OECD Economics Department Working Papers No. 429

Assessing the OECD Jobs Strategy: Past Developments and Reforms

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https://dx.doi.org/10.1787/673876504152

OECD

Unclassified **ECO/WKP(2005)16**

Organisation de Coopération et de Développement Economiques
Organisation for Economic Co-operation and Development

11-May-2005

English - Or. English

ECONOMICS DEPARTMENT

ECO/WKP(2005)16
Unclassified

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ABSTRACT/RÉSUMÉ

Assessing the OECD Jobs Strategy: Past Developments and Reforms

In 1994, the OECD published a set of recommendations -- known as the OECD Jobs Strategy -- to deal with high and persistent unemployment that affected many member countries. These recommendations are currently being reassessed by the OECD and this paper contributes to this process. It provides a detailed description of labour market reforms in member countries over the past ten years, together with a short overview of changes in macroeconomic policies and reforms affecting product markets. It attempts to rank countries according with their past reform efforts, using an aggregate reform intensity indicator, and analyses the link, though in a very preliminary way, between reforms and labour market performance. Overall, there is little evidence of a link between initial conditions and subsequent reform efforts, with some countries taking only modest measures despite a poor starting point, while others carrying out ambitious programs even though their initial conditions were already relatively favourable. Over the past decade, member countries have employed very diverse reform strategies, from comprehensive reforms package (Denmark, Finland and the Netherlands) -- as recommended in the initial Jobs Strategy -- to reforms more narrowly targeted on specific fields where deep action was undertaken (France, Italy, the United Kingdom and Ireland). The intensity of reforms has differed markedly across policy fields, with more action being undertaken in areas that are more widely accepted by the population, such as active labour market policies and cuts of labour taxes.
Please note that annexes are available on the Economics Department Website at: www.oecd.org/eco/Working_Papers.

JEL Classification : I38, J22, J26, J31, J38, J51, J65, P16.

Key words : Welfare and poverty : government policy; time allocation and labour supply; retirement policies; wage level and structure; wage, compensation and labour costs: public policy; trade unions: objectives, structure and effect; unemployment insurance, severance pay, plant closings; capitalist systems: political economy.

Évaluation de la Stratégie de l'OCDE pour l'Emploi : Évolutions et réformes entreprises dans le passé.

En 1994, l'OCDE a publié un ensemble de recommandations -- connu sous le nom de Stratégie de l'OCDE pour l'Emploi -- afin de remédier au chômage élevé et persistant qui affectait beaucoup de pays membres. Le Secrétariat réévalue actuellement ces recommandations, et ce document s'inscrit dans ce processus de réévaluation. Il fournit une description détaillée les réformes du marché du travail entreprises dans les pays membres au cours des dix dernières années ainsi qu'un résumé des modifications de politique macroéconomique et des réformes des marchés des produits. Il contient une tentative de classer les pays selon les efforts de réforme qu'ils ont déployés dans le passé, basée sur un indicateur agrégé d'intensité des réformes, et analyse d'une manière rudimentaire le lien entre les réformes et la performance du marché du travail. En général, il paraît difficile d'établir un lien entre les conditions initiales et l'effort de réforme déployé par la suite : certains pays n'ont entrepris que des réformes modestes malgré une mauvaise situation initiale alors que d'autres pays mettaient en œuvre des programmes de réformes ambitieux bien que leurs conditions initiales étaient déjà relativement favorables. Durant la dernière décennie, les pays membres ont utilisé des stratégies de réforme très différentes, certains (Danemark, Finlande et les Pays-Bas) mettant en œuvre des ensembles de réformes globaux (couvrant presque tous les aspects du marché du travail) -- comme il était recommandé dans la Stratégie pour l'Emploi -- alors que d'autres (France, Irlande, Italie et Royaume Uni) restreignaient leur action à des réformes ciblées sur certains aspects spécifiques du marché de l'emploi qui ont fait l'objet d'une action en profondeur. L'intensité des réformes a varié beaucoup d'un domaine à l'autre et des réformes plus importantes ont généralement été adoptées concernant des aspects bénéficiant d'un plus grand support de la population, comme les politiques actives de l'emploi et les réductions des taxes sur le travail. Veuillez noter que les annexes sont disponibles sur le site web du département des affaires économiques: www.oecd.org/eco/documentsdetravail.

Classification JEL : I38, J22, J26, J31, J38, J51, J65, P16.

Mots Clés : Aide sociale et pauvreté : politique du gouvernement ; allocation du temps et offre de travail ; politique des pensions ; niveau et structure des salaires ; salaires, indemnisations et coûts du travail : politique publique ; syndicats : objectifs, structure et effets ; assurance chômage, indemnités de licenciement, fermeture d'entreprises ; systèmes capitalistes : économie politique.

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ASSESSING THE OECD JOBS STRATEGY: PAST DEVELOPMENTS AND REFORMS

By Nicola Brandt, Jean-Marc Burniaux and Romain Duval[1]

1. Section 1. Introduction and main findings

1.1 Introduction

1. In response to high and persistent unemployment in many OECD countries in the late eighties, the OECD undertook a major study of the factors underlying the malfunctioning of labour markets. It was published in 1994 as the OECD Jobs Study and proposed a wide-ranging set of policy recommendations to reduce unemployment, raise employment and increase prosperity (OECD, 1994). These recommendations covered nine broad policy areas, including macroeconomic policy, creation and diffusion of innovation, entrepreneurial climate, labour force skills, competences and education as well as various aspects of labour-market policies and institutions. The recommendations are quoted in full in Annex 1. They were subsequently expanded to cover policies related to product market competition in the OECD Jobs Strategy (OECD, 1995a).

2. The general policy recommendations of the Jobs Strategy were tailored on a country-by-country basis to take account of country-specific institutional, social and cultural characteristics in the regular country reviews by the Economic and Development Review Committee (EDRC). These country-specific recommendations, referred to in this paper as EDRC recommendations, were published in OECD Economic Surveys over the 1995-1997 period for most member countries. Countries' progress in following upon the EDRC recommendations was subsequently monitored and assessed. Reviews of the progress made in implementing the EDRC recommendations were published in 1997 and 1999 (OECD, 1997a and 1999). In addition, specific fields of the Jobs Strategy have been further analysed by the OECD Secretariat, such as ways of enhancing the effectiveness of active labour market policies (OECD, 1996a) and labour supply effects embedded in tax and benefit systems (OECD, 1995b; 1997b). More recently, the focus has shifted to the role of interactions between different policy fields, such as between product market regulations and labour market policies (Nicoletti *et al.*, 2001) or between active labour market policies, income support and a range of other inactivity benefits (OECD *Employment Outlook 2003*, Chapter 4).

3. The OECD Jobs Strategy is currently beein reassessed, with a final report scheduled to be issued in 2006. This Working Paper contributes to this reassessment by providing a detailed description of labour market reforms in member countries over the past ten years, and giving a short overview of changes in macroeconomic policies and reforms affecting product markets.[2] Though the link between reforms and

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2. The JS policy areas not covered in this reassessment, such as entrepreneurship, education and science and technology, have been discussed in detail in the OECD Growth Study (OECD, 2003).

performance is very briefly explored in a simple correlation analysis at the end of the paper, the description and analysis here are primarily intended to serve as an introduction to the more analytical evaluation that will take place during later stages of the JS reassessment.

4. The paper is organised as follows. First, a brief introductory section reports the main trends in labour market performance and different dimensions of equity during the past decade. The following section draws a broad picture of the reform process since the JS was launched, with the focus on changes in labour market policy and a more summary account of reforms related to product market and macroeconomic policies. The final section examines reform strategies pursued by member countries and provides some preliminary evidence of the association between reforms undertaken by countries and the improvement of their labour market performance.

1.2 Summary of main findings

5. Section 2 shows that the past ten years have witnessed an overall improvement in labour market performance. Structural unemployment has declined in a vast majority of OECD countries, and this development has been accompanied by an increase of employment and participation rates, notably, for women. Countries where labour market performance improved most include Denmark, Ireland, the Netherlands and New Zealand. In contrast, no progress was reported in Germany and Greece and structural unemployment is still high in Finland, France, Italy and Spain. This evolution coincided with a slight increase of income inequality in many countries, reflecting reduced redistribution through taxes and benefits rather than greater inequality of factor incomes.

6. The broad picture of reforms is as follows:

- During the 1994–2004 period, many OECD countries have undertaken reforms consistent with the Jobs Strategy, including reforms corresponding to the specific recommendations made by the EDRC. In addition, reforms that did not correspond to any EDRC recommendations have also been implemented over the past ten years. Among OECD countries, Denmark, Finland and the Netherlands appear to have been particularly active in introducing far-reaching reform programmes. At the other extreme, few reforms have been reported for the Czech Republic, Iceland, Japan, Mexico and Switzerland. In many countries, labour market reforms took place in the context of more stable macroeconomic conditions than in previous decades and were accompanied by efforts to strengthen product market competition.

- There is no clear relationship between the initial conditions of labour market performance and subsequent reform efforts. Some countries have taken only modest action despite a poor starting point (Greece, Hungary, Poland, Spain), while others carried out important reforms even though their initial conditions were already relatively favourable (*e.g.* Denmark, Sweden and the United Kingdom). In some cases (Australia, the Netherlands and the United Kingdom), relatively favourable labour market performance in the mid-1990s had been preceded by wide-ranging reforms in the 1980s and early 1990s. Some other countries (such as New Zealand) had implemented reforms that had yet to have full effects in the mid-1990s, lessening the need for further reforms.

- Countries have pursued different strategies to improve labour market performance. Denmark, Finland and the Netherlands stand out for having pursued a comprehensive reform strategy as recommended in the JS, thereby benefiting from the potential synergies across policy areas. By contrast, in some other countries -- such as France, Italy, the

United Kingdom and Ireland, in particular -- the reform process was more narrowly targeted on specific fields.

- The intensity of reforms has differed markedly across policy fields. Overall, governments were more active in reducing labour taxes, deregulating temporary contracts and implementing new activation schemes than in deregulating permanent contracts or reforming unemployment and related welfare benefit systems. This pattern suggests that the reform effort has focused so far on the JS policy recommendations that are perhaps more widely accepted by the population. This may reflect the resistance of labour market "insiders" to reforms that would reduce their bargaining power as well as government concerns about equity and jobs security.

- The pattern of reforms over the past decade reveals the existence of typical policy packages. Many countries, and in particular Australia, the Netherlands and the United Kingdom, have applied a combination of labour tax cuts, often targeted to low income, and a re-direction of active labour market policies (ALMPs) towards more effective job search and early activation, including an element of compulsion. Activation policies have often been associated with reforms to early-retirement, sickness, disability and old-age pension systems. A number of OECD countries, including Germany, Italy, the Netherlands, and, to a lesser extent, Belgium and Denmark, have also combined deregulation of statutory employment protection for temporary contracts with more flexible working-time arrangements and/or an easing of existing constraints on part-time work. Finally, countries which have undertaken most labour market reforms recently are also those that had most deregulated their product markets beforehand.

SECTION 2. OVERVIEW OF RECENT PERFORMANCE

7. Since 1994, labour market performance in OECD countries has generally improved markedly. In particular, the following trends have been observed:

- Estimated structural unemployment rates (as proxied by the NAIRU)[3] have declined in a majority of OECD countries (Figure 1, Panel A). Substantial reductions have been reported in several countries – Australia, Denmark, the Netherlands, New Zealand and the United Kingdom -- and sometimes from very high levels of unemployment, such as in France, Ireland and Spain. Only in Germany, Greece, Japan and Korea does structural unemployment appear to have increased significantly during the period 1994-2003. The patterns of structural unemployment rates have been mirrored fairly closely by the evolution of actual unemployment rates (Figure 1, Panel B). It is noticeable that some of the Central European countries[4] have witnessed steep rises in unemployment, partly reflecting the effects of the transition to a market economy.

- The picture for long-term unemployment is more mixed (Figure 2). As a proportion of total unemployment, it dropped markedly in many countries, in particular those where reductions of unemployment were the largest. But substantial increases of long-term unemployment were observed in countries where structural unemployment rates rose or remained unchanged -- such as in Austria, Germany, Greece and Japan -- and in the Central European countries.

- Aggregate participation rates have increased in a majority of OECD countries[5] (Figure 3, Panel A), in particular in Ireland, the Netherlands, Norway and Spain, though they dropped in Turkey and several Central European countries. At the same time, the proportion of discouraged workers to the total working-age population fell in most countries (Figure 4). Aggregate employment rates, adjusted for the cycle, also increased in a majority of countries (Figure 3, Panel B).

- Despite a decline of annual hours worked per worker in almost all OECD countries (Figure 5, Panel A), labour utilisation (calculated as the ratio of annual hours worked to the working-age population) has increased in many of them (Figure 5, Panel B), reflecting higher participation rates and lower unemployment. However, labour utilisation has dropped in the Czech Republic, France, Germany, Japan, the Slovak Republic, Switzerland and the United States.

Several OECD countries managed to make progress on all the indicators of labour market performance reviewed above, including Australia, Canada, Denmark, Ireland, Korea, the Netherlands and New Zealand.

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3. Structural unemployment cannot be observed and can only be estimated with uncertainty. The NAIRU is derived from estimated econometric relationships that explain inflation developments imperfectly and are sometimes subject to large margins of error. It depends on the choice of different specifications in explaining inflation. It is also subject to all the limitations related to reduced-form filtering methods, including a high sensitivity to the most recent observations (Turner et al., 2001).

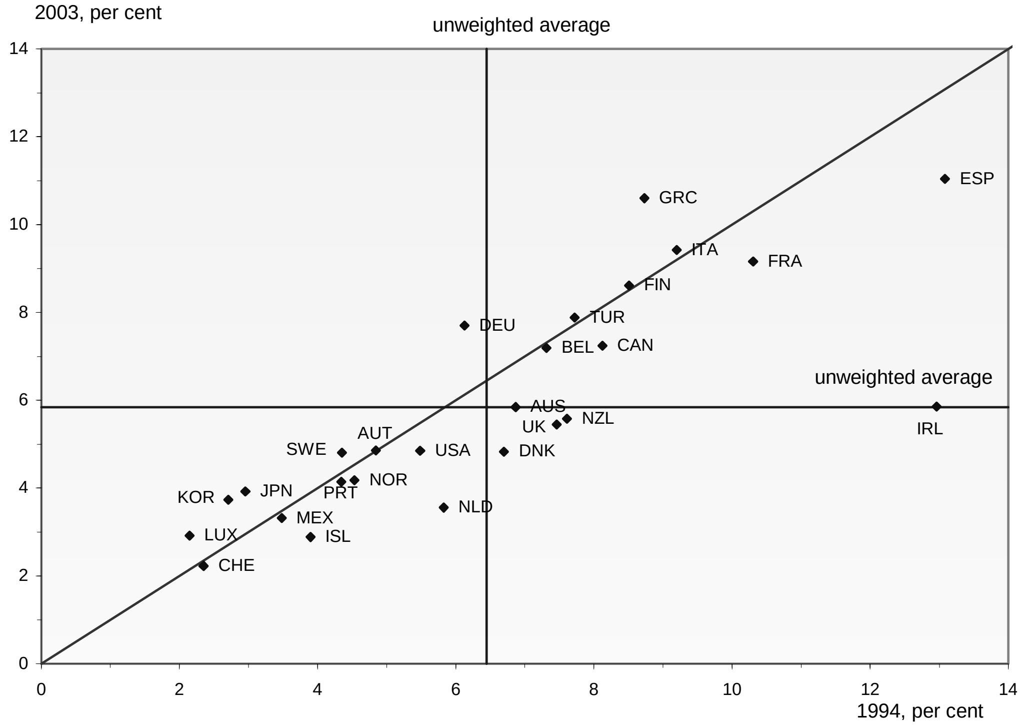
4. There are no estimates of the NAIRU available so far for these countries.

5. A very similar pattern emerges when aggregate participation rates are adjusted for the cycle. However, such adjustments cannot be done for Turkey and the Central European countries because output gaps are not available.

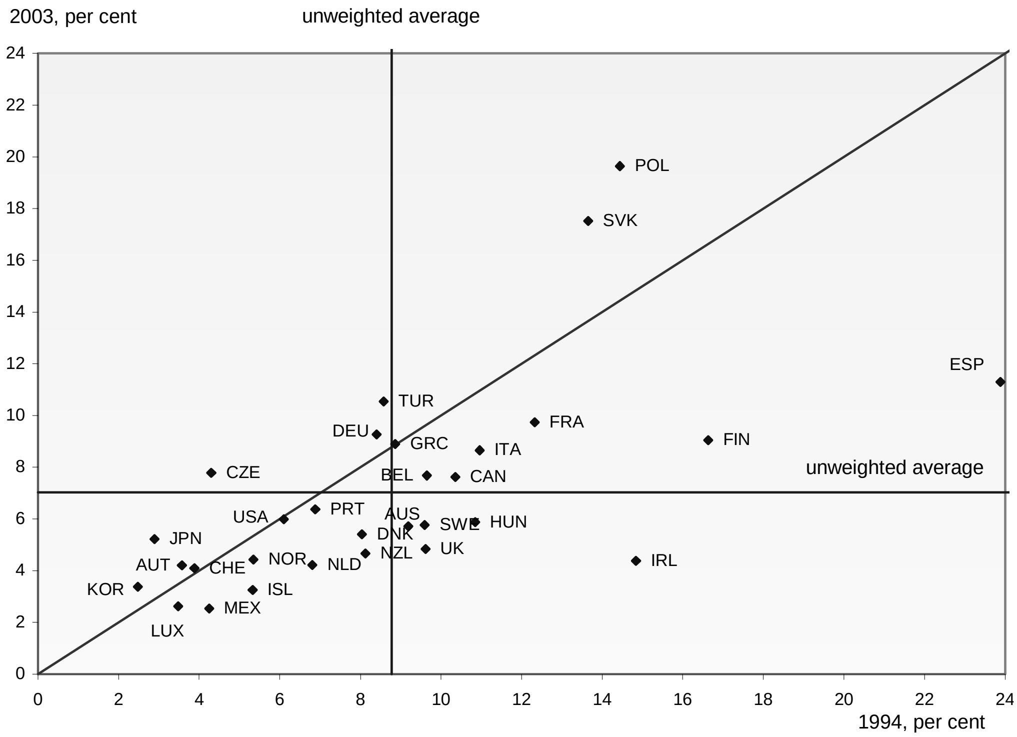
In contrast, labour market performance deteriorated with respect to most of the indicators in Austria, France, Germany, Japan, Sweden and several Central European countries.

