the

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<sup>10</sup> Among the nine old EU member states are Belgium, Greece, Spain, France, Ireland, Luxembourg, Netherlands, Portugal and the UK. In other countries like Germany, minimum pay is negotiated among social partners and is not accounted for in this context. An overview is given in EUROSTAT (1998).

<sup>11</sup> EUROSTAT (2004), figures for this calculation refer to January 2004.

Figure 3.3: Minimum wages relative to average wages, 2002



Netherlands and 50 percent in Ireland. From a historical perspective, real minimum wages relative to average wages in manufacturing have decreased in a wide range of countries, for instance in the US, the Netherlands, Belgium, Greece, Portugal, Spain and the Czech Republic. However, Luxembourg, France and Poland even increased their statutory minimum pay whereas in Hungary and Japan, the level remained the same.<sup>12</sup>

As a consequence, the share of full-time workers earning the minimum wage differs markedly between countries. The US, the UK and Ireland are characterised by small fractions of 1.5, 1.9 and 2.1 percent, respectively. Ireland's high relative minimum wage does currently not impose a restriction on wage flexibility because the economic boom of recent years has boosted market wages for most workers above the minimum level. Hungary, France, Luxembourg and Latvia are ranked at the upper end of the scale with shares of 11.4, 14, 15.1 and 15.4 percent, respectively.<sup>13</sup> Hence, it seems obvious that

<sup>12</sup>OECD (1998), p. 41. Time series for Poland, Hungary and the Czech Republic refer to the 1990s, for other OECD members to the period 1970 to 1996.

<sup>13</sup>EUROSTAT (2004), see also European Commission (2003a), pp. 79-80. Other studies like OECD

Table 3.3: Minimum wage systems in selected OECD countries

Country	Determination	Variation by	Rates for young employees
Austria	legally binding collective agreement at industry level	industry, job tenure, region, dependants, age	embodied in industry agreements
Belgium	unions and employers	age, job tenure	small reductions for <23
Canada	by statute at the federal and provincial levels	industry	reduced rates have been abolished
CZ	by statute	n.a.	only reductions for minors
Denmark	collective agreements	industry, age	40% for <18
Finland	collective agreements	age, occupation, industry, region	n.a.
France	government, constrained by formula	age, training	80% (age 16), 90% (age 17)+ schemes+30-75% for trainees
Germany	collective agreements	age, qualifications, trainee status, region	part of industry agreements
Greece	collective agreements	manual/non-manual, job tenure, marital status, qualifications	lower rates for short job tenure
Hungary	by statute	n.a.	no reduced rates
Ireland	joint labour committees in 16 low-paying industries	age, industry, region, occupation, job tenure	63% (<18); 81% (<21) in hotels
Italy	collective agreements	age, industry, job tenure	part of industry agreements
Japan	by statute for each of the 47 prefectures	working hours, stauts, industry	no reduced rates
L	statutory minimum wages	age, skill, family characteristics	70% for <21
NL	statutory minimum wage	age	34.5% (age 16), rising to 84% (age 22)
Norway	collective agreements	industry, age, job tenure, job	n.a.
Poland	by statute	n.a.	no reduced rates
Portugal	statutory minimum wage	age, trainee status, industry	75 percent (<18)
Spain	statutory minimum wage	age, homeworkers, casual workers	66% (<18)
Sweden	collective agreements	age, industry,tenure, occupation	85% (<24)
Switzerl.	collective agreements on industry level	age, industry	part of industry agreements
UK	pre-1993 by Wage Councils by industry (now only agriculture)	age, industry	pre-1993 no minimum wage for <21
US	federal minimum wage (higher in some states)	limited youth sub-minimum	no reduction

Sources: Dolado et al. (1996) and OECD (1999b).

Note: Minimum wages are defined in a broader sense than in the text. Also countries where minimum wages are part of negotiations between social partners are included in the table.

minimum wages in English speaking countries as well as in some Eastern European states do not restrict labour market flexibility to a significant extent. In France, just to mention a counter-example, flexibility of low wages is restricted for a substantially larger share of the workforce.

Employment effects of minimum wages are both widely and controversially discussed in the literature. While Dolado et al. (1996) do not regard minimum wages as a more serious constraint on the labour market than in the 1960s, Nickell and Bell (1995) and Card and Krueger (1995) explain the rise in unemployment rates by trends against the less-skilled in connection with imperfect wage adjustments. However, Card and Krueger (1995) do not find large employment effects of the federal minimum wage in the US. The overall effect on employment seems to be rather small. What is clear, though, is the negative impact on the employment of young workers.<sup>14</sup> Therefore, many European countries account for that by means of lower minimum wages for the young. The variability in this respect is higher in Europe than it is in the United States.<sup>15</sup> Table 3.3 provides a detailed overview about minimum wage systems in selected OECD countries.