Figure 1. **Evolution of unemployment rates in OECD countries, 1994-2003**

Panel A. **NAIRU**[1]

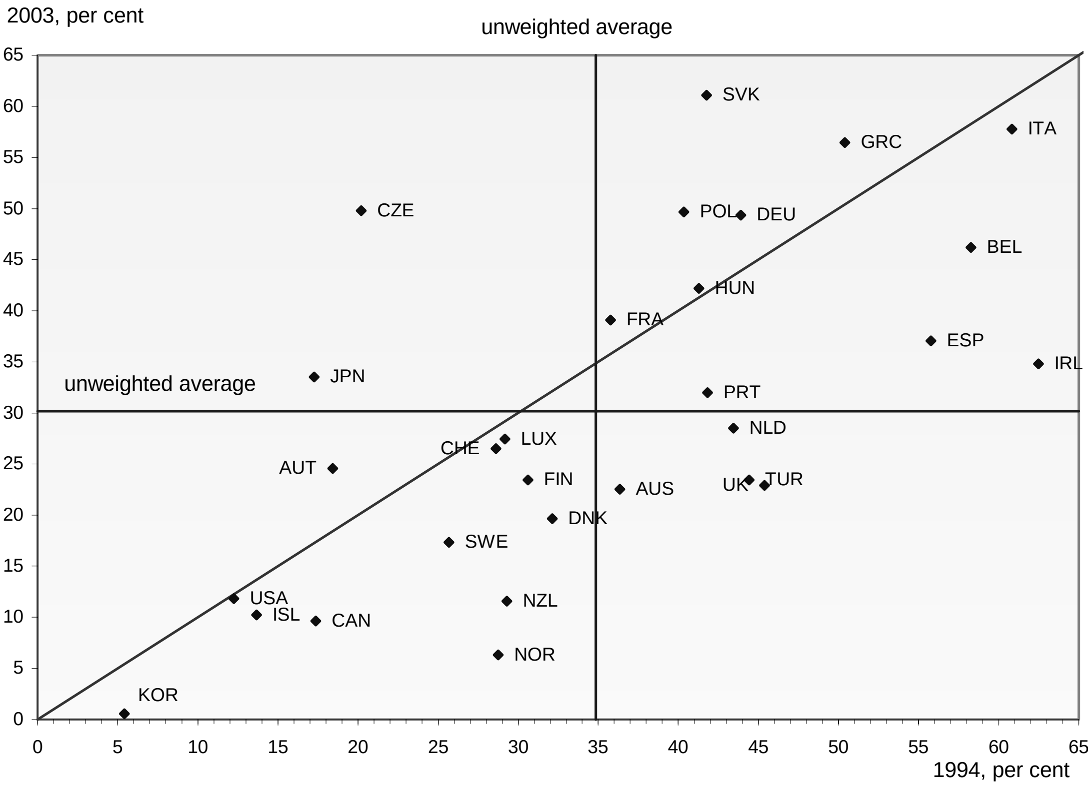


Panel B. **Aggregate unemployment rates**



1. 1992 for Denmark, Greece, Iceland, Luxembourg, Netherlands, Portugal and Turkey.

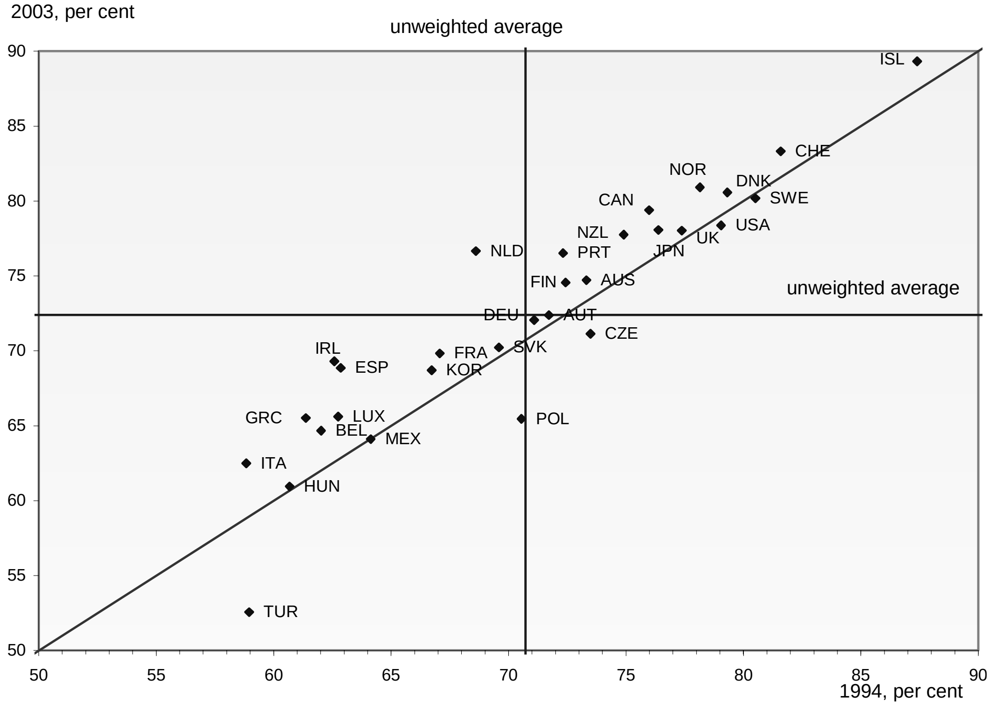
Figure 2. **Incidence of long-term unemployment[1] in OECD countries, 1994-2003**



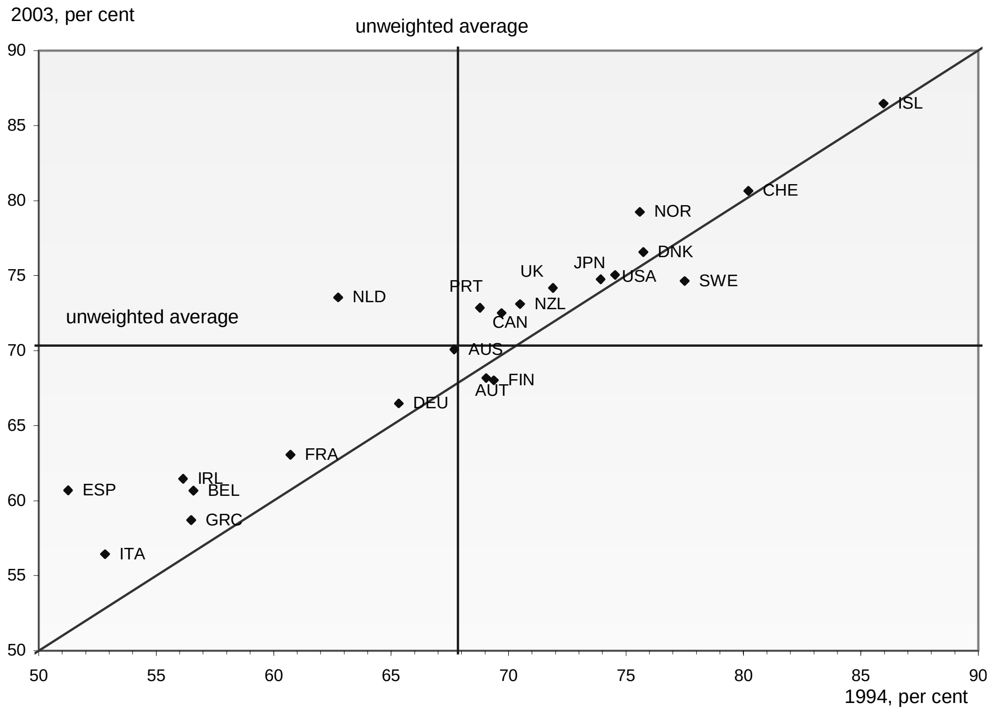
1. Those continously unemployed for 12 months and more as a percentage of total unemployment.

Figure 3. **Evolution of employment and participation in OECD countries, 1994-2003**[1]

Panel A. **Aggregate participation rates**

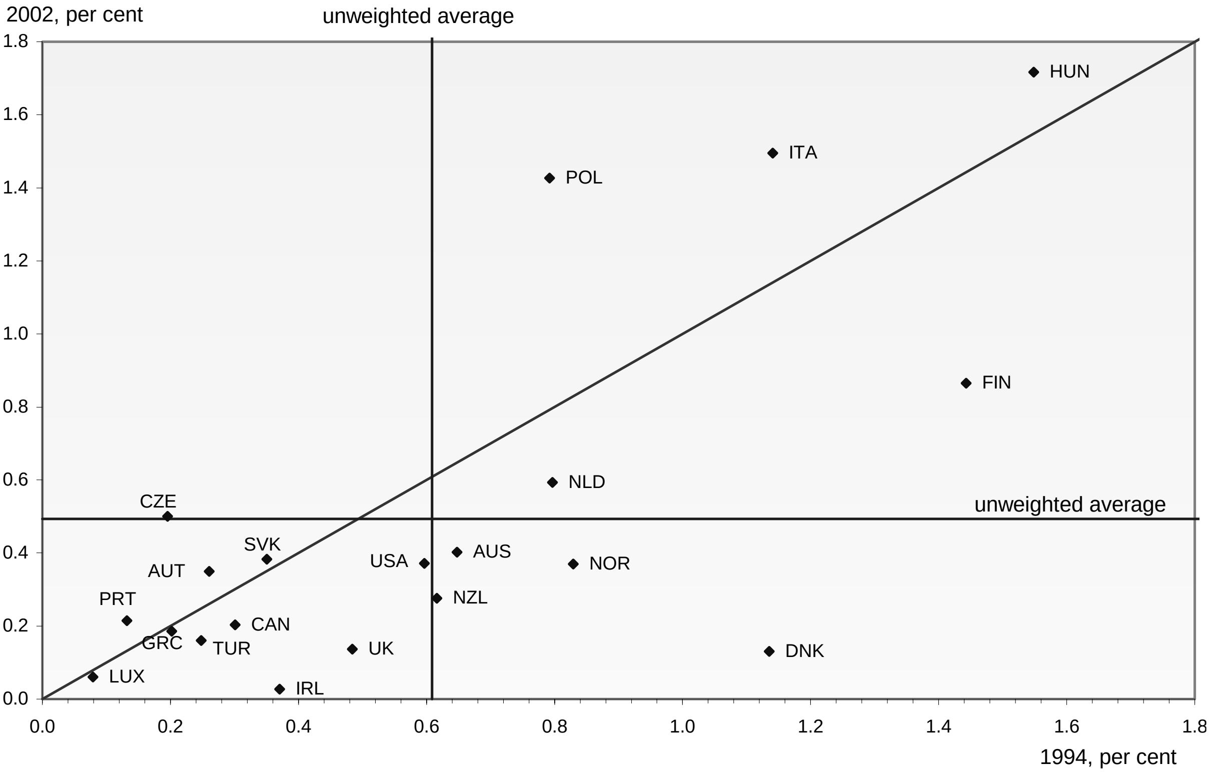


Panel B. **Cyclically-adjusted employment rate**[2]



1. 2002 for Iceland and Luxembourg.
2. Estimated by controlling for the output gap and smoothed by using a Hodrick-Prescott filter.

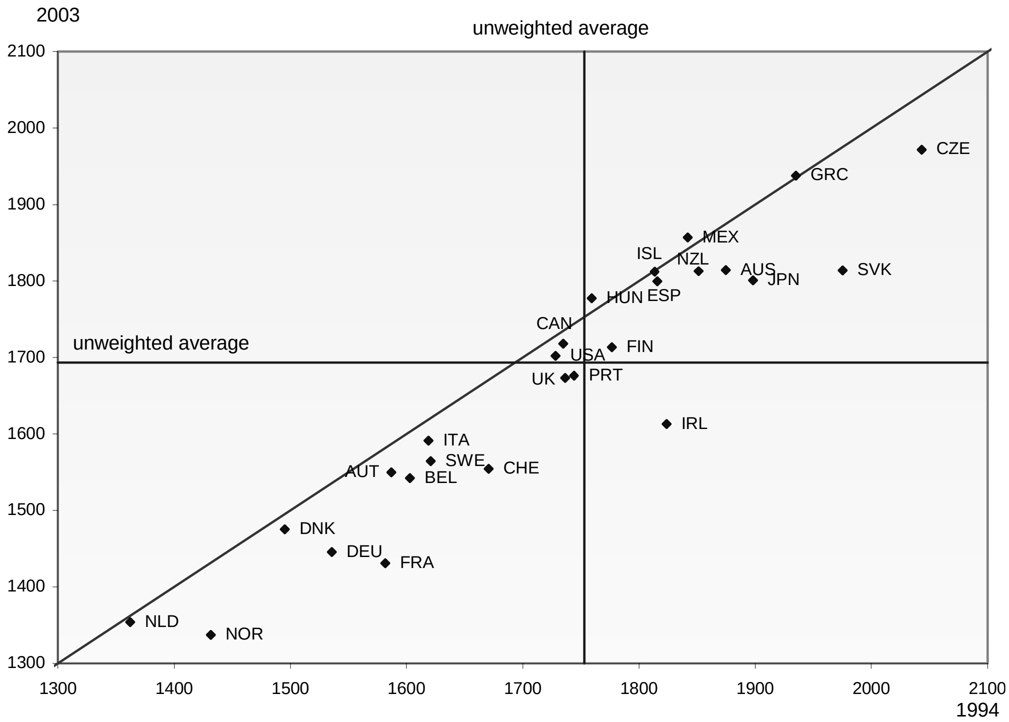
Figure 4. **Number of discouraged workers[1] as a proportion of working-age population, 1994[2]- 2002[3]**



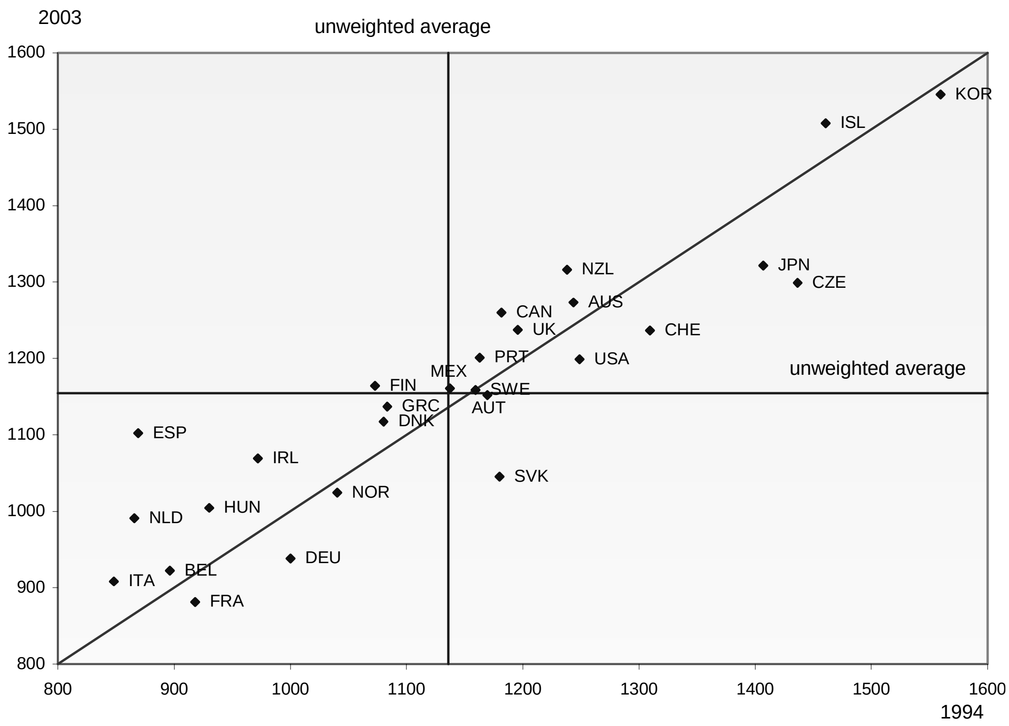
1. Persons not in the labour force who desire to work but believe that there is no work available due to various reasons.
2. 1995 for Austria, Finland and Hungary.
3. 2001 for United States.

Figure 5. **Labour utilisation, 1994[1]-2003**

Panel A. **Annual hours worked per worker**



Panel B. **Annual hours worked per person at working age[2]**



1. 1995 for Austria.
2. 15-64 or 16-64 age group.

8. Not all segments of the working-age population were affected by these trends in the same way. Some groups -- youth, women and older workers -- have always had lower attachments to the job market than prime-age men and developments during the past decade have been contrasting for the different groups:

- In a majority of OECD countries, youth unemployment has risen relative to the unemployment rate of prime-age males (Figure 6).[6] With the exceptions of France, Ireland, the Netherlands, and some Nordic countries, this development has been accompanied by lower youth participation in the labour market relative to that of prime-age men (Figure 7). In fact, youth participation continued to decline in absolute terms during the past decade, reflecting mainly young people spending a longer time in education.

- In contrast, relative female unemployment rates dropped in many OECD countries (Figure 8). Exceptions to this general pattern were recorded in the Central European and Nordic countries, as well as in Greece, Korea, Luxembourg, Spain and the United Kingdom. These changes took place in the context of an overall and substantial increase of female participation (Figure 9), partly reflecting the higher work propensity of younger female cohorts (except in some Central European countries and Sweden).

- Unemployment rates of older workers (Figure 10) have declined on average in OECD relative to the rates of prime-age males. The evolution across countries has been mixed, with substantial drops in Belgium, Central European countries, Iceland and Switzerland contrasting with large increase in relative unemployment in Austria, France, Korea, the Netherlands, New Zealand, Spain and Sweden. At the same time, relative participation rates of older workers (Figure 11) have increased during the past decade in a majority of countries and for the OECD average as a whole.

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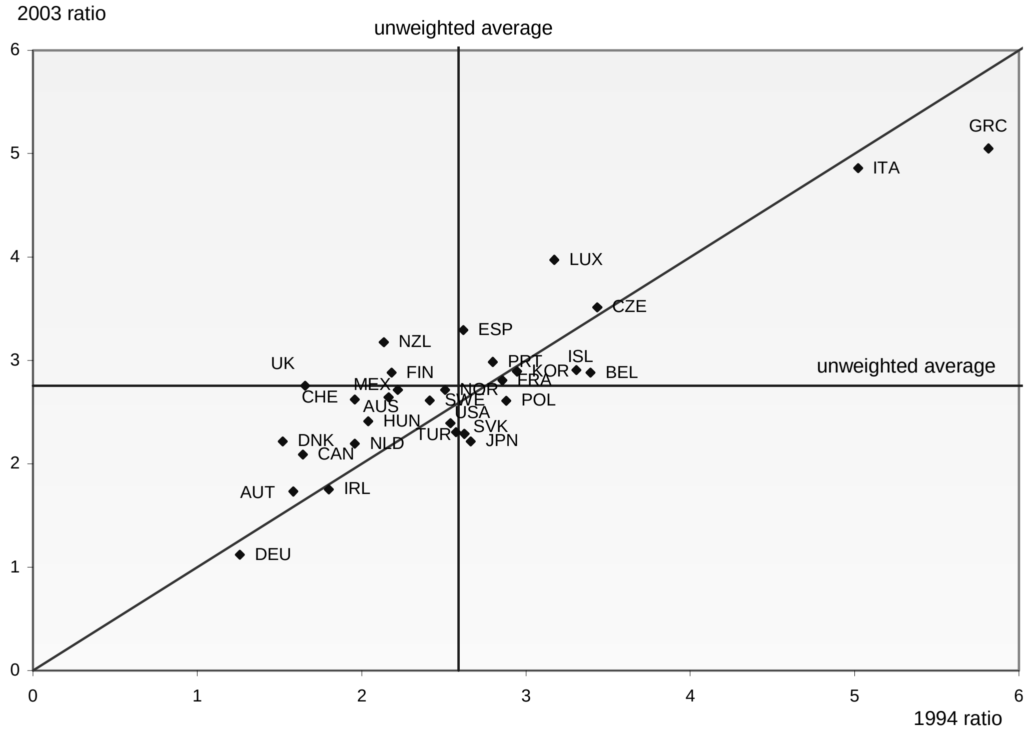
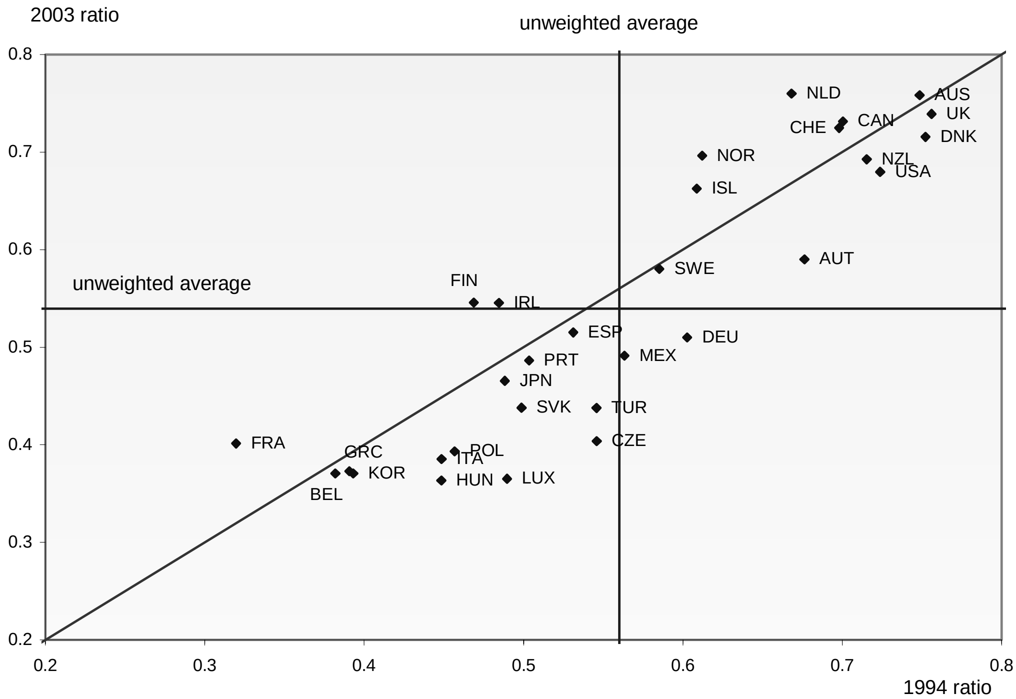
6. Relative indicators aim at controlling for the impact of changes in general labour market conditions on group-specific unemployment rates. The general conditions can be captured by the unemployment rate of the group that is most closely attached to the labour market, i.e. prime-age males. Relative indicators can be expressed in terms of gaps (differences) or ratios. This paper uses ratios, though both methods have their advantages and disadvantages. Glyn and Salverda (2000) have argued that unemployment gaps are more appropriate to measure the probabilities of one group, youth for instance, of being unemployed relative to the reference group. However, there is evidence that gaps vary systematically with the overall unemployment rate. For instance, youth unemployment rates are typically more sensitive to the cycle than unemployment rates of prime-aged men. Layard, Jackman and Nickell (1991) show that if wages of individual groups vary logarithmically with group-specific unemployment rates, then relative wages are unchanged when unemployment ratios are unchanged. In this sense, changes in unemployment ratios represent deviations from neutrality.

Figure 6. **Youth[1] unemployment rates (relative to prime-age men), 1994-2003[2]**



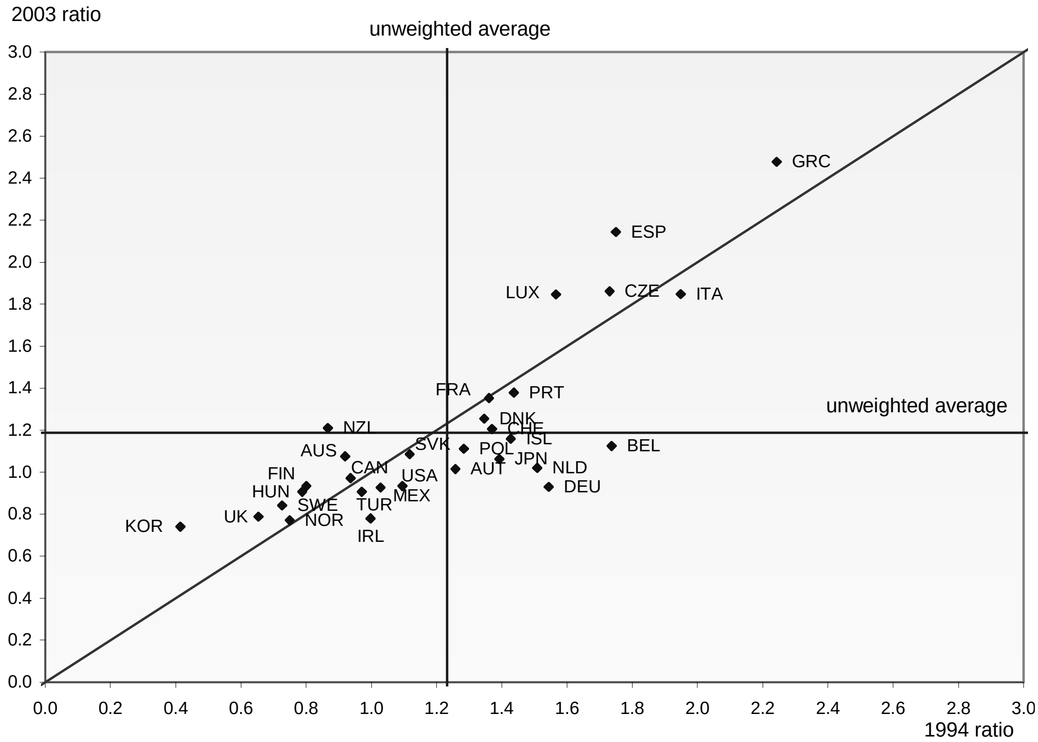
1. 15-24 or 16-24 age group.
2. 2002 for Iceland and Luxembourg.

Figure 7. **Youth[1] participation rates (relative to prime-age men), 1994-2003[2]**



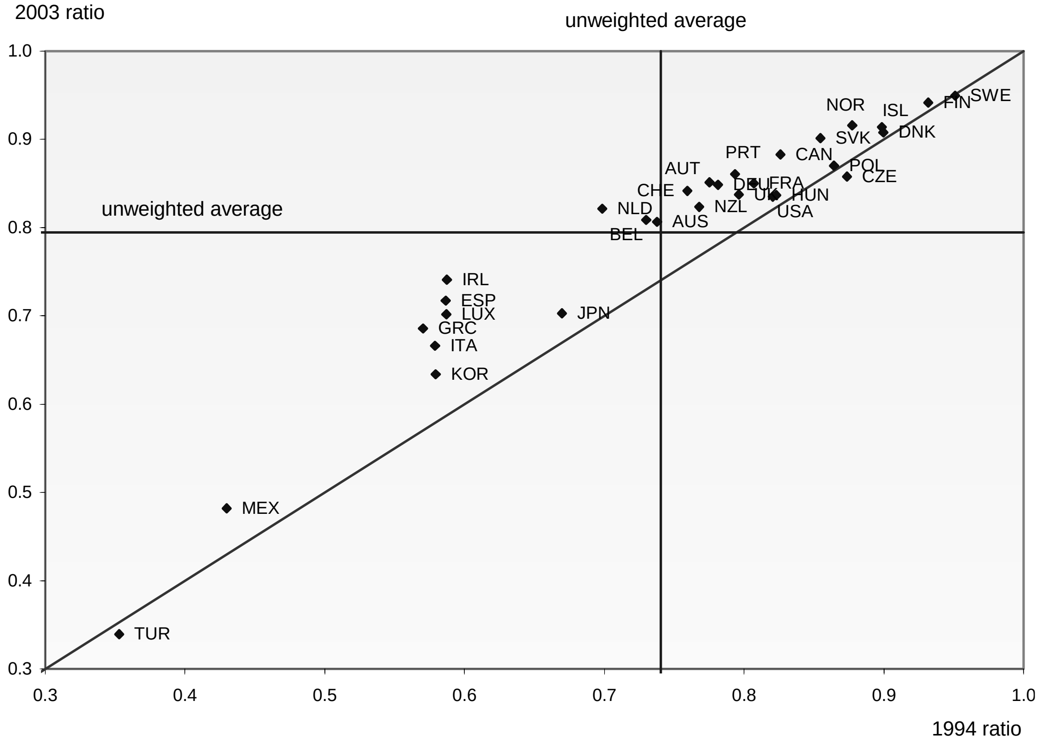
1. 15-24 or 16-24 age group.
2. 2002 for Iceland and Luxembourg.

Figure 8. **Female unemployment rates (relative to prime-age men), 1994-2003**[1]



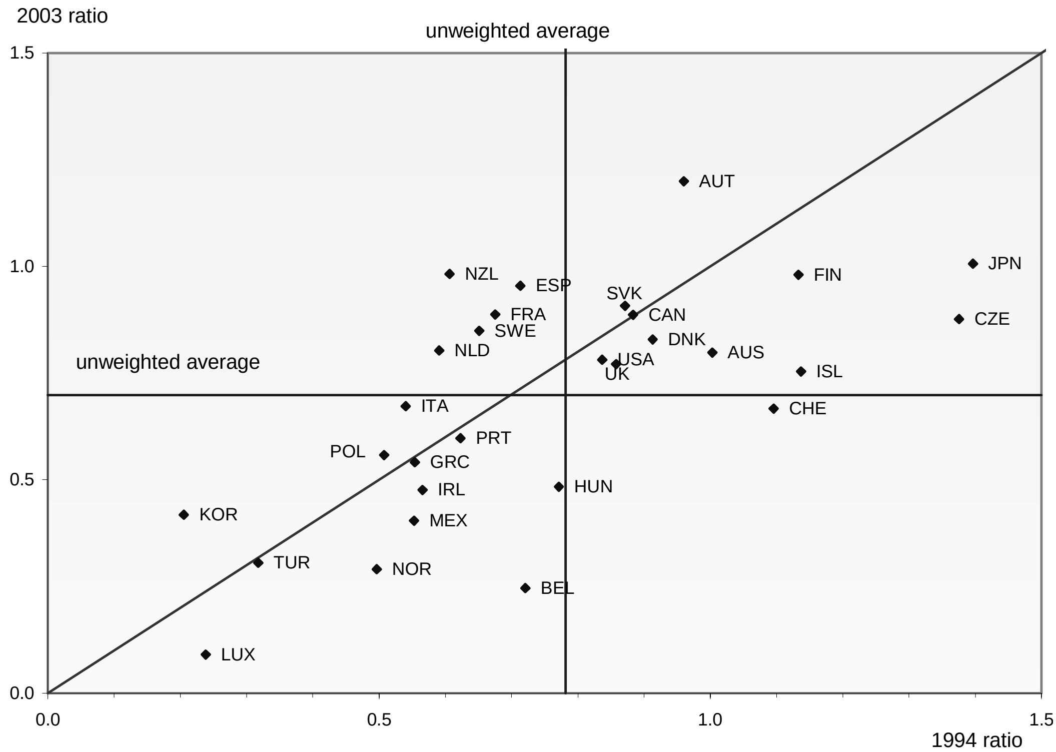
1. 2002 for Iceland and Luxembourg.

Figure 9. **Female participation rates (relative to prime-age men), 1994-2003**[1]



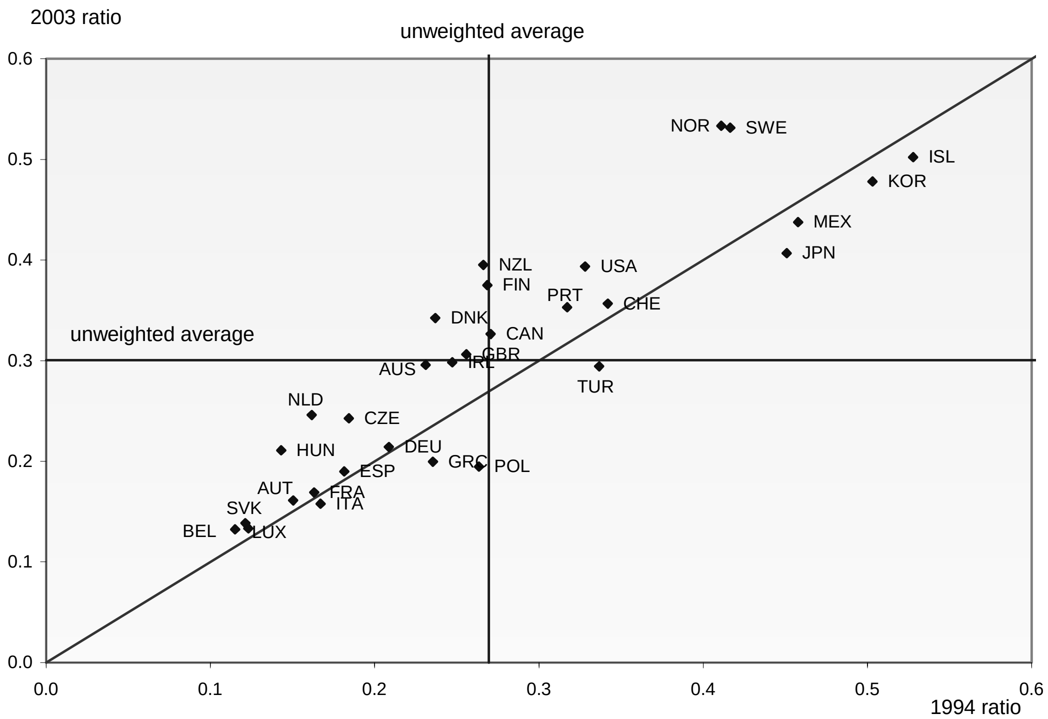
1. 2002 for Iceland and Luxembourg.

Figure 10. **Unemployment rates of older workers (relative to prime-age men), 1994-2003**[1]



1. 2002 for Iceland and Luxembourg.

Figure 11. **Participation rates of older workers (relative to prime-age men), 1994-2003**[1]



1. 2002 for Iceland and Luxembourg.

9. In the absence of data on changes in inequality of lifetime incomes, it is difficult to assess in a systematic way whether the changes in labour market performance described above have been associated with changes in inequality. However, on the basis of static annual data, a preliminary analysis suggests little systematic relationship:

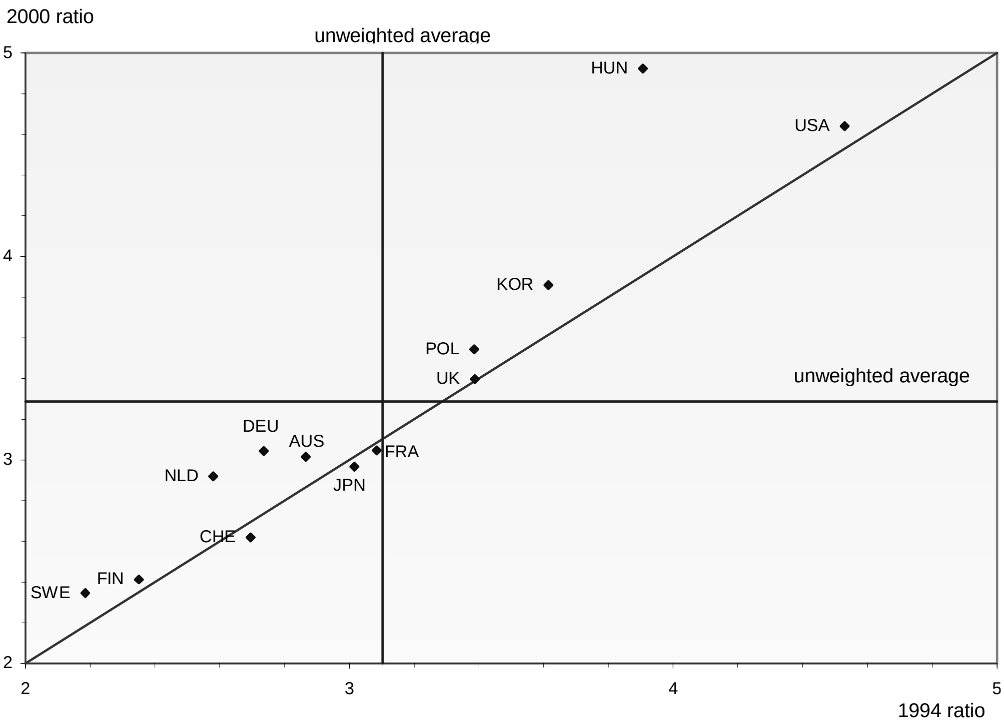
- Gross earnings inequality has increased on average in OECD countries for which data are available (Figure 12). This occurred in countries where labour market performance improved considerably (Australia, the Netherlands), as well as in countries where it deteriorated (Germany, Hungary, Korea and Poland). Broadly unchanged wage dispersion was recorded both in countries with deteriorating labour market performance (France, Japan and Switzerland) and in the United Kingdom where performance improved.