### **Unemployment benefits**

While the empirical evidence of minimum wages' employment effect is not clearcut, there is considerable support for the theory that the generosity of the benefit system has a negative impact on employment.<sup>16</sup> As replacement payments determine workers' reservation wages, higher benefits reduce the incentive to become re-employed and accept low-paid jobs. Moreover, the unemployment spell continues with higher replacement payments, as unemployed workers can afford to wait for a better job offer or take higher risks when negotiating wages.<sup>17</sup> Basically, the impact of benefit systems is similar to that of minimum wages, only that they work via the supply side of labour.

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(1999b) have different figures as other references are used. However, the ranking basically remains identical.

<sup>14</sup>See Brown et al. (1982) and Brown (1999) .

<sup>15</sup>Dolado et al. (1996), p. 357.

<sup>16</sup>OECD (1994b), chapter 8. See also Nickell (1997).

<sup>17</sup>See Layard (1988) and Johnson and Layard (1986).

The institutional design of unemployment insurance varies substantially across countries. While Finland, Ireland, Poland and the UK pay fixed amounts (calculated as a percentage of average production workers' income), most governments determine replacement rates as a fraction of previous gross earnings. In a few cases like Austria, the Czech Republic and Germany, unemployment benefits guarantee a certain amount of previous net income. In Denmark, social security contributions must be deducted.

Table 3.4: Average of net replacement rates (NRR) over last 60 months, 2002

Country	Overall average	No children		Two children	
		Single person	One-earner married couple	Lone parent	One-earner married couple
Italy	5	5	5	6	6
US	6	6	6	5	5
Korea	6	6	6	7	6
Czech Rep.	9	4	4	13	13
Japan	13	7	7	27	10
Canada	20	11	12	27	28
Luxembourg	25	17	17	33	33
Poland	26	21	21	31	29
Greece	26	22	23	29	29
Spain	30	29	28	32	31
Switzerland	31	30	30	33	33
Sweden	32	17	17	50	42
UK	33	34	34	32	32
Hungary	36	32	32	40	39
Slovak Rep.	37	28	33	42	45
Portugal	48	44	46	51	51
Ireland	49	35	53	47	61
Norway	54	39	40	80	57
Austria	62	52	55	70	73
Netherlands	65	60	67	64	70
Germany	67	57	54	81	76
Denmark	67	58	64	75	73
France	68	62	64	74	74
Finland	69	60	64	77	73
Belgium	69	66	67	74	69

Source: OECD (2004d): Table 3.3b.

Due to the very complex and country-specific designs it is impossible to generate a ranking by benefit generosity in an easy way. In order to get a better understanding of

the unemployment benefit system's generosity, the OECD (2004) has calculated average net replacement rates (NRR) over 5 years of unemployment. Table 3.4 reports these NRRs for four different family types. Italy leads the ranking with a net replacement rate of only 5 percent. Apart from this outlier, European countries generally feature high in replacement levels. Austria, the Netherlands, Germany, Denmark, France, Finland and Belgium all provide income replacements above 60 percent of previous net earnings. On the other hand, unemployment protection is rather low in the US (6 percent) or Japan (13 percent). Eastern European countries like the Czech Republic, Poland or Hungary rank in the less generous part of the distribution with 9, 26 and 36 percent respectively. The overall picture does not change substantially with family types.

### **Social assistance**

People who do not qualify for unemployment benefits, and who lack resources to make their living, fall back on governments' social assistance. Concerning the impact of social assistance on labour supply, the same reasoning applies as in the previous section. The more generous these welfare payments are designed, the less attractive it is to accept a low-paid job. Across OECD countries, the picture is very mixed and benefits differ immensely with family types. Table 3.5 provides information on the determination of social assistance and the maximum amounts with respect to different family types. As benefits differ substantially across regions, the second column clarifies how this variation is accounted for in this classification. "National rates" means that benefits are identical across regions within a country, whereas "national guidelines" are taken if these recommendations are enforced in different ways. When social benefits vary across regions, "national averages" are taken, if known. Otherwise the figures refer to a representative jurisdiction.<sup>18</sup> While lack of resources is the main criterion for eligibility, some countries impose further conditions. A US citizen can only receive social assistance if he or she is actively looking for work, or participates in employment, training or workfare.