- Household inequality (calculated as the ratio of the highest to the lowest quintile) at the level of primary income (*i.e.* excluding taxes and transfers) did not develop in a consistent manner across the 15 countries for which data are available (Figure 13). This may suggest that, in general, changes in labour market conditions have offset the influence from earnings dispersion though other factors, such as changes in household formation, may also have played a role. The offset was particularly marked in Ireland, whereas in Australia better outcomes in the labour market have been associated with greater primary income inequality.

- Overall household inequality -- including taxes and transfers -- rose in more countries than it fell from 1995 to 2000 (Figure 14), with the re-distributive impact of taxes and transfers falling in most countries (Figure 15). Exceptions to the rise in overall inequality were recorded in Ireland, Italy and the United States, while the sharp rise in primary income inequality in Australia was offset by an equally sharp increase in the redistributive impact of taxes and transfers.

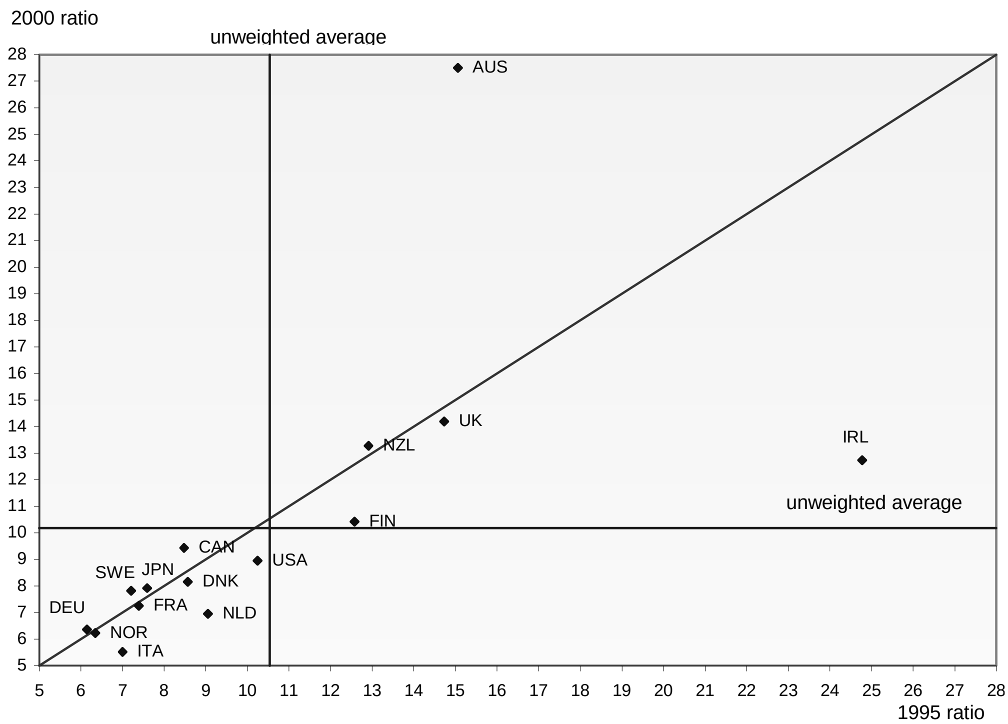
- Poverty rates, *i.e.* the proportion of the population with income below 50 per cent of the current median income, have risen marginally on average in the OECD area (Figure 16). Significant increases were recorded both in countries where labour market performance improved (*e.g.* Australia and Ireland) and in countries when performance deteriorated or remained weak (*e.g.* Belgium and Japan).

Figure 12. **Gross earnings inequality[1], 1994-2000[2]**



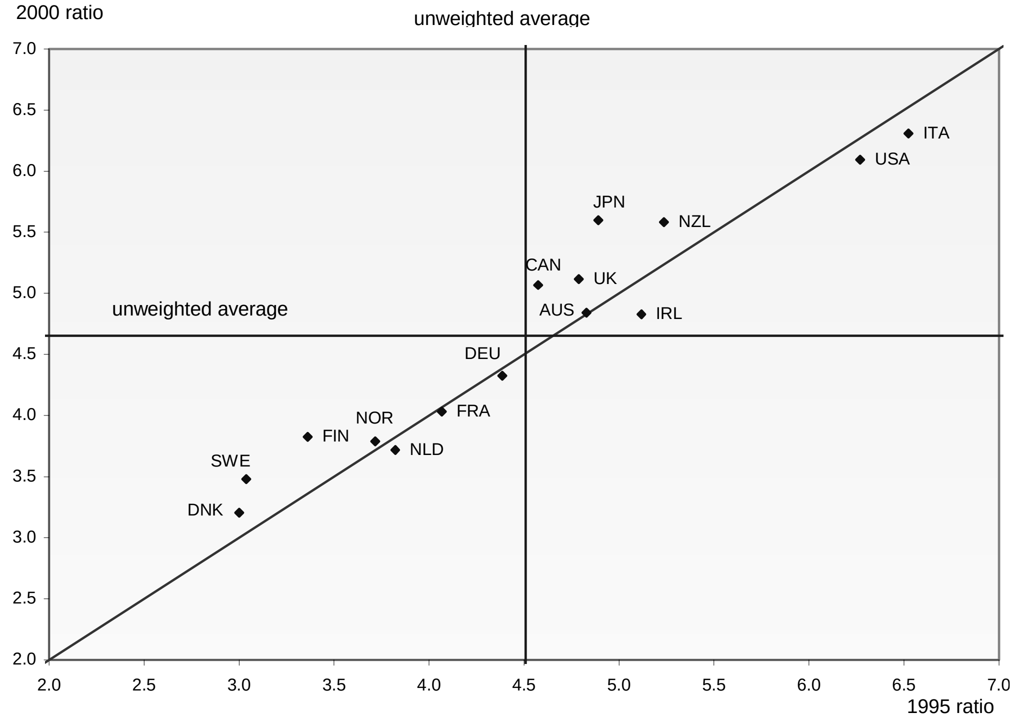
1. As measured by the ratio of the 90th to 10th percentile earnings.
2. 1998 for France and Germany, 1999 for Japan, Korea, Netherlands, Poland and Switzerland.

Figure 13. **Evolution of household inequality[1] before taxes and transfers across OECD countries, 1995-2000**



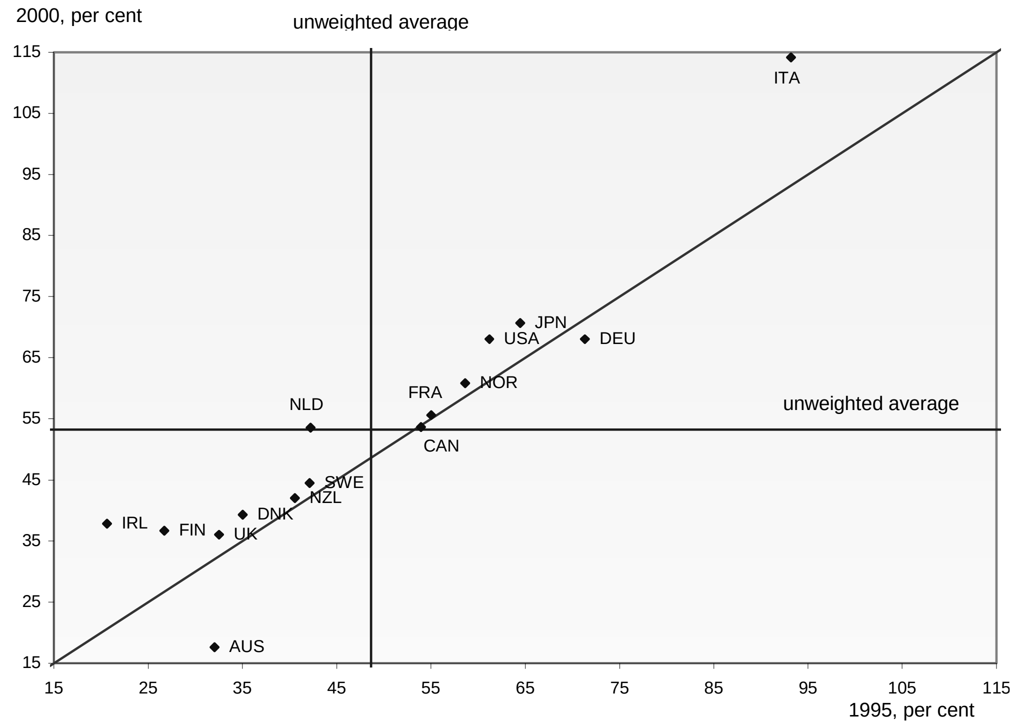
1. Calculated as the ratio of the highest to the lowest quintile earnings.

Figure 14. **Evolution of household inequality[1] including taxes and transfers across OECD countries, 1995-2000**



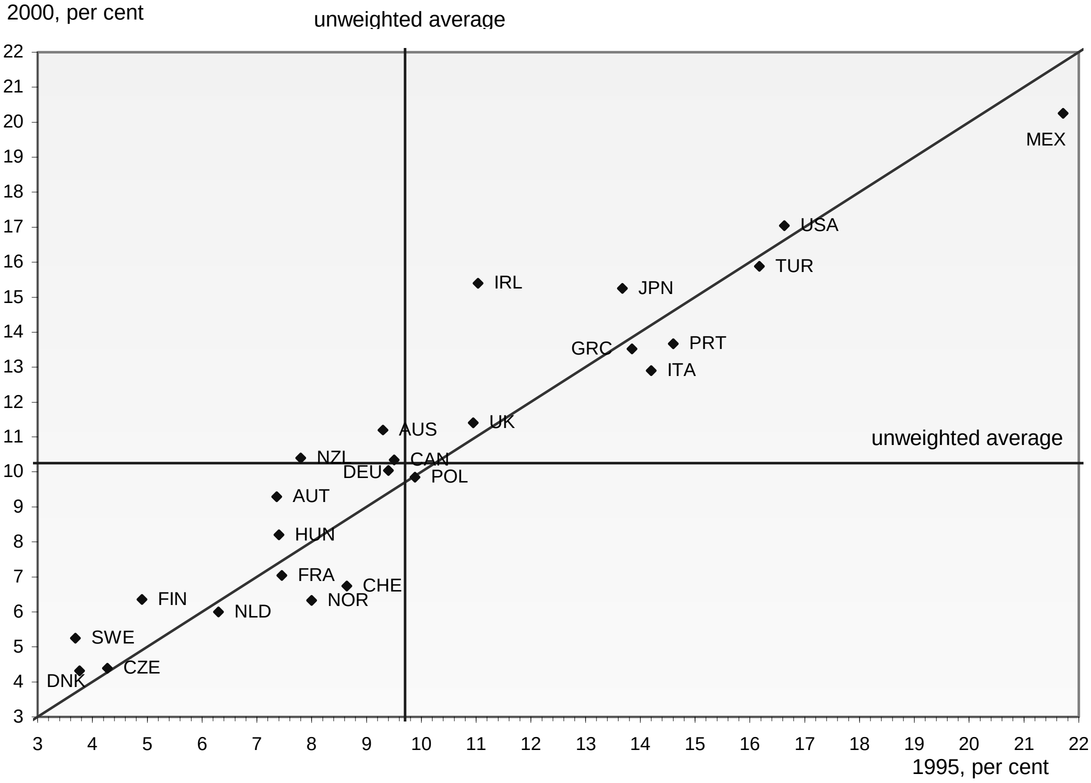
1. Calculated as the ratio of the highest to the lowest quintile earnings.

Figure 15. **Impact of taxes and transfers on inequality[1] across OECD countries, 1995-2000**



1. Calculated as the household inequality including taxes and transfers (Figure 14) as a percentage of the inequality before taxes and transfers (Figure 13).

Figure 16. **Poverty rates[1] among the entire population, 1995-2000**



1. Calculated as the proportion of the population with income below 50 per cent of the current median income.

SECTION 3. POLICY REFORMS SINCE 1994

10. This section provides a comprehensive description of changes in labour market policies grouped into seven broad areas, following the classification employed in OECD (1999). For each area, the following sub-sections briefly summarise the considerations underlying the initial JS recommendations and review the history of reforms. In addition, two sub-sections deal with reforms aimed at enhancing product market competition and macroeconomic policy. Background material for this section, including a review of main reforms for each country, is provided in Annex 2.

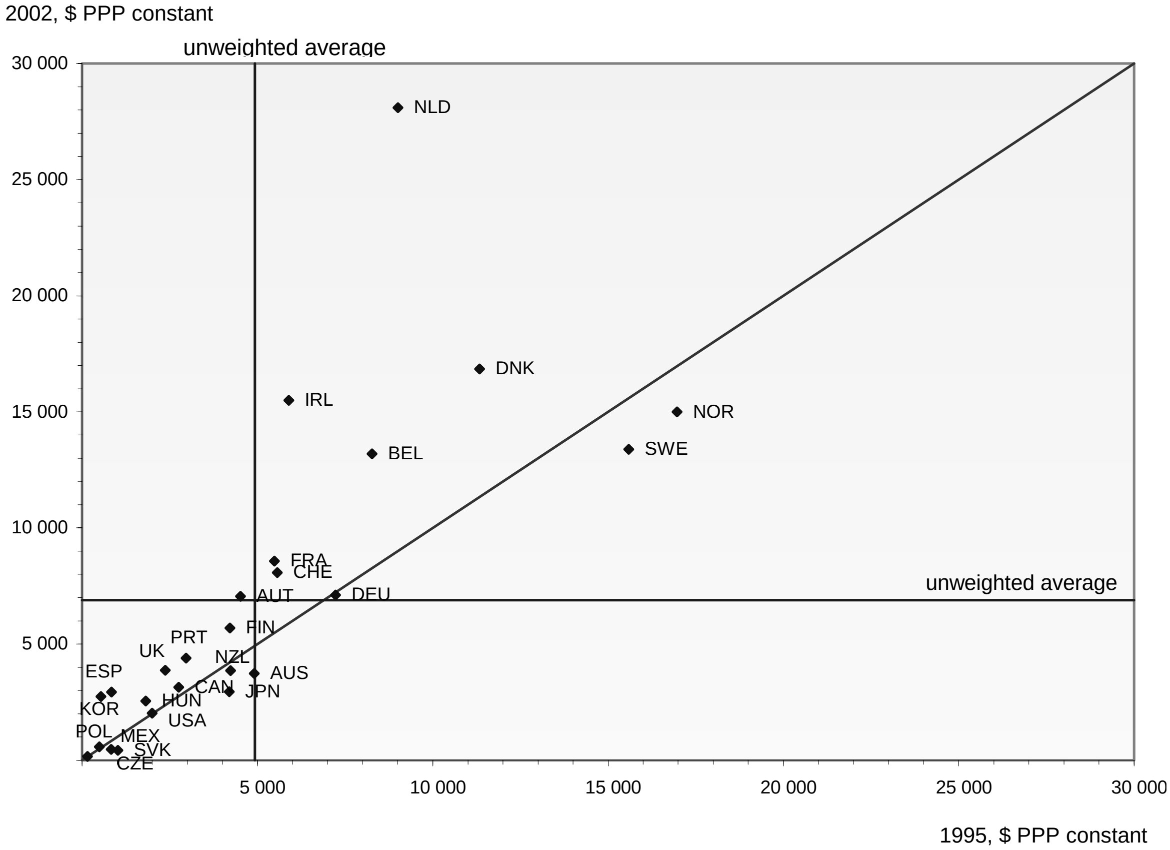
3.1 Labour market reforms

3.1.1 Active labour market policies

11. Properly designed active labour market policies (ALMPs) can reduce unemployment by improving the efficiency of the job-matching process and by enhancing the work experience and skills of those who take part in them. If the programmes succeed in intensifying job search and skill enhancement, they tend to benefit most those groups with the least stable employment histories, *e.g.* youth, women and low-skilled workers. In practice, however, the effectiveness of ALMPs has been found to differ significantly between different types of programmes. In particular, the outcomes of public job creation and wage subsidy programmes, which often entail large dead-weight losses (subsidised jobs are created that would have been created even without the subsidy) and substitution effects (workers who qualify for a subsidy replace others who do not), have often been disappointing in terms of bringing the unemployed back into unsubsidised work (Martin, 2000). While empirical macroeconomic studies fail to agree on the direction or the magnitude of effects from aggregate ALMP spending on aggregate unemployment (Layard *et al.*, 1991; Nickell, 1997, 1998; Scarpetta, 1996), microeconomic studies find a positive impact for some types of programmes, but not for others (Martin, 2000; Morgan and Mourougane, 2001). Furthermore, any beneficial effects of ALMPs need to be weighted against the costs of taxes required to finance them, which may in turn increase unemployment. Moreover, certain programmes may reduce search efforts, if not properly designed, and in the case where participation in ALMPs represents a more attractive alternative than open unemployment (financially or possibly with respect to the stigma associated with alternatives), they can augment wage demands (Calmfors and Forslund, 1991).

12. Figure 17 shows the extent of active labour market spending per unemployed person in those OECD countries for which data were available in 1995 and 2002. Spending on ALMPs was comparatively high in 1995 in Belgium, the Netherlands and the Nordic countries, while it was significantly lower in Canada, the United Kingdom and the United States, and, especially so, in the Central European countries, Korea, Mexico, and Spain. A few countries, including Belgium, Denmark and the Netherlands raised their spending on ALMPs per unemployed person from an already high level. Austria, France, Ireland and Switzerland increased it from a more intermediate level.

Figure 17. **Spending on active labour market policies per unemployed person in OECD countries: 1995-2002**



13. Reforms in many OECD countries over the past decade have been geared towards evaluating labour market policies with the aim of concentrating on the most effective programmes, rather than raising ALMP spending per unemployed person. Reforms have concentrated on four broad areas (Table 1):

– *Enhanced placement efforts of the Public Employment Service (PES).* A number of countries (*e.g.* Australia, Canada, Germany, the Netherlands, New Zealand, and Norway) introduced profiling and/or individual action plans aimed at providing the appropriate mix of counselling, training and other active measures to bring each jobseeker quickly back into unsubsidised work. Customised assistance with intensive support for the long-term unemployed and other weak groups was another widespread measure. In many countries enhanced job-search assistance involved more frequent and intense contacts with the PES serving to monitor job-search activities.

– *Greater emphasis on testing and monitoring work availability*. Many member countries introduced stricter or more strictly enforced job-search requirements. A few countries (New Zealand, Norway, Poland and Sweden) have aimed to exploit interactions between ALMPs and reforms to unemployment benefit systems *via* an increasing use of ALMP programmes as a work availability test.

– *Increased activation of the unemployed.* Along the same lines, almost half of all member countries have recently employed ALMP measures to activate jobseekers early in the unemployment spell to prevent a loss of skills or damage to their motivation as a result of long-term unemployment. Compulsory activation, introduced by a few member countries (Australia, Denmark, Sweden, Switzerland and the United Kingdom), goes even further by making benefit receipt dependent on participation in an activation measure after some time has elapsed.

– *More efficient administration of PES activities.* Recognising that it seems to be important to tie active labour market programmes closely to the obligation of job search and ensuing benefit eligibility, a number of OECD member countries improved the collaboration between agencies administering different benefits and public placement services, while others have integrated them completely. In an effort to seize the benefits of the market mechanism and thus improve the efficiency of placement, Australia made its employment placement services contestable, while outsourcing most of its labour market programmes. More recently, some other member countries (such as Denmark and the Netherlands) have also engaged in contracting out placement services and/or active labour market programmes.

In EU countries, some of these measures, notably early activation and individual action plans, have been introduced following EU guidelines.

Table 1. **Active labour market policies:**
Policy reforms over the 1994-2004 period[1]

	More evaluations	Overall increase of activation: through more intense job search	Overall increase of activation: through individual action plans/profiling	Overall increase of activation: + job search monitoring	Public Employment Service: Closer link with benefit administration through: Increased cooperation	Public Employment Service: Closer link with benefit administration through: Integration	Public Employment Service: More competition through: Contestability of placement	Public Employment Service: More competition through: Contracting out of ALMPs	Increased use of ALMPs as: Work availability test	Increased use of ALMPs as: Early activation: In general	Increased use of ALMPs as: Early activation: Compulsory
Australia	+		+	+	+		+	+			+
Austria		+	+								
Belgium	+		+		+					+	
Canada	+		+								
Czech Republic	+			+							
Denmark	+		+	+	+			+			+
Finland	+		+		+					+	
France	+	+	+		+					+	
Germany	+		+			+		+		+	
Greece	+		+				+			+	
Hungary	+	+					+				
Iceland			+	+		+					
Ireland	+		+			X[3]				+	
Italy		+					+				
Japan		+				+					
Korea		+				+					
Luxembourg			X[2]							+	
Mexico		+									
Netherlands	+		+		+		+	+		+	
New Zealand	+		+	+		+		X[4]	+		
Norway	+	+	+				+	+			
Poland	+	+							+		
Portugal	+	+					+			+	
Slovak Republic		+									
Spain		+							+		
Sweden	+		X[2]								+
Switzerland	+		+								+
Turkey		+									
United Kingdom	+		+	+		+					+
United States	+	+				+					

1. + : reforms following the Jobs Strategy.
2. For vulnerable groups only.
3. Integration of local and national employment services.
4. Some services for Maori and Pacific Island Jobseekers.
Source: OECD *Economic Surveys.*

3.1.2 Labour Taxes

14. High labour taxes are generally expected to have an adverse impact on labour market outcomes and such concerns have prompted reforms in this area. By driving a wedge between marginal productivity and the reward for work, high tax rates tend to depress labour supply and effort.[7] To the extent that high personal income taxes translate into higher wages as wage earners succeed in shifting the tax burden onto employers, the resulting increase in labour cost will have adverse effects on employment conditions. Similar considerations apply to high payroll taxes or employers' social security contributions which are even more likely to raise labour costs in the presence of wage floors created by other policies. On the other hand, if employers succeed in shifting such taxes onto employees in the form of lower wages, this may have a negative effect on labour supply -- in particular in the case of low-wage earners -- as the real take-home wage decreases. In any case, a high tax burden on labour creates an incentive to resort to the shadow economy.[8] A number of empirical studies have found that high labour taxes tend to increase unemployment rates (Belot and van Ours, 2000; Nickell, 1997), although other studies are less conclusive (Scarpetta, 1996; Nunziata, 2003; Macculloch, and DiTella (2002)). Daveri and Tabellini (2000) find a particularly strong impact in countries with powerful trade unions and a low or intermediate degree of centralisation/co-ordination of the wage bargaining process**,** and Elmeskov *et al.* (1998) also find notably large effects in countries with intermediate centralisation/co-ordination. This suggests that such an environment allows trade unions to compensate for higher taxes by successfully pushing for higher wages.[9]

15. Government revenue components that are relevant for labour market outcomes include all taxes and charges that are not paid in exchange for direct government provision of goods, services and transfers to the individual taxpayer. Personal income taxes clearly fall into that category, together with indirect taxes levied on goods and services. However, it is less clear how contributions to public social security schemes should be treated. To the extent that they are perceived by employees as giving rights to future transfers, they would resemble compulsory savings or insurance contributions more than a tax, with a potentially very different impact on employees' incentives to supply labour. Thus, the relevant tax components for labour market outcomes depend on specific design features and may not always be the same for different countries. In practice, it is difficult to divide social security contributions into taxes, compulsory saving and insurance premia.[10] Therefore, in the indicators presented below all contributions are treated as taxes.

16. The relevant tax measure also differs depending on what aspect of labour market performance is being considered. Thus, average tax wedges are the most important determinants for individual incentives concerning the choice whether to work or not, while marginal tax rates influence the decision to supply a little more or less labour. Likewise, the average tax burden is likely to influence employers' incentives to hire, while marginal tax wedges have an influence on the decision to pay a slightly higher or lower wage or demand an extra hour of work or not. For analysing unemployment and labour force participation, the role of average tax wedges is arguably more relevant. It should be noted that in-work benefits, such as tax credits for low incomes, which have been introduced in a number of member countries to reduce average tax wedges for low incomes and thus enhance incentives to work, come almost inevitably at the price of

7. See OECD (2004a).

8. However, high tax rates per se do not appear to influence levels of undeclared work across countries and time, see OECD Employment Outlook 2004.

9. The likely implications of different wage bargaining systems for wage claims are discussed in more detail below.

10. Disney (2004) attempts to divide contributions into tax and premia contributions.

Table 2. **Labour taxes and social security contributions: Policy reforms over the 1994-2004 period**[1]

	Reductions for all incomes		Targeted reductions for low incomes	
	Overall	Payroll taxes	Overall	Payroll taxes
Australia	+	-	+	
Austria	+		+	
Belgium	+		+	+
Canada	+	[+, -]	+	
Czech Republic	+			-
Denmark	X[2]	[+, -]	X[2]	
Finland	[+, -]	[+, -]	+	
France	+	[+, -]	+	+
Germany	+	[+, -]	+	[+, -]
Greece	[+, -]		[+, -]	+
Hungary	+	[+, -]	[+, -]	
Iceland	[+, -]	[+, -]		
Ireland	+	+	+	+
Italy	+	+	+	+
Japan	+	-		
Korea	+	[+, -]	+	
Luxembourg	+	[+, -]	+	
Mexico	[+, -]	[+, -]	+	-
Netherlands	+	[+, -]	+	[+, -]
New Zealand	[+, -]		+	+
Norway	[+, -]	-	+	
Poland	[+, -]	-	[+, -]	
Portugal	+	[+, -]	+	
Slovak Republic	+	+	[+, -]	
Spain	+	X[3]	+	
Sweden	[+, -]	[+, -]	+	
Switzerland		[+, -]		
Turkey	[+, -][4]	-	[+, -]4	
United Kingdom	+	+	+	+
United States	+		+	

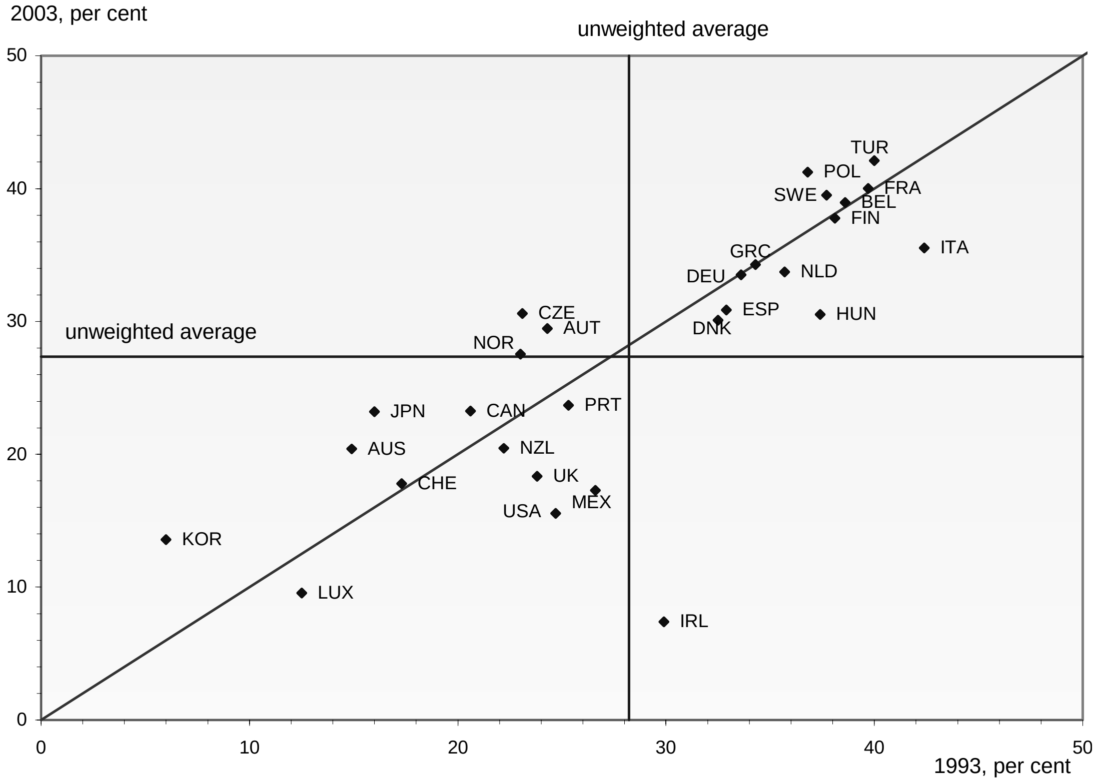
1. + : reforms following the Jobs Strategy;
 - : reforms contrary to the Jobs Strategy;
 [+, -] : reform elements going in different directions.
2. Tax reductions at the national level have been counteracted by increases at the local level.
3. Reductions for new permanent contracts.
4. Large increases in tax wedges through bracket creep as a result of high inflation.

Source: OECD *Economic Surveys.*

raising marginal tax rates in those income ranges where the benefit is phased out (as well as in those income ranges where taxes are higher than they would be otherwise in order to finance the scheme), thus impinging on incentives to work more or to attain slightly higher wages for workers within these income ranges.

17. Figure 18 shows that countries with a relatively high direct labour tax burden[11] on average incomes in 1993 included Belgium, Finland, France, Hungary, Italy, Poland, Sweden, Turkey and, to a somewhat lesser degree, Germany, Greece and the Netherlands. Direct tax wedges at this income level were below average for all English-speaking countries (except Ireland) and especially low in Japan, Korea, Luxemburg and Switzerland. This picture is similar for the labour tax burden on lower incomes (Figures 19, 20 and 21).[12] In all cases, the exclusion of indirect taxes in the tax wedge indicators tends to bias downwards the result, particularly in countries where indirect taxes are high, such as in the Nordic countries.

Figure 18. **Tax wedge, couple (100% and 0% of APW[1]) with 2 children, 1993[2]-2003[3]**

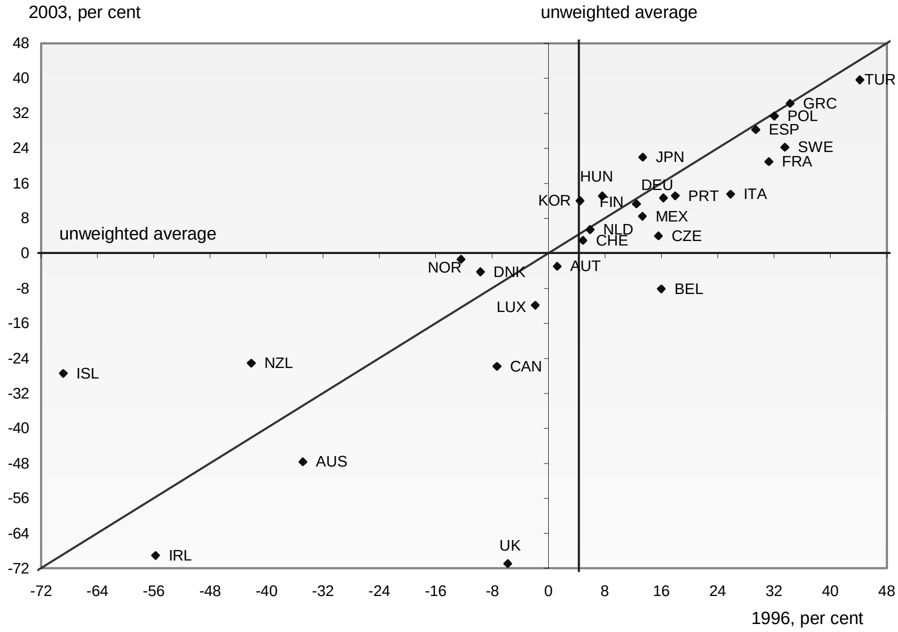


1. Average production worker income.
2. 1994 for France, 1995 for Hungary and Korea.
3. Some of the apparent changes in the tax wedge are due to changes in methodology for Australia, Austria, Czech Republic, Finland, Germany, Hungary, Italy, Japan, Mexico and Netherlands.

11. The measure includes personal income taxes, as well as employers' and employees' social security contributions, minus cash benefits. The relevance of the latter for employment depends mainly on whether or not they are available for benefit recipients as well. Again, this depends on specific design features and may differ from country to country. The measure does not include indirect taxes.

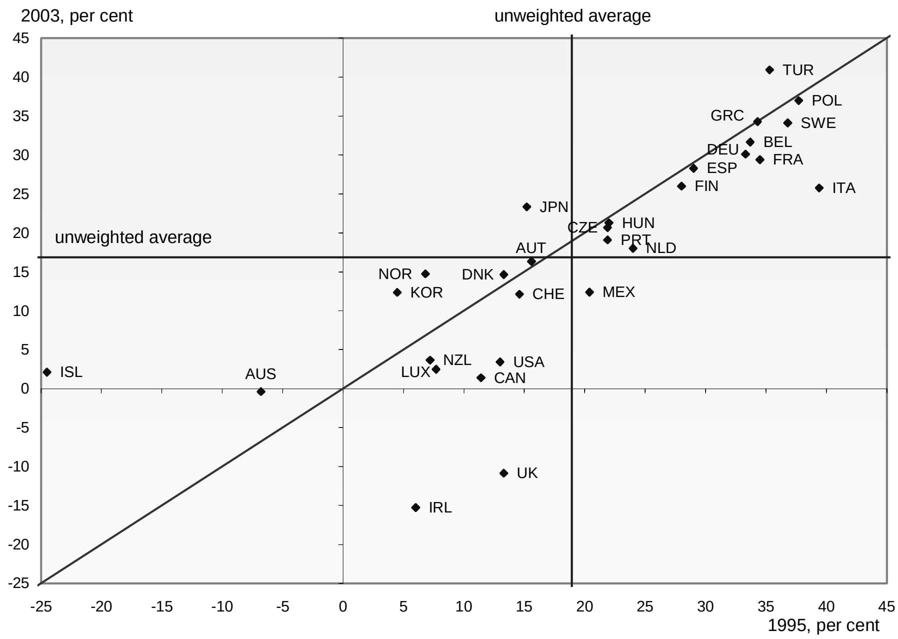
12. Negative tax wedges reported in these figures reflect tax credits and child benefits in excess of any taxes.

Figure 19. **Tax wedge,[1] single earner (40% of APW[2]) with 2 children, 1996-2003[3]**



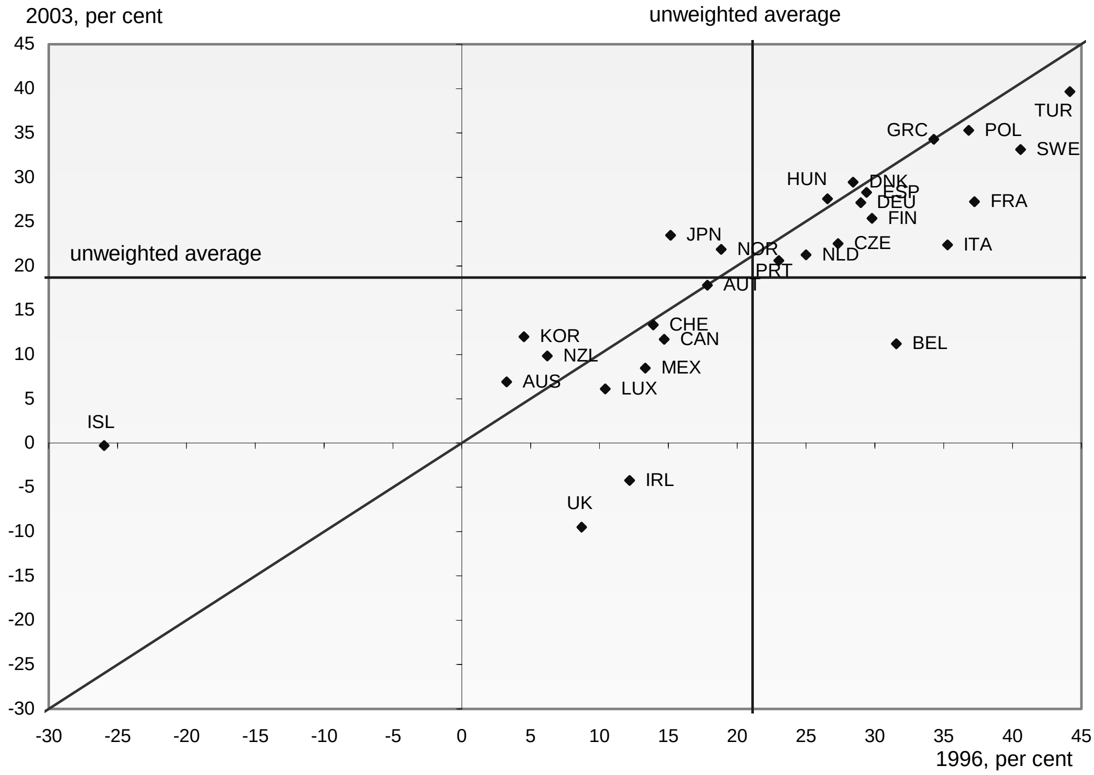
1. Negative tax wedges reflect tax credits and child benefits in excess of any tax paid.
2. Average production worker income.
3. Some of the apparent changes in the tax wedge are due to changes in methodology for Australia, Austria, Czech Republic, Finland, Germany, Hungary, Iceland, Italy, Japan, Korea, Mexico and the Netherlands.