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<sup>18</sup>See OECD (2004d), p. 28.

Table 3.5: Social assistance benefits, 2002

Country	Determination	Maximum amounts (% of APW)		
		Head of household	Spouse/ partner	Per child
Austria	national average	19	12	6
Belgium	national rates	23	8	4-10
Canada	regionally	16	12	4-5
Czech Rep.	national rates	24	17	13-17
Denmark	national rates	31	31	10
Finland	national average	16	11	9-12
France	national rates	20	9	0-9
Germany	national rates	11	9	5-10
Hungary	national guidelines	16	n.a.	n.a.
Iceland	regionally	31	25	n.a.
Ireland	national guidelines	24	16	3
Italy	regionally	16	9	7-8
Japan	regionally	24	13	6-7
Korea	national rates	16	10	9-10
Luxembourg	national rates	36	18	3
Netherlands	national rates	30	13	n.a.
Norway	regionally adjusted	30	7	4-16
	national rates			
Poland	social worker discretion	21	n.a.	n.a.
Portugal	national rates	20	20	10
Slovak Rep.	national rates	27	12	8
Spain	regionally	27	3	3
Sweden	national guidelines	16	11	7-12
Switzerland	national guidelines	22	12	6; 12
UK	national rates	11	8	10
US	national rates	5	4	4

Source: OECD (2004d): Table 1.4.

Note: APW=average production worker

With regard to maximum benefits, the distribution ranges from five percent of an average production worker's salary in the US to 36 percent in Luxembourg. If households earn additional income, benefits are reduced by 50 percent (Portugal), 75 percent (Canada) or 100 percent in most countries. However, some states like Denmark, the UK or Germany have implemented disregards. Only if these amounts are exceeded, benefits are reduced by the prevailing rates. In addition, the maximum amount a household can receive depends on the size and the structure of the family.

A second adult in the household may only get 11 percent in addition of the head of household (Spain) or up to 100 percent like in Denmark or Portugal. If just one child is present, total benefits do not rise at all in France whereas social assistance increases by more than 70 percent in the US, the UK and Germany.

Despite the detailed information, an overall evaluation of the system's generosity remains difficult because interactions with other benefit schemes must be taken into account. Furthermore, some countries grant extra payments on top for rent or clothing which are not reflected in Table 3.5. Nevertheless, an impression the reader might get is that the United States and the United Kingdom feature with a rather low generosity while continental European states are characterised by higher welfare payments.

### **3.1.4 Employment protection legislation (EPL)**

Another important field of labour market regulation comprises rules for the hiring and firing of workers. Once established to enhance employment conditions, EPL also imposes additional costs on firms for hiring employees. Theoretically, two effects stand vis-à-vis. On the one hand, EPL reduces inflows into unemployment and thus protects job owners, whereas on the other hand, it makes reentry into the job market more difficult for outsiders. A priori, the net effect is ambiguous and subject to empirical investigation. According to OECD (2004c), EPL has benefited workers with some years of work experience while young people and prime-age women are discriminated by such policies. From a welfare perspective, there must be an optimal degree of EPL if higher job security increases employees' efforts and co-operation. Thus, EPL may enhance economic efficiency as long as labour market flexibility is not restricted too much.

The relation between EPL and employment has gained attention after Lazear's seminal paper in 1990. For 22 developed countries over the years 1956 to 1984, he finds that a regime shift from no severance pay to obligatory three months salary compensation would reduce the employment-population-ratio by one percent. In France, for instance, 59 percent of unemployment can be explained by changes in severance pay requirements. In order to capture the degree of EPL, the OECD (1999a, 2004c) has

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developed an index that allows a ranking of countries. For that purpose, three areas are distinguished, namely regular employment, temporary employment and additional rules for collective dismissals. Out of these sub-indices, the OECD has derived an overall EPL index between zero and six with six being the highest protection level.