Figure 20. **Tax wedge,[1] single earner (67% of APW[2]) with 2 children, 1995[3]-2003[4]**



1. Negative tax wedges reflect tax credits and child benefits in excess of any tax paid.
2. Average production worker income.
3. 1996 for Korea.
4. Some of the apparent changes in the tax wedge are due to changes in methodology for Australia, Austria, Czech Republic, Finland, Germany, Hungary, Iceland, Italy, Japan, Korea, Mexico and the Netherlands.

Figure 21. **Tax wedge,[1] couple (both earning 40% of APW[2]) with 2 children, 1996-2003[3]**



1. Negative tax wedges reflect tax credits and child benefits in excess of any tax paid.
2. Average production worker income.
3. Some of the apparent changes in the tax wedge are due to changes in methodology for Australia, Austria, Czech Republic, Finland, Germany, Hungary, Iceland, Italy, Japan, Korea, Mexico and the Netherlands.

18. Many OECD countries have made considerable efforts over the 1994-2004 period to lower the labour tax burden in general and on low incomes in particular:

– Average direct tax wedges on the income of the stylised average production worker have fallen in most member countries for which data are available, except in Iceland, Japan, Korea, and Norway where the tax wedge rose.[13] Tax wedges in Austria, Canada, the Czech Republic, France and Poland remained stable or increased slightly. Thus, while Table 2 indicates that over the course of the past ten years many countries have raised some taxes at some points in time and lowered the same or other tax components at others, the net effect has been a

13. In Korea and Japan, this was mainly due to increases in social security contributions. In Norway, personal income taxes increased along with social contributions. In Iceland, cash benefits were decreased along with increasing social contributions, although in this country an upward revision of the average production worker's income is partly responsible for the reported increase in the tax wedge. The reported increase in the tax wedge in Australia is mainly due to a methodological revision, as state payroll taxes were included for the first time in the calculation of the tax wedge in 2002. If changes in tax wedges result from changes in methodology, this is indicated in the tables in Annex 2.

decrease of average tax wedges in most cases. Tax cuts on average incomes have been particularly striking[14] in Hungary, Ireland, Italy, the United Kingdom and the United States. Efforts to lower the tax burden on labour were undertaken both in countries that had already taxed labour comparatively moderately in 1993 and in countries which at that time had relatively high tax wedges.

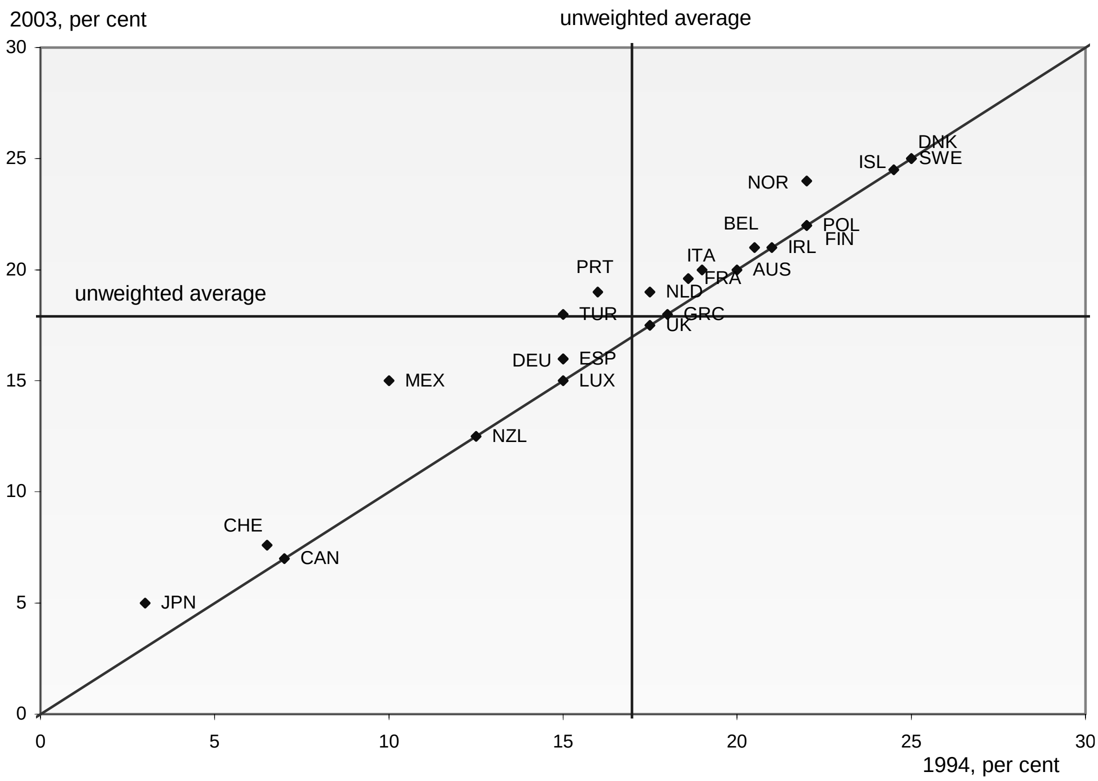
– Average direct tax wedges on very low labour income (defined as 40 per cent of the earnings of the average production worker, *i.e.* at or below full-time statutory minimum wages in many countries) have also shown a tendency to fall (Figure 19), often reflecting the introduction or strengthening of explicit "making-work-pay" policies. The largest cuts at this earnings level have taken place in Belgium, Canada and the United Kingdom. A few countries registered an increase in the tax wedge on very low incomes, as a result of an increase in net taxes (Japan and Korea) or reduced cash benefits (Iceland and Norway).

– Average direct tax wedges on moderately low incomes (at 67 per cent of the average production worker earnings) have also been reduced in a number of countries, the most profound cuts taking place in Ireland and the United Kingdom (Figure 20). Comparing Figure 18 with Figures 19 and 21 also shows that some countries with largely stable taxes on average incomes have targeted tax cuts on lower incomes, notably Belgium, Canada, France and Sweden. Again, countries that significantly decreased taxes on lower incomes included some that already had a relatively light labour tax burden for these income groups in 1996 and some that had higher taxes at that time. Figures 19 and 21 seem to suggest that some low-tax countries have engaged in tax cuts with even greater vigour than countries with higher taxes.

– A number of countries have increased value-added taxes over the past ten years, (Figure 22) including some where the direct labour tax burden had increased, such as Japan, and others that have reduced direct taxes on labour, including Italy and the Netherlands.

14. The large decrease in Mexico in Figure 18 is in part due to the fact that employers' contributions to privatised social security are no longer reported as taxes from 1999.

Figure 22. **Rates of value-added taxes, 1994-2003**



3.1.3 Employment Protection Legislation

19. Reforms to restrictive employment protection legislation (EPL) have been advocated on the grounds that it may have serious adverse effects, especially on the weakest groups in the labour market. Strict EPL constitutes a cost to firing workers, which entails disincentives to hiring in the first place. Thus, EPL can be expected to reduce both inflows to and outflows from unemployment, implying that its expected impact on the unemployment rate is ambiguous. Econometric estimates of the impact of EPL on the unemployment rate do not settle the matter either.[15] However, by reducing turnover, the job prospects for those with relatively weak attachment to the labour market, such as young workers and women, have been found to be compromised (OECD 2004a). As well, the incidence of long-term unemployment is likely to be boosted by restrictive EPL. Moreover, if wages are not sufficiently flexible to allow high dismissal costs to be reflected in lower wages, *e.g.* due to wage floors, the job prospects of low-wage workers will be adversely affected. By reducing turnover, strict EPL may also hamper the effectiveness of the Public Employment Service and other ALMPs aiming at re-integrating unemployed workers in the labour market. On the other hand, some degree of EPL may counteract the emergence of implicit contracts between workers and firms in industries with seasonal employment fluctuations to use unemployment insurance as part of the remuneration in what is effectively a continuous employment relationship.

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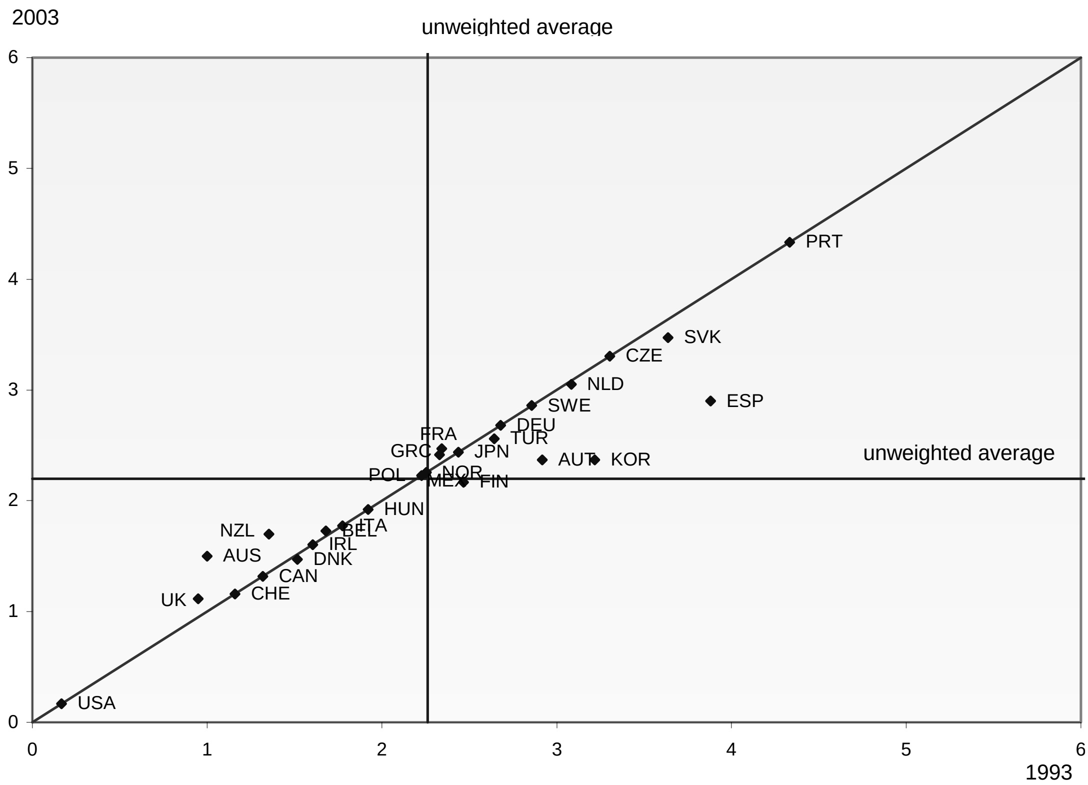
15. Scarpetta (1996) and Elmeskov et al. (1998) find a positive effect in some of their estimated equations, while Nickell (1997) and Nunziata (2003) find no significant effect. OECD (2004a) finds the depressing effect of EPL on employment to be stronger than the effect on aggregate unemployment.

20. There is some empirical evidence that in a setting where extensive employment protection for workers with permanent contracts coexists with lighter regulation for temporary contracts, wage pressure may increase to the extent that unions pursue mainly the interests of permanent workers (Bentolila and Dolado, 1994). The argument behind this is that the "insiders" on permanent contracts can raise their wage claims without much risk of job losses as any resulting negative effects on employment will be borne mainly by the "outsiders" who work on temporary contracts. Moreover, deregulated temporary contracts may merely increase the turnover in this segment of the labour market -- potentially implying disincentives to train the concerned workers -- without constituting a stepping stone to more permanent work relationships, as long as these remain costly to dissolve (Blanchard and Landier, 2002). These arguments have recently raised concerns that a deregulation of EPL focused on temporary contracts may not improve labour market performance (Dolado *et al*., 2002).

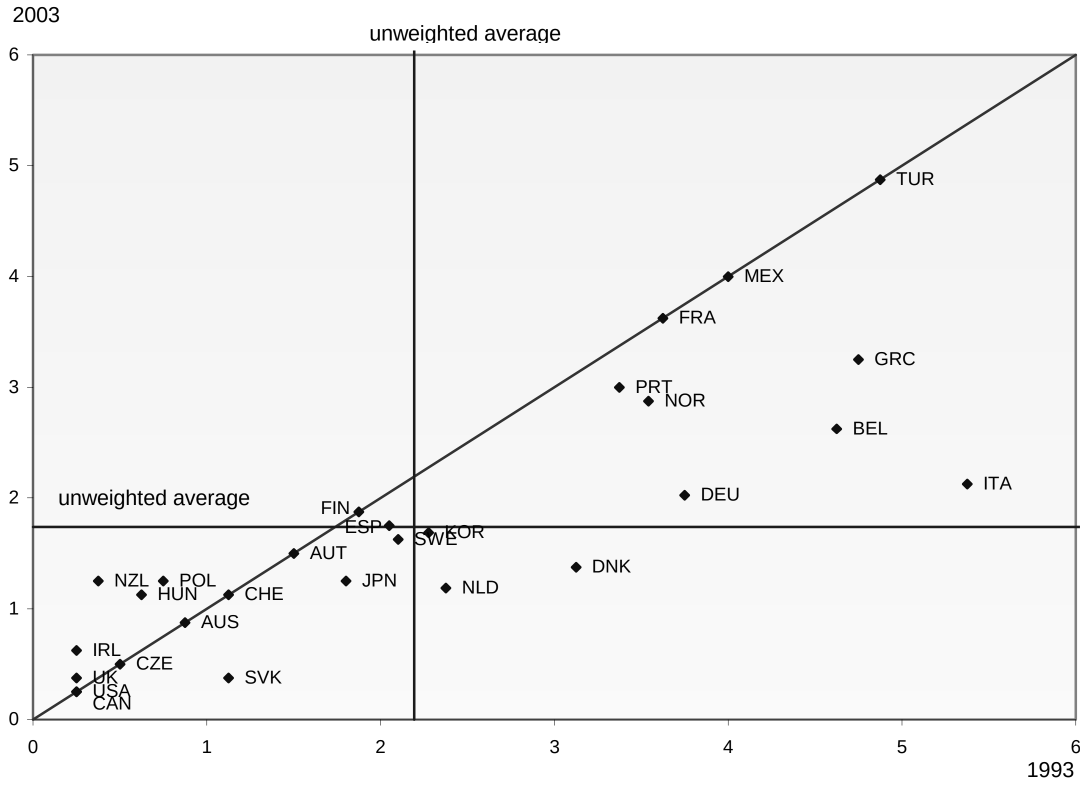
Figure 23. **EPL indexes for permanent contracts in OECD countries, 1993-2003**



Index 0-6 scale from least to most restrictive

21. Nevertheless, many OECD countries have pursued a highly selective approach to EPL reforms, concentrating relaxation on temporary jobs and maintaining or strengthening high protection for permanent workers. Figure 23 shows that most countries have maintained the strictness of EPL for workers with permanent contracts over the 1993-2003 period. There were also large cross-country differences in EPL strictness in 2003: it tended to be relatively low in English-speaking countries, Denmark and Switzerland, while it was relatively high in the Netherlands, Portugal, Spain, Sweden and some Central European countries. EPL strictness for temporary workers has been relaxed in many countries over the past decade (Figure 24).

Figure 24. **EPL indexes for temporary[1] contracts in OECD countries, 1993-2003**



Index 0-6 scale from least to most restrictive

1. The figure for Spain is different from the one reported in Employment Outllook (2004) due to a re-assessment of regulation in this area.

22. Over the 1994-2003 period, only Korea and the Slovak Republic eased statutory protection for both permanent and temporary contracts according to the OECD EPL indicator (Figures 23 and 24). On the other hand, New Zealand and the United Kingdom combined a strengthening of both types of contracts, although from a starting point with relatively flexible regulation. While keeping the stance of EPL broadly unchanged for permanent workers, the easing for temporary workers was particularly marked in Belgium, Italy, Greece, Germany and the Netherlands, all of which had regulated temporary work contracts comparatively heavily in 1993 (Table 3). On the other hand, Hungary and Ireland kept protection for permanent workers unchanged, while tightening it for temporary workers from a low level. Spain tightened rules for temporary contracts somewhat recently after having liberalised them early in the 1990s, while easing protection from a high level for permanent workers. This reform mix reflects concerns regarding potentially detrimental effects of a dual labour market discussed above, which emerged in Spain after selective liberalisation of temporary contracts in the 1980s in the context of an ongoing relatively strict protection for workers with permanent contracts.

Table 3. **Employment Protection Legislation: Policy reforms over the 1994-2004 period**[1]

	Permanent Contracts				Temporary Contracts	
	Dismissals	Notice Periods	Trial Period	Severance Pay	Fixed-term contracts	Temporary Work Agencies
Australia	+	-		-		
Austria	[+, -]			+	+	+
Belgium		-			+	+
Canada						
Czech Republic					-	
Denmark						+
Finland		+			+	+
France	[+, -]			-		-
Germany	[+, -]				+	+
Greece	+			-	+	+
Hungary					-	
Iceland						
Ireland				-	-	
Italy	+				+	+
Japan	+					+
Korea	+				+	
Luxembourg						
Mexico						
Netherlands	+				+	+
New Zealand	-				-	-
Norway						+
Poland	+				[+, -]	-
Portugal	+			+	+	+
Slovak Republic	+				+	
Spain	+	+		+	-	[+, -]
Sweden	+				+	
Switzerland						
Turkey						
United Kingdom	+		-	-	-	
United States						

1. + : reforms following the Jobs Strategy;
- : reforms contrary to the Jobs Strategy;
[+, -] : reform elements going in different directions.