### **Regular employment and collective dismissals**

Although temporary forms of employment have increased in OECD countries in recent years, regular employment is still by far the most dominant form.<sup>19</sup> Therefore, protection for regular contracts takes up the main part of the EPL index. According to OECD (1999a), three broad sub-areas can be identified in this context: Procedural requirements that an employer must meet to terminate the contract, regulation of notice and severance pay, and penalties for unfair dismissals. From these categories the OECD develops a sub-indicator revealing the protection of regular employment. With regard to procedural requirements, the ranking takes into consideration whether a written statement mentioning reasons for dismissal is required, whether a third party must be consulted or whether a third party even has to approve the company's decision. The Netherlands have implemented the strictest rules, whereas Canada and the United States can be found at the other end of the scale. The picture is basically the same for notice and severance pay requirements. All OECD countries have set formal rules for length of notice, but only two thirds prescribe severance payments. Here, Southern European countries dictate the strictest rules. In Italy and Portugal, companies have to pay a severance of 18 to 20 monthly salaries to their employees if they have worked for the company for 20 years. Canada and the US have not regulated that issue at all. Concerning the last category, unfair dismissals, many countries have laws that make dismissals illegal for specific reasons such as gender or race. The least restrictive legislation to dismiss employees for any reason can be found in the US, followed by the UK and Switzerland. Germany ranks 23rd out of 28 OECD countries, Hungary and Poland rank 11th and 12th, respectively. The Czech and Slovak Republic have similar regulation as Germany. This sub-indicator is shown in column 4 in Table

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<sup>19</sup>OECD (2002b), chapter 3.

3.6 for all countries. Again, the English speaking economies are characterised by the least restrictive regulation whereas continental European states have protected their employees the most.

When it comes to collective dismissals, all countries have introduced additional, generally stricter rules on top of individual dismissal regulation. Surprisingly, also the US, Canada and the UK reach relatively high index values of 2.9. Sweden and Italy constitute the end with indices of 4.5 and 4.9, respectively. This ranking can be found in the last column of Table 3.6.

### **Temporary employment**

One method to make the labour market more flexible without touching the dismissal legislation is to allow for temporary work. Thereby, employers take a lower risk because they do not have to pay severance packages or consider length of notice periods. Short-time work, fixed-term contracts and the recognition of temporary work agencies (TWA) are possible ways to go. In fact, all countries allow fixed-term contracts. Many however, restrict them to so-called objective reasons such as time-limited projects, seasonal work or replacement of employees who are temporarily absent.<sup>20</sup> The US, Canada and the UK literally do not regulate, whereas Germany for instance, has specified by law how many consecutive fixed-term contracts an employee can be given until he must receive a permanent one. The ranking in this category shows a huge gap between the group of less regulated countries and Southern European countries such as Greece, Italy, Portugal and Spain. In between, one can find Central and Western European states, whereas France compares more to Southern Europe and Nordic countries. Eastern European EU members like Poland, the Czech Republic and Hungary have similar regulations to the US. The Czech and Slovak Republic have installed a very lax regulation. They reach an index of 0.5 and 0.3, respectively. Hungary follows with a value of 1.1. Table 3.6 also reveals the complete ranking of this sub-index.

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<sup>20</sup>OECD (1999a), p. 59.

Table 3.6: Summary indicators of the strictness of employment protection legislation (EPL), 2003

Rank	Country	Overall EPL	Regular employment	Temporary employment	Collective dismissal
1	US	0.2	0.2 (1)	0.3 (1)	2.9 (10)
2	UK	0.7	1.1 (2)	0.4 (3)	2.9 (10)
3	Canada	0.8	1.3 (4)	0.3 (1)	2.9 (10)
4	Ireland	1.1	1.6 (7)	0.6 (6)	2.4 (6)
	Switzerland	1.1	1.2 (3)	1.1 (8)	3.9 (23)
6	Australia	1.2	1.5 (5)	0.9 (7)	2.9 (10)
7	Denmark	1.4	1.5 (5)	1.4 (14)	3.9 (23)
8	Hungary	1.5	1.9 (11)	1.1 (8)	2.9 (10)
	New Zealand	1.5	1.7 (8)	1.3 (11)	0.4 (1)
10	Poland	1.7	2.2 (12)	1.3 (11)	4.1 (25)
11	Japan	1.8	2.4 (16)	1.3 (11)	1.5 (2)
12	Austria	1.9	2.4 (16)	1.5 (15)	3.3 (18)
	Czech Rep.	1.9	3.3 (26)	0.5 (5)	2.1 (4)
	Italy	1.9	1.8 (10)	2.1 (20)	4.9 (28)
	Slovak Rep.	1.9	3.5 (27)	0.4 (3)	2.5 (8)
16	Finland	2.0	2.2 (12)	1.9 (19)	2.6 (9)
	Korea	2.0	2.4 (16)	1.7 (17)	1.9 (3)
18	Netherlands	2.1	3.1 (25)	1.2 (10)	3.0 (16)
19	Belgium	2.2	1.7 (8)	2.6 (21)	4.1 (25)
	Germany	2.2	2.7 (23)	1.8 (18)	3.8 (21)
	Sweden	2.2	2.9 (24)	1.6 (16)	4.5 (27)
22	Norway	2.6	2.3 (14)	2.9 (23)	2.9 (10)
23	Greece	2.8	2.4 (16)	3.3 (24)	3.3 (18)
24	France	3.0	2.5 (20)	3.6 (26)	2.1 (4)
25	Mexico	3.1	2.3 (14)	4.0 (27)	3.8 (21)
	Spain	3.1	2.6 (21)	3.5 (25)	3.1 (17)
27	Portugal	3.5	4.3 (28)	2.8 (22)	3.6 (20)
28	Turkey	3.7	2.6 (21)	4.9 (28)	2.4 (6)

Source: OECD (2004c), Table 2.A2.4, p. 117.