Source: OECD *Economic Surveys.*

3.1.4 Unemployment benefits

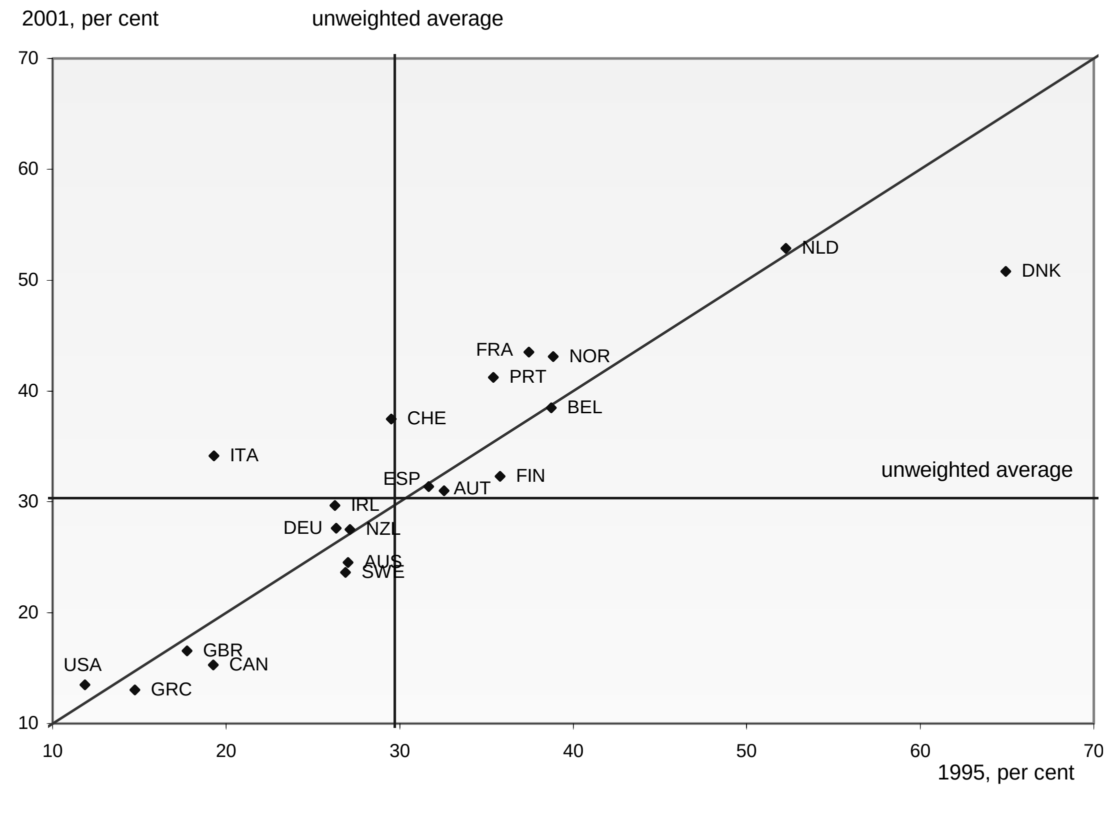
23. Relatively high unemployment benefits that are available for a relatively long duration can have adverse effects on labour market performance. In particular, such benefits may raise unemployment *via* two mechanisms: *i*) by reducing the job-search intensity of the unemployed and their willingness to accept job offers, benefits can weaken the job-matching process; and, *ii*) by lowering the economic cost of unemployment, they may put upward pressure on workers' wage claims and ultimately reduce labour demand.[16] On the other hand, unemployment benefits may allow jobseekers more time to find better matches, thereby lowering unemployment and enhancing productivity. In addition, adequate income support for the unemployed is widely seen as being necessary for social reasons, cushioning the impact of

16. Furthermore, benefits need to be financed by taxes which in turn may have a negative impact on employment.

job losses on living standards of the unemployed, and is also in some countries regarded as being a precondition for relatively light EPL. If the effects of unemployment benefits on job-search intensity and wage claims dominate the potentially favourable impact on the quality of job matches, a trade-off between equity and efficiency may arise. In empirical work, there is much evidence that various indicators of the level and duration of unemployment benefits have a significantly positive impact on unemployment (Scarpetta, 1996; Nickell, 1998; Elmeskov *et al*., 1998; Nunziata, 2003). Furthermore, benefit eligibility conditions, monitoring of job search and sanctions also influence unemployment and wage outcomes.

24. Figure 25 shows the OECD summary measure of benefit entitlements, averaging gross replacement rates for different income and family situations at different lengths of the unemployment spell, which thus provides a summary measure of both the amount of benefits paid and the duration of their receipt.[17] According to this measure, unemployment benefits were relatively high and available for a comparatively long time in 1995 in Belgium, Denmark, Finland, France, the Netherlands, Norway and Portugal and relatively low with a short duration in Canada, Greece, Italy, the United Kingdom and the United States.

Figure 25. **OECD summary measure of benefit entitlements, 1995-2001**



1. The Figure shows gross replacement rates aggregated across different income groups, family situations and benefit durations.

17. Gross replacement rates are used here because comparable net replacement rates are only available over a shorter period. For methodological details on the construction of these indicators, and their limitations, see OECD, *Benefits and Wages: OECD Indicators*.

25. Although a number of countries lowered replacement rates or the duration of benefits (Table 4), far-reaching cuts were rare. A large drop in the summary measure for unemployment benefit entitlements can only be observed for Denmark (Figure 25), while Italy is the only country that raised benefits significantly, albeit from a very low level. Nevertheless, a few countries have reduced benefit replacement rates somewhat since the mid-1990s, including Finland from a comparatively high level and some Central European countries from lower levels. By contrast, France, starting from a position with an already relatively high benefit level, abandoned its decrease over the duration of the unemployment spell, thereby increasing the replacement rate later in the spell. Some cuts in the maximum entitlement periods have taken place in a number of countries, with Korea being unique in extending benefit periods (though only to 60 days). The introduction of employment-conditional transfers and tax credits in some countries (see above) amounted to a lowering of the net replacement rate.

Table 4. **Unemployment benefit systems:**
Policy reforms over the 1994-2004 period[1]

	Benefit Generosity		Others Conditions						
	Replacement rates	duration	Tightened work availability conditions	Condition benefits on training	Eligibility conditions	Waiting periods	Lower work disincentives	Establish or strengthen UI schemes	Limit re-qualification
Australia			+	+			+		
Austria	[+, -]		X[2]		+	+	+		+
Belgium		+	+		+		+		
Canada	[+, -]	+					+		
Czech Republic	[+, -]	-	+		+		+		
Denmark	+	+	+	+	+		+		
Finland	[+, -]		+	+	+	+	+		
France	-	+					+		
Germany	[+, -]	+	+						
Greece							+	+	
Hungary	+	+	+				+		
Iceland		+	+		+		+		
Ireland	+		+				+		
Italy	-	-	+	+					
Japan		[+, -]					+		
Korea								+	
Luxembourg			+						
Mexico									
Netherlands		+	+		+				
New Zealand			+				+		
Norway	[+, -]	+	+		+	+	-		+
Poland	+	[+, -]	+	+	+				
Portugal				+			+		
Slovak Republic	+		+				+		
Spain	+	-	+				+		
Sweden	[+, -]		+	+	+	+			
Switzerland		[+, -]	+	+	+	+			
Turkey				+				+	
United Kingdom		+		+					
United States				X[3]			X[3]		

1. + : reforms following the Jobs Strategy;
- : reforms contrary to the Jobs Strategy;
[+, -] : reform elements going in different directions.
2. implemented in 2005.
3. confined to welfare recipients.

Source: OECD *Economic Surveys.*

26. Countries seem to have been more determined in pursuing other reforms that effectively put pressure on benefit recipients to find a job more quickly:

- Work-availability conditions have been tightened in a number of countries. These reforms have typically circumscribed the scope for the unemployed to reject job offers because of occupational incompatibility with the previous job, pay and/or workplace location.

- Stricter sanctions for refusal of suitable job offers have typically accompanied tighter work-availability conditions. A few countries, including the Benelux states, introduced sanctions to better enforce existing work-availability and willingness-to-work conditions.

- Eligibility conditions were tightened in a number of member countries, in most cases increasing the minimum period of work before qualifying for benefits. Norway increased the minimum insurable income.

- Waiting periods before the unemployed are eligible to receive benefits were introduced in a few countries, with the aim of reducing the use of unemployment benefits as a subsidy to sectors with irregular activity.

As discussed earlier, closer co-operation and integration of benefit administration and ALMP activities has also been pursued in a few countries. Moreover, many countries introduced possibilities to combine benefits receipt and earnings at least for some time or widened them, *e.g.* by lowering withdrawal rates for unemployment or social assistance benefits, *i.e.* the rate at which these benefits are withdrawn as wage income increases. The intention of these making-work-pay reforms is to raise incentives for the unemployed to take up work.

3.1.5 Wage setting and industrial relations

27. Decentralised wage bargaining at the firm level has often been regarded as employment-friendly, preventing excessive wage claims since this would lead to a loss of market shares to competitors with detrimental effects on employment. On the other hand, very centralised or coordinated bargaining systems may induce bargaining parties to internalise the detrimental effects -- *e.g.* on employment -- that excessive wage pressure can have at the macroeconomic level. It may also facilitate implicit or explicit “social pacts” under which unions agree to restrain wage demands in exchange for policy concessions from the government.

28. These considerations suggest that the relationship between unemployment and the degree of corporatism may not be monotonic but rather “hump-shaped” (Calmfors and Driffill, 1988): intermediate systems based on branch-level bargaining without higher-level coordination yield the worst labour market outcomes, as they benefit neither from the internalisation of negative externalities associated with centralised/coordinated systems nor from the market discipline that prevails at the decentralised level.[18] Intermediate-level bargaining may have particularly detrimental effects in the presence of legal extensions of sectoral collective agreements which reduce the scope for competition to moderate wage demands and outcomes (see Box 1). For instance, the compressed wage structure that is usually associated with centralisation/coordination may price a number of low-skilled workers out of work (Calmfors, 1993). Similarly, insufficient wage flexibility at the regional level can maintain pockets of high unemployment in the presence of limited geographical mobility.[19] The tendency for centralised or coordinated bargaining systems to harmonise wages and working conditions across workers and regions can also have negative consequences on employment (Siebert, 1997).

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18. Some empirical work supporting the “hump-shaped” hypothesis includes Scarpetta (1996), but others have found little evidence (for a literature survey on this topic, see Flanagan, 1999).

19. McHugh (2002) also suggests that the greater the degree of centralisation, the more unions are able to put pressure on the authorities to grant a favourable legal environment for their activities, i.e. making them more powerful in wage bargaining.

Box 1. Legal extension of collective contracts in OECD countries

Legal extension of sectoral collective agreements or functional equivalents (such as compulsory membership of employer federations) is applied in around half of all OECD countries. Extensions are mainly available in continental European countries, with the exception of the Scandinavian countries. Some functional equivalent for statutory extension still exists in Australia through the role played by the "arbitration system" in setting minimal provisions at the sectoral level. However, its influence has been significantly reduced over the past decade following the 1993 Industrial Relations Reform Act. Another country that underwent major changes in legal extension procedures in the 1990s is New Zealand, where the 1991 Employment Contracts Act terminated a long-standing tradition of extensions.

The potential impact of extensions on labour market outcomes differs significantly across countries depending on the details of statutory provisions (see table below). To provide a summary measure of the stance of policy in this area, an index has been constructed to cover the various aspects of legal provisions for the three different forms of extensions: an extension to all employees in firms affiliated to one of the signatory employers' organisations (type 1), an extension to all employees in firms not affiliated to any of the signatory employers' organisations (type 2) and an extension of an agreement to a sectoral or geographical area outside its initial scope (enlargement). For type 1 and 2 extensions, the stance of policy is derived as a product between indices of restrictiveness of the binding mechanism for extensions and the extent of the content extended, respectively. The index for binding mechanism takes a value of 0.5 when there are preconditions for extensions (such as sectoral representativeness of signatory organisations) and 1 otherwise, and the index for content extended takes a value of 0.5 when only minimal provisions of an agreement can be extended and 1 when all provisions can be extended. The possibility of enlargement is represented by a value of 1. The overall index is obtained by adding up measures of the stance of policy in the three different forms of extension.

According to this overall index, legal extension mechanisms are particularly extensive in Austria, France, Luxembourg, Portugal and Spain. They are also important in Belgium, Finland, Italy and the Netherlands. By contrast, such interventions seem to be limited in Australia, Germany, Greece, Ireland and Switzerland.

Legal extension of sectoral collective agreements[1] in selected OECD countries

	Extensions of type 1		Extensions of type 2		Enlargement procedures	Total
	(a) Binding mechanisms	(b) Content extended	(c) Binding mechanisms	(d) Content extended	(e)	Index
Australia	0.5	0.5	0.5	0.5	0	0.75
Austria	1	1	1	1	1	4
Belgium	1	0.5	1	1	0	2.5
Canada	0	0	0	0	0	0
Denmark	0	0	0	0	0	0
Finland	1	1	0.5	0.5	0	1.5
France	1	1	1	1	0	3
Germany	0	0	0.5	0.5	0	0.5
Greece	0	0	0.5	1	0	1
Ireland	0	0	0.5	0.5	0	0.5
Italy	1	1	1	0.5	0	2
Japan	0	0	0	0	0	0
Luxembourg	1	1	1	1	0	3
Netherlands	1	1	0.5	0.5	0	1.5
New Zealand	0	0	0	0	0	0
Norway	0	0	0	0	0	0
Portugal	1	1	1	1	1	4
Spain	1	1	0.5	1	1	3
Sweden	0	0	0	0	0	0
Switzerland	0	0	0.5	1	0	1
United Kingdom	0	0	0	0	0	0
United States	0	0	0	0	0	0
OECD average	0.4	0.4	0.5	0.5	0.1	1.3

1. Or functional equivalent (e.g. compulsory membership of employers to the Chamber of Commerce in Austria).
2. The formula used to compute the index of legal extension of sectoral collective agreements is:
[(a) * (b)] + 2*[(c) * (d)] + (e). The double weighting of extensions of type 2 with respect to extensions of type 1 aims to reflect that the former normally affects two categories of employees (i.e. those in both signatory and non-signatory firms), while the latter affects one category of employees (those in signatory firms) only.

29. Possibly reflecting in part these uncertainties, reforms to bargaining structures have been very modest over the past ten years (Table.5). Moreover, rather than being a result of government reform programmes, change was often prompted by the social partners themselves, as the decentralisation of wage bargaining in Denmark in the context of still high coordination, or it occurred as a result of changes in behaviour adopted by individual agents, such as increased use of opt-out clauses in a number of countries. Australia is one of the rare examples where the continuing process towards decentralisation was a result of changes in legislation. Belgium moved in the opposite direction, with bargaining at the central level determining maximum rather than minimum wage targets as from 1996. A greater use of opt-out clauses or other provisions allowing elements of firm bargaining in systems with established sectoral level-bargaining has been adopted in some European countries. As the opt-out clause can in most cases only be invoked in agreement with the organisations of employers and employees, the effectiveness of these measures in allowing wage setting more in line with local conditions is subject to some doubt. As an example, in Spain where the option of invoking such clauses for firms in distress was introduced in 1994, it has rarely been used.

Table 5. **Wage formation and industrial relations: Policy reforms over the 1994-2004 period[1]**

	Decentralisation	Centralisation	Wages more linked to skill level and productivity	Opt-out clauses or more firm bargaining	Minimum Wage
Australia	+				
Austria	+				
Belgium		+[2]			
Canada					
Czech Republic					-
Denmark	+[3]				
Finland	[+, -]				
France					-
Germany	+			+	
Greece				+	
Hungary					-
Iceland					
Ireland					-
Italy				+	
Japan					
Korea					
Luxembourg					-
Mexico	+		+		
Netherlands			+	+	
New Zealand					-
Norway					
Poland					+
Portugal			+		
Slovak Republic				+	-
Spain	+			+	
Sweden	+				
Switzerland					
Turkey					
United Kingdom					-
United States					

1. + : reforms following the Jobs Strategy;
 - : reforms contrary to the Jobs Strategy;
 [+, -] : reform elements going in different directions.
2. Refers to centralisation implying wage moderation.
3. Decentralisation prompted by social partners.

Source: OECD *Economic Surveys.*

30. In general, there has been no movement in reducing relatively high statutory minimum wages which are often thought to impinge on employment prospects for young and/or low-wage workers. The only exception is Poland where minimum wage rates for younger workers were lowered. Yet, most countries generally seem to prefer lowering taxes or social security contributions on low incomes to cut the labour costs for minimum-wage workers and raise work incentives by increasing their take-home pay. The minimum wage has been increased substantially relative to the median wage in Hungary. In France, the introduction of the 35-hour week implied the creation of several different hourly minimum wages whose harmonisation is resulting in an increase in relation to average and median earnings. A minimum wage was introduced in the United Kingdom in 1999, increasing rapidly relative to average wages thereafter, while the introduction of a minimum wage in Ireland in 2000 occurred at a relatively high level in international comparison to begin with. In order to alleviate possible adverse employment effects from these measures, sub-minimum rates were introduced for young workers in both countries. Moreover, these changes must be seen in the context of other labour-market reforms in these countries, notably the increased use of make-work-pay policies. Moreover, the empirical evidence concerning a negative impact of minimum wages on employment is mixed with some studies finding evidence of this effect for youth unemployment (Neumark and Washer, 1999; OECD *Employment Outlook*, 1998, Chapter 2), while others not detecting any effects (Card and Krueger, 1997; Dolado *et al.*, 1996; Elmeskov *et al.*, 1998).

3.1.6 Working-time flexibility

31. More flexible working-time arrangements may allow firms to adapt working hours to the cycle more easily and with lower costs. They can increase productivity per hour as work becomes more concentrated on periods of intense activity and allows more intensive use of capital equipment. This can reduce overall production costs, thus making room for more employment creation. Moreover, removing statutory discrimination against part-time work can attract people into the labour force who may not wish to work full-time, *e.g.* to better combine professional and family life or because they wish to reduce their working hours at the end of their career.

32. There have been some movements in the more regulated continental European countries and in some non-European OECD countries to increase working-time flexibility over the past decade (Table 6). More flexible calculation of maximum allowable working time and its distribution over an extended period – typically a year – have been introduced in a number of OECD countries. However, some countries restricted working-hour arrangements through reducing maximum allowable overtime or raising the cost of overtime work. The most notable change in this field was the introduction of the 35-hour week in France, which also made recourse to overtime more difficult and costly overall,[20] but paved the way for increased annualisation of working time. Some countries, including Portugal, restricted their maximum average weekly working time to 48 hours to comply with the EU Working Time Directive, which also includes minimum daily and weekly rest periods, in-work breaks and paid annual leave.

20. However, the recent "Loi Fillon" has relaxed this overtime restriction.

Table 6. **Working-time flexibility and part-time work: Policy reforms over the 1994-2004 period[1]**

	Working Time Flexibility	Part-time Work
Australia		
Austria	+	+
Belgium	+	+
Canada		X[2]
Czech Republic	-	
Denmark		+
Finland	X[3]	+
France	[+, -][4]	+
Germany	+	+
Greece	[+, -]	+
Hungary		
Iceland		
Ireland		
Italy		+
Japan	+	+
Korea		+
Luxembourg	+	+
Mexico		+
Netherlands		+
New Zealand		
Norway	+	
Poland	+	
Portugal	[+, -]	+
Slovak Republic	+	
Spain	-[5]	[+, -]
Sweden		
Switzerland	+	
Turkey		
United Kingdom		
United States		

1. + : reforms following the Jobs Strategy;
 - : reforms contrary to the Jobs Strategy;
 [+, -] : reform elements going in different directions.
2. Better coverage of part-time workers in unemployment benefit system.
3. Maximum allowable workingtime reduced, but more flexibility at the local level.
4. Some provisions to make working time more flexible; but overtime becomes more expensive as a result of the introduction of the 35-hours week.
5. Subsidies offered in some regions to introduce 35-hours week'.