### Summary indicators of strictness of employment protection legislation

In order to construct an overall cardinal index, the OECD proceeds in four steps. First of all, the entire set of information items - which have been gathered in sub-indices as described above - has to be translated into the scale between zero (no regulation) and six (maximum regulation). On the consecutive stage, weighted averages are constructed to generate aggregated information, out of which the sub-indices (stage 3) are formed as unweighted averages. The three areas described above are finally merged to the overall EPL index as reported in Table 3.6.<sup>21</sup> The weights used should reflect repetitive information already covered in other items or an economically stronger impact of certain institutional features on the strictness of regulation.

The overall situation of strictness in employment protection legislation closely resembles the ranking by sub-indices. The US, the UK, Canada, Ireland and Switzerland offer the least restrictive legislation. Denmark leads other major European countries with an overall index of 1.4. Germany ranks 19th, whereas Eastern European members such as Hungary or the Czech Republic can be found in the midfield with values of 1.5 and 1.9, respectively. The strictest regulation has been implemented in France, Spain and Portugal. In these countries, both high protection against individual dismissal and strict rules for temporary employment are at work.

Recent figures also allow an evaluation of changes in EPL strictness over time. Over the last number of decades, a convergence process could be observed without having changed the relative position of most countries. Only France and Italy form exceptions in this regard. While Italy has substantially deregulated its labour market since the 1980s and now ranks in the middle of the spectrum, France has drifted in the opposite direction. The US and the UK have provided and still provide the least strict labour market regulation. High EPL states relaxed their rules, thus converging to the leaders of the ranking. While Portugal and Spain undertook comprehensive reforms with regard to both regular and temporary employment, most other countries reformed partially and specifically targeted temporary work regulations.<sup>22</sup>

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<sup>21</sup>For details, refer to OECD (1999a), chapter 2, Annex 2.B.

<sup>22</sup>OECD (1999a).

### 3.1.5 Regulation of holidays and working time

Working time and holiday regulation - issues that are not covered in OECD's EPL indexation - are negotiated between social partners. In some countries, the government is involved as a third party as well (tripartite bargaining). The outcome however, must meet certain standards which are generally set by government authorities alone. The statutory maximum working day must not be longer than 13 hours in Ireland, the UK, Greece, Italy, Cyprus and Denmark. In some countries like Austria and France, the maximum amounts to ten hours, whereas Germany has even set its maximum to eight hours.<sup>23</sup> This figure simply says that workers must not be forced to work longer than average. With regard to the statutory maximum working week, the normal limit is 48 hours. However, several countries like Austria, Spain and several Eastern European countries have set 40 hours as the maximum. Annual paid leave is also regulated by governments. The statutory annual paid leave is 20 days in most countries, only a few like France or Austria allow 25. Of course, these standards do not reflect how many hours are being worked and how many days workers can take off. This will be discussed in section 3.3 below.

### 3.1.6 Overall evaluation of labour market flexibility

In institutional comparisons, it is quite hard to come up with a clear and transparent figure by which countries can be unambiguously ranked. So far, we have discussed labour market institutions in several respects in order to get an impression of labour market flexibility. The index for strictness in employment protection legislation calculated by the OECD was an exception as it provided a cardinal measure. From the facts we concluded that Anglo-Saxon countries seem to possess a rather flexible labour market compared to Western European economies. In the latter, employment protection is stricter, unions have a stronger influence in the wage-setting process and benefit schemes are more generous.<sup>24</sup> However, this description by itself does not provide ev-

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<sup>23</sup>EIRO (2004b).

<sup>24</sup>See also Blau and Kahn (1999), p. 1448.

idence that labour markets have more difficulties in absorbing external shocks like an increase in low-wage competition from former communist countries or other emerging markets. Therefore, it is worthwhile to survey some empirical work.

Nickell (1997) identifies labour market institutions as a main determinant of unemployment, whereas other rigidities have no observable impact on unemployment. To the former group of features, Nickell counts generous unemployment benefits that are paid without time limits and desist from pressure on the unemployed to find a new job or strong influence of unions combined with collective bargaining on a central level. Siebert (1997) also draws a clear connection between labour market institutions and unemployment. He makes the expansion of the welfare state responsible for persistent unemployment in many countries, especially Germany, as adjustments to adverse shocks could not be compensated in the same way as in the United States. These shocks comprise the two oil crises, implications from international competition with newly industrialised economies as well as technological progress.

According to the IMD World Competitiveness Yearbook (2005) labour market regulations have been assessed by executives that represent a cross-section of the business community in each country. With regard to regulations such as hiring and firing practices and minimum wage constraints, Germany reaches only 1.88 out of 10 points and ranks last out of 60 participating countries.<sup>25</sup> This means that business activity is hindered most in this country. Surprisingly, Denmark heads the list with a score of 7.79. The US comes 10th, the UK 26th. Most continental European countries appear in the lower half of the ranking. When it comes to incentives to look for new employment, Germany also performs badly. Only Argentina shows a more generous unemployment scheme. The pattern is pretty similar to the previous ranking. Continental European states gather at the end of the list. Surprisingly, the US only reaches place 45 out of 60 in this category.<sup>26</sup>

The OECD (1994b) has calculated two elasticities that describe the degree of labour market rigidity: one is the response of labour demand on changes in real wages, the

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<sup>25</sup>Contrary to the EPL index, a low value indicates poor performance.

<sup>26</sup>International Institute for Management Development IMD (2004), Tables 2.4.16 and 2.4.17.

Table 3.7: Long-term employment elasticity and long-term real wage response

	Long-term employment elasticity	Median lag (years)		Long-term real wage response	Median lag (years)
US	-1.0	1.0	US	-1.0	1.0
Canada	-0.9	1.0	UK	-1.0	1.0
France	-1.0	2.0	France	-3.5	1.5
Germany	-1.0	2.0	Finland	-6.0	2.0
Finland	-1.0	3.0	Italy	-3.5	2.0
Japan	-0.8	3.0	Sweden	-10.0	2.5
UK	-1.0	4.0	Japan	-5.0	3.0
Italy	-0.5	5.0	Canada	-2.0	3.5
Sweden	-0.9	7.0	Germany	-3.0	4.0

Source: OECD (1994b), pp. 1-5.

other figure reflects the response of wages on changes in labour demand (extent of unemployment). According to Table 3.7 that reports these figures for selected OECD countries, a one percent increase in the real wage reduces labour demand by one percent in the long run and vice versa. The big difference across countries however, can be found in the adjustment speed. While half of the adjustment is completed after only one year in the US and Canada, the same process takes twice as long in Germany and France. Surprisingly, the UK needs four years for half of the adjustment. In Italy and Sweden the adjustment takes even longer. The long-term real wage response to a one percent change in unemployment, as reported in the right part of the table, is extraordinarily high in Sweden and is also at a relatively high level in Finland and Japan. What is more important however, is once again the adjustment speed. In that respect, the United States rank at the top of the list next to the United Kingdom. Germany shows the poorest performance with a median lag of four years. These results provide further evidence for what we had suspected before: wages tend to adjust faster in the US and the UK thus indicating a higher flexibility of the labour market.

With regard to the new Eastern European EU member states - for which similar indicators do not exist (yet) - unionisation is lower than in Western Europe and collective bargaining mainly takes place at the company level. Concerning the generosity of

the unemployment benefit system, data are only available for Poland, Czech Republic, Slovakia and Hungary. Hungary has the most generous system of the four, but still rather ungenerous relative to the old members of the European Union. As decentralised bargaining and ungenerous benefit systems are major determinants of labour market flexibility<sup>27</sup>, one can assume that Eastern Europe shows a higher flexibility than other European countries, although the low regulation of Anglo-Saxon countries might not be reached.

### 3.2 Labour market reforms in selected countries

To complement the discussion of institutional labour market features, this section provides a brief overview of major labour market reforms in selected European economies. It turns out that the political response to increasing unemployment trends since the oil crises in the 1970s has differed across countries both in timing and direction.

#### Denmark

In 1994, a comprehensive labour market reform initiated by the Social Democratic Prime Minister Rasmussen, came into force. What is known as the *flexicurity* approach combines flexibility (high job mobility due to low employment protection), social security (due to a generous welfare system) and active labour market programmes.<sup>28</sup> Dismissal rules were reduced to a minimum so that employees can literally be fired without delay. In addition, the insured unemployed have become subject to a two-period system with a strong emphasis on activation in the second period. Unemployment benefits were initially only granted for up to 4 years (previously 9 years) in the first period. If someone is still unemployed after the first period, he or she directly switches to the second stage where authorities offer compulsory job training. Refusal to participate in these programmes causes significant cuts in benefits. Whereas the first stage was reduced to one year by 1999 and for young employees below 25 years even

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<sup>27</sup>Nickell (1997).

<sup>28</sup>OECD (2004c), pp. 97-98.

to six months, the second period still spans three years. The recent 2003 reform *More people into employment* entirely abolished the two-period scheme. Active job seeking may be requested from the first day of unemployment while the maximum duration of benefit payments still amounts to 4 years.

Another aspect of recent labour market reforms has been the shift from a rule based to an individual action plan system where individual needs of the unemployed are better taken into consideration. This programme is specifically designed to fight long-term unemployment.<sup>29</sup> Overall, the Danish approach has often been seen as a third way between low labour market regulation of Anglo-Saxon economies and stricter EPL and more generous welfare schemes in other continental European states.

### Netherlands

In 1982, government authorities and social partners agreed to give up wage indexation, to moderate wage claims, to remove obstacles to temporary work and to introduce full social-security coverage for part-time workers. In addition, working time was reduced, provided that this did not lead to an increase in labour costs or a reduction in firms' operating hours. This consensus became popular as the Wassenaar Agreement. Since then, the Dutch *consensus model* – that is, lack of industrial strife and wage developments in line with productivity improvements – has often been cited as a key factor for improved employment performance.<sup>30</sup>

In 1986-87, the unemployment insurance system was significantly curtailed. The duration of benefits was reduced from thirty to six months for younger workers and the replacement rate was lowered from 80 to 70 percent. As benefits are linked to the minimum wage, lowering the minimum wage also reduced the minimum benefit. By 1998, the minimum benefit had been pared to 60 percent of the average wage, a decline of 9 percentage points since the early 1980s. In addition, in 1995 the government tightened the eligibility standards for benefits, requiring a longer period of employment. Recipients are now also expected to accept any "suitable" job offer. Those who refuse to

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<sup>29</sup>Madsen (1999).

<sup>30</sup>See Tille and Yi (2001).

do so receive reduced benefits. Finally, what constitutes a suitable offer is interpreted more liberally for recipients who have had relatively long unemployment spells - a change in the rules that is designed to induce the unemployed to intensify their job search as time passes. In the 1990s, active labour market policies to fight long-term unemployment and new early retirement regulations complemented the reforms of the 1980s.

### **Sweden**

In 1991 wage bargaining under public supervision became more decentralised. In the same year, the government curtailed pre-tax unemployment benefits from 90 to 75 percent of previous gross earnings (later increased again to 80 percent). In 2001 and 2002, ceilings on unemployment benefits were raised in two steps. Since 1996, benefit sanctions can be extended from 20 to 60 days if someone declines a job or training offer. Social assistance recipients can now be required to undertake education or training as well. Beneficiaries of welfare payments are required to participate in activation programmes after 27 months of unemployment. This regulation also comprises part-time employment since 2001. With respect to employment protection legislation, fixed-term contracts for up to 12 months were introduced in 1997, without restriction concerning the nature of the work.

Sweden is renowned for its extensive active labour market policies (ALMP) which were further strengthened during the last years. In 1995, the government implemented subsidies for social security contributions if a firm hired an unemployed person. Long-term unemployment was combatted by individual programmes for persons at risk. In 1998, special activation for people under 24 became compulsory after 100 days of unemployment. Concerning the targeting of ALMPs a 50 percent wage subsidy for firms hiring long-term unemployed over 60 and intensified effort for training of low-skilled, long-term unemployed over 55 was supposed to increase employment prospects for these groups.<sup>31</sup>

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<sup>31</sup>Brandt, Burniaux and Duval (2005).

## United Kingdom

British Prime Minister Margaret Thatcher fundamentally reformed labour market institutions in the 1980s. In several Employment Acts the "Iron Lady" forcefully broke up trade unions' power. Moreover, work incentives were increased through a modification of welfare payments. Unemployment benefits dropped or were even entirely abolished for young people. Unemployed workers had to be interviewed every six months about their progress in job seeking. Another direction of the Thatcher reforms aimed at a lower weight of the government in the market economy. Many state-owned enterprises were privatised, government employment reduced and tax rates lowered.<sup>32</sup>

More recently, notification requirements for collective dismissals have been relaxed and maximum duration of fixed-term contracts were reduced to 4 years (before unlimited) in 2000. Since 1999, unemployment benefits are granted only for a period up to 6 months (previously 12 months) if spouses are working. In 1998, the British government initiated the *New Deal for Young People* which conditioned the entitlement of unemployment benefits on the participation in activation programmes 6 months after dismissal. This regulation was later extended to employees older than 25 years, long-term unemployed and disabled people. Active labour market programmes targeted at more and better training, subsidised work with the voluntary sector, design of a job search plan and compulsory interviews every two weeks. To account for high unemployment rates among the young, reduced minimum wage rates for 18-21 year-old work force members were introduced in 1999.<sup>33</sup>

## Germany

Germany's welfare state expanded tremendously in the 1970s and became even more generous thereafter. The evident labour market problems that especially emerged after German Unification were comprehensively addressed in Chancellor Schröder's speech on March 14, 2003, where he proposed the *Agenda 2010*. Apart from other reform proposals, the concept focused on the liberalisation of the labour market. The so-

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<sup>32</sup>Blanchflower and Freeman (1993).

<sup>33</sup>Brandt, Burniaux and Duval (2005).

called Hartz-reform makes up the core of this package. Hartz I and II which came into force on January 1, 2003, introduced Ich-AGs (unemployed can apply for public financial support if they plan self-employment), Minijobs (firms neither pay taxes nor social security contributions up to a monthly salary of 400 euro per employee) and Personnel-Service-Agencies within the Public Employment Service (PES) to improve job placement of unemployed workers. Hartz III (in place since January 1, 2004) aims at the restructuring of the German Public Employment Service in the fashion of more decentralisation and more service orientation. The final goal was to place unemployed workers on free positions more efficiently at lower costs. Hartz IV was the most hotly debated regulation and caused country-wide demonstrations. From January 1, 2005, unemployment and social assistance were merged bringing about a level of social assistance that was in fact lower than the previous one. Unemployment insurance which guarantees about two thirds of previous net earnings is only granted up to 12 months (previously 24 months) since. Exceptions exist for older persons above 55 who are entitled to receive unemployment insurance benefits for up to 18 months. Thereafter, the unemployed are only entitled to the lower benefits.

After a relaxation and retightening of dismissal rules in 1996 and 1999, dismissal protection was only active in companies that employed more than 10 people. Restrictions on fixed-term contracts were reduced in the sense that longer periods and more renewals were possible. Private temporary work agencies received more freedom for job placement in several steps till 2004. In 2002 and 2005 sanctions for job offer denials became tighter. Since 2002, a special programme for unemployed over the age of 50 - the so-called Job-AQTIV regulation - is supposed to reduce high unemployment rates in this age group. Individual profiling, job rotation, intensified training and better access to temporary work are the key instruments to achieve this goal.

## **Italy**

In Italy, employment protection legislation was eased in several steps since 1997. Fixed-term contracts are no longer automatically transformed into contracts with indefinite duration and low-skilled workers can now be hired more easily. Private temporary

work agencies were allowed in 1998, although restrictions on job placements were entirely abolished as recently as 2003. In addition, administrative obligations for hiring employees were relieved in 2002.

With regard to unemployment benefits, replacement rates have been increased to 60 percent of average gross earnings of the previous three months. Although the maximum duration has been extended from six to twelve months in 2003, it is still relatively short from a European perspective. In addition, replacement ratios automatically decline to 40 and 30 percent respectively in the last two quarters of entitlement. Another new regulation allots benefits conditional on participation in training.<sup>34</sup>

### France

Labour market reforms in France have rather tightened regulation. In 2002, severance entitlements were raised, conditions for lay-offs generally tightened - but temporarily suspended again afterwards. Furthermore, firms now must pay higher premia to employees if a temporary contract is not transformed into a permanent one. In addition, the steady decrease of unemployment benefits over the coverage period was slowed down and entirely abolished in 2001. The maximum duration of unemployment entitlements shrank from 30 to 23 months in 2003.

In 2000, weekly working hours were reduced from 39 to 35 and more money was allocated towards active labour market programmes. Recent demonstrations in France against the *Contrat Première Embauche* have underlined the difficulty in undertaking substantial reforms that might break the crusted structure. Thousands of French protested against the government's intention to introduce a probation period of two years for young employees below 25. Thereby, dismissal rules would have effectively been abolished for this age group. The protesters succeeded when President Chirac withdrew the law and proposed more active labour market policies instead.

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<sup>34</sup>Brandt, Burniaux and Duval (2005).