Source: OECD *Economic Surveys.*

33. Rights and possibilities for voluntary part-time work were strengthened in a number of member countries. This took different forms depending on the country: making the reference period for calculating working time more flexible, granting equal legal status to full-time work for part-time employment relations or, in some cases, by creating a legal claim to part-time work. Financial incentives to take up part-time work were increased in Canada and Germany by strengthening part-time workers' entitlements to unemployment benefits, and in France by adjusting the recently introduced employment-conditional tax credit so that it also benefits part-timers.

3.1.7 Incentives to stay in the labour force

34. The EDRC review process of the Jobs Strategy highlighted adverse effects on labour supply that may arise from income transfers which induce older workers to retire at an early age and/or disabled people of working age to remain inactive. Such schemes were often introduced with the aim of lowering

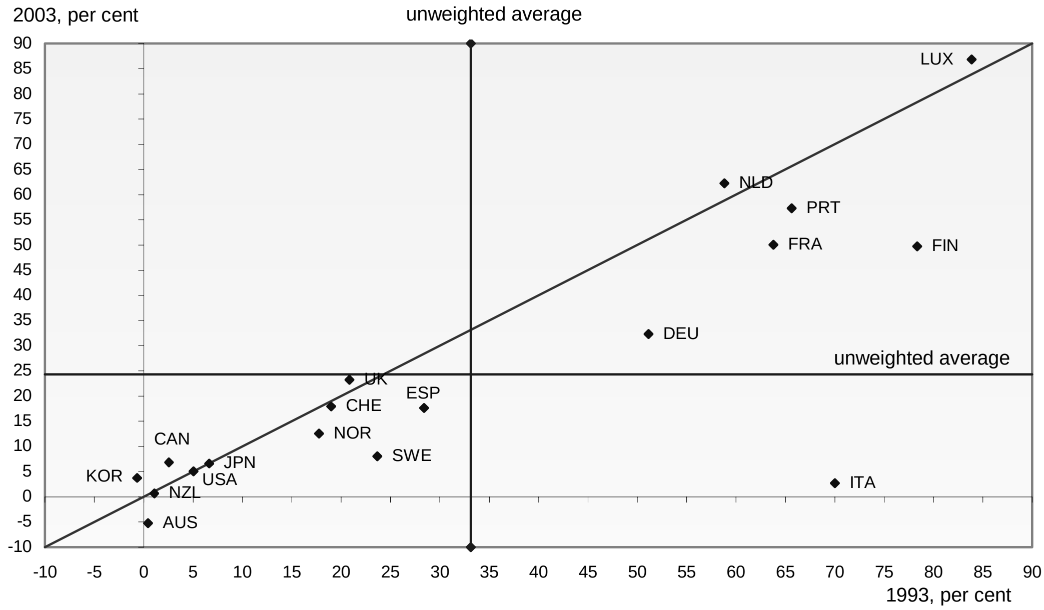
unemployment, the expectation being that a retired worker would be replaced by an unemployed worker. However, experience has shown this view to be fallacious. Indeed, early retirement *via* special unemployment schemes, disability programmes and/or dedicated early retirement programmes often seem to undermine employment performance. Figures 26 and 27 show the development of the implicit tax on continuing work between 1993 and 2003.[21] The tax measures the costs of staying in the labour market, in terms of contributions paid and foregone benefits that are not covered by higher benefits after retirement due to continued work.[22] According to the 1993 figures the incentive to withdraw early from the labour market as a result of the presence of early retirement schemes was particular high in some continental European countries, including Finland, France, Italy, Luxembourg, the Netherlands, Portugal and Spain while it was considerably lower in English-speaking countries, Korea, Japan, Norway and Sweden. The incentives to withdraw early embedded in the old-age pension system were particularly high also in France, Italy, Luxembourg and the Netherlands (Figure 28).[23]

21. The 2003 value actually corresponds to the value the implicit tax rate will take once all currently legislated changes are implemented and once all existing pension systems have matured. It should be borne in mind that in some cases (e.g. Italy) these changes will be phased in over several decades.

22. For details on the assumptions underlying these calculations and the limits to their interpretation, see Duval (2003). For a full documentation of recent changes to old-age pension systems and early retirement schemes in OECD countries, see the country-specific reports published recently by the OECD as part of the Ageing and Employment Policies series.

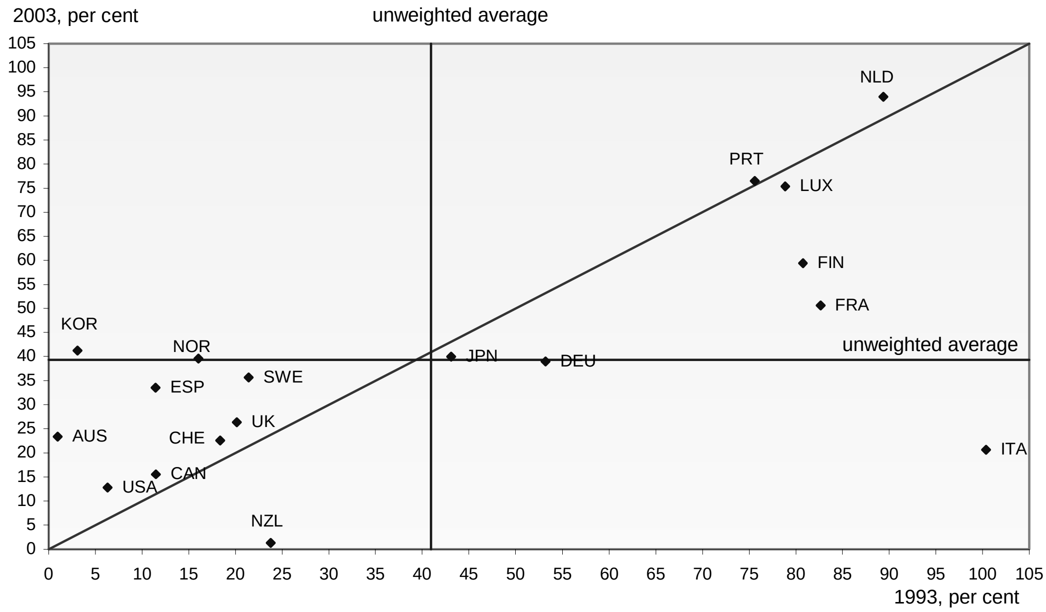
23. For the Netherlands, the calculations reflect a "typical" early-retirement (VUT) scheme. However, reforms are being introduced to these widespread early retirement schemes in order to make them more "actuarially neutral".

Figure 26. **Implicit tax embedded in early-retirement schemes on continuing work[1] from age 55 to age 60, 1993-2003**



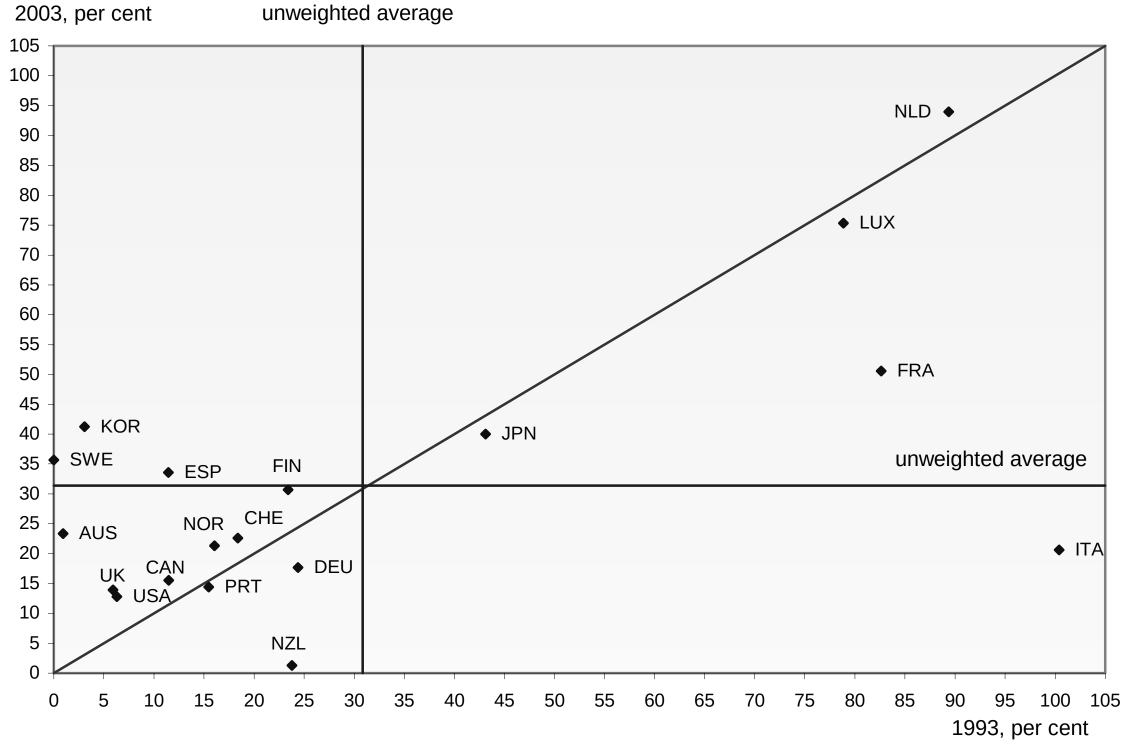
1. The implicit tax on continued work is defined as the average annual change in pension/social wealth (i.e the present value of the future stream of pension/social benefits), net of additional contributions paid, resulting from a decision to postpone retirement from age 55 to age 60. The calculations are made for a single worker with average earnings. For 2003, they reflect the steady-state of currently legislated systems once they have fully matured (e.g Korea) and once recent reforms have been fully phased in, which in some cases (e.g Italy) will take several decades.

Figure 27. **Implicit tax embedded in early-retirement schemes on continuing work[1] from age 60 to age 65, 1993-2003**



1. The implicit tax on continued work is defined as the average annual change in pension/social wealth (i.e the present value of the future stream of pension/social benefits), net of additional contributions paid, resulting from a decision to postpone retirement from age 60 to age 65. The calculations are made for a single worker with average earnings. For 2003, they reflect the steady-state of currently legislated systems once they have fully matured (e.g Korea) and once recent reforms have been fully phased in, which in some cases (e.g Italy) will take several decades.

Figure 28. **Implicit tax embedded in old-age pensions on continuing work**[1]
from age 60 to age 65,
1993-2003



1. The implicit tax on continued work is defined as the average annual change in pension wealth (i.e the present value of the future stream of pension benefits), net of additional contributions paid, resulting from a decision a decision to postpone retirement from age 60 to age 65. The calculations are made for a single worker with average earnings. For 2003, they reflect the steady-state of currently legislated systems once they have fully matured (e.g Korea) and once recent reforms have been fully phased in, which in some cases (e.g Italy) will take several decades.

35. Recognising the adverse results on labour supply and concerns prompted by ageing populations, many OECD countries reduced financial disincentives to stay in the labour market over the past ten years (Table 7). A number of member countries tightened eligibility to early retirement and invalidity schemes, while others did the same with unemployment benefit provisions for older workers, who enjoy an extended duration of unemployment benefit receipt in many OECD countries and are often exempted from job-search requirements. Incentives for older workers to stay in the labour market were strengthened in Japan and Poland through provisions that facilitate combining pensions with income from work. Moreover, actuarial adjustments to early (or late) receipt of regular old-age pensions or other financial incentives to stay in the workforce were introduced in a number of countries.

Table 7. **Early-retirement, invalidity and old-age pension schemes: Policy reforms over the 1994-2004 period**[1]

	Early Retirement Schemes	Unemployment benefits for older workers	Regular old-age pension systems	Invalidity Schemes	Sickness Benefits	Rehabilitation and job brokering
Australia				+		+
Austria	+		+	[+, -]	-	
Belgium	+	+				
Canada				+		+
Czech Republic		-	+	+		+
Denmark	+	+	+	[+, -]		+
Finland	+	+	+	[+, -]		+
France	[+, -]	+	+			
Germany	+	+	+	[+, -]	[+, -]	
Greece	-					
Hungary	+	+	+	+	+	+
Iceland			+			
Ireland						
Italy	+	-	+	+		
Japan	+	+				
Korea			+			
Luxembourg			+	+		+
Mexico						
Netherlands		+	+	+	+	+
New Zealand	+			+	+	
Norway	-	+		+		+
Poland	+		+	+	+	
Portugal	+		+			
Slovak Republic	+		+			
Spain			[+, -]	+		
Sweden	+		[+, -]		+	
Switzerland	+		[+, -]			
Turkey	+		+			
United Kingdom				+		+
United States			[+, -]	+		

1. + : reforms following the Jobs Strategy;
- : reforms contrary to the Jobs Strategy;
[+, -] : reform elements going in different directions.

Source: OECD *Economic Surveys.*

36. Eligibility criteria for invalidity schemes were also tightened in several OECD countries, although this did not prevent recourse to the disability and sickness benefit schemes from rising in some cases (OECD, 2003b). The Netherlands introduced experience rating for employers, whereby insurance contributions are based on the past recourse to the system, and stronger requirements for both employers and employees to engage in reintegration efforts for people on long-term sickness benefits. In addition, eligibility criteria for sickness benefits were tightened in some other OECD countries, while some countries enhanced rehabilitation, possibilities to take up work and job brokering for disabled people. Hungary introduced an obligation for larger employers to employ a certain percentage of disabled workers or become subject to a fine.

3.2 Product market reforms

37. A growing body of recent literature[24] has supported the conjecture of the JS that competition in product markets can have an impact on labour market performance. Increased competition as a result of product market reforms will boost real wages *via* lower prices, even if this effect may be attenuated somewhat if wages prior to reforms contain a large rental element that is reduced as intensified competition lowers product market rents and thereby the scope for rent sharing. The increase in real wages will stimulate labour supply and employment. Furthermore, an increase in product market competition is likely to result in changes in the functioning of the labour market with repercussions for employment and unemployment. Stronger competition may harden the bargaining position of employers and increase the employment costs of pushing for higher wages, thereby leading to lower unemployment. Reduced incidence and extent of rent sharing would also tend to reduce "wait unemployment" as it would become less attractive to prolong and limit search for employment opportunities in "high-wage" sectors.

38. While these effects will tend to reduce unemployment and boost employment in the long run, there could be significant short-term adjustment problems. This is because weak competition forces in product markets not only spill over into wages but also to productivity levels as rents are taken out as "quiet life" and "x-inefficiency". Under these circumstances, increased competition may result in a labour shake-out. This in turn may lead to a protracted increase in joblessness and a drop in employment rates, especially when unemployment and related benefits are linked to past wages, including any rent components, thus making unemployment and other forms of inactivity financially attractive compared with wages that are not artificially boosted by rents.

39. An update of the OECD indicators of product market regulation (PMR)[25] points to a reduction of regulatory impediments to product market competition during the period from 1998 to 2003 (see Figure 29). Moreover, there has been some convergence across countries with the environment in the most regulated countries (Belgium, France, Greece, Ireland, Italy, Poland, Portugal, Spain and Turkey) moving towards that in more liberal countries.

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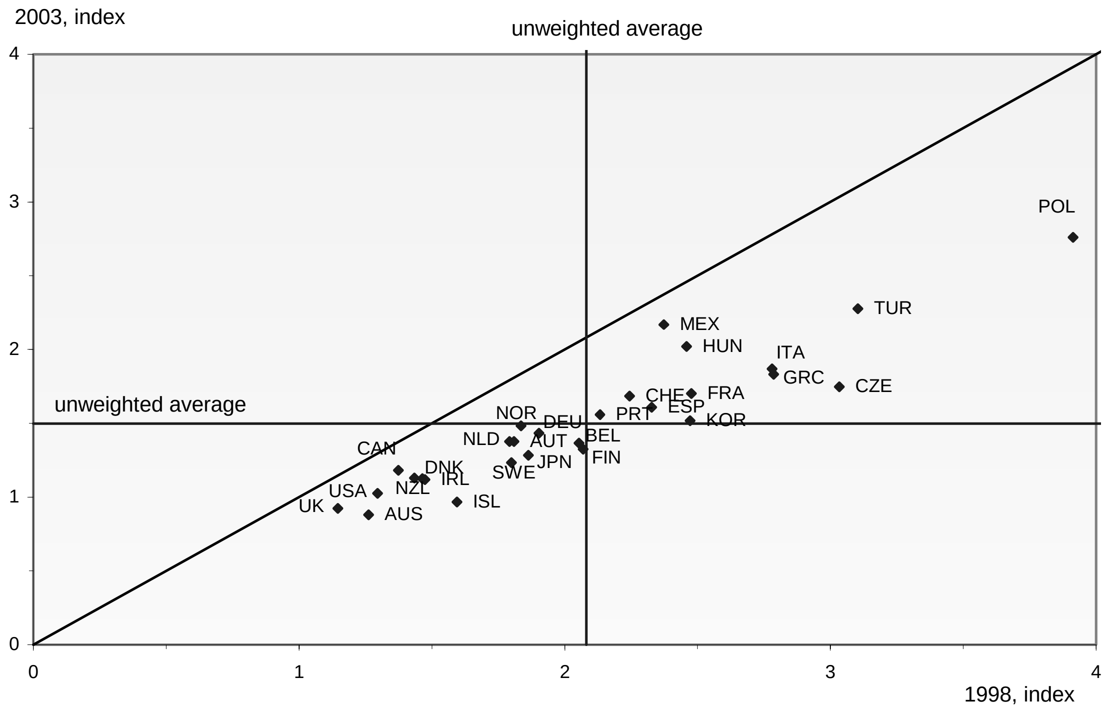
24. See Krueger and Pischke (1997), Amable and Gatti (2001), Pissarides (2001), Spector (2002), Blanchard and Giavazzi (2003); Messina (2003); Ebell and Haefke (2003).

25. See OECD (2005).

Figure 29. **Changes in product market regulation, 1998-2003**



40. The update shows that much of the improvement of product market competition since 1998 has been driven by the easing or elimination of coercive forms of regulation (such as command-and-control measures and price controls) and a reduction of controls on public or private business enterprise. Significant easing in all types of barriers to trade and investment has also been recorded. In contrast, progress in removing legal impediments to new entry in sectors sheltered from competition has been limited and the extent of privatisation has been modest. Therefore, a "hard core" of regulations still persists in almost all countries, in particular concerning barriers to entry in non-manufacturing industries.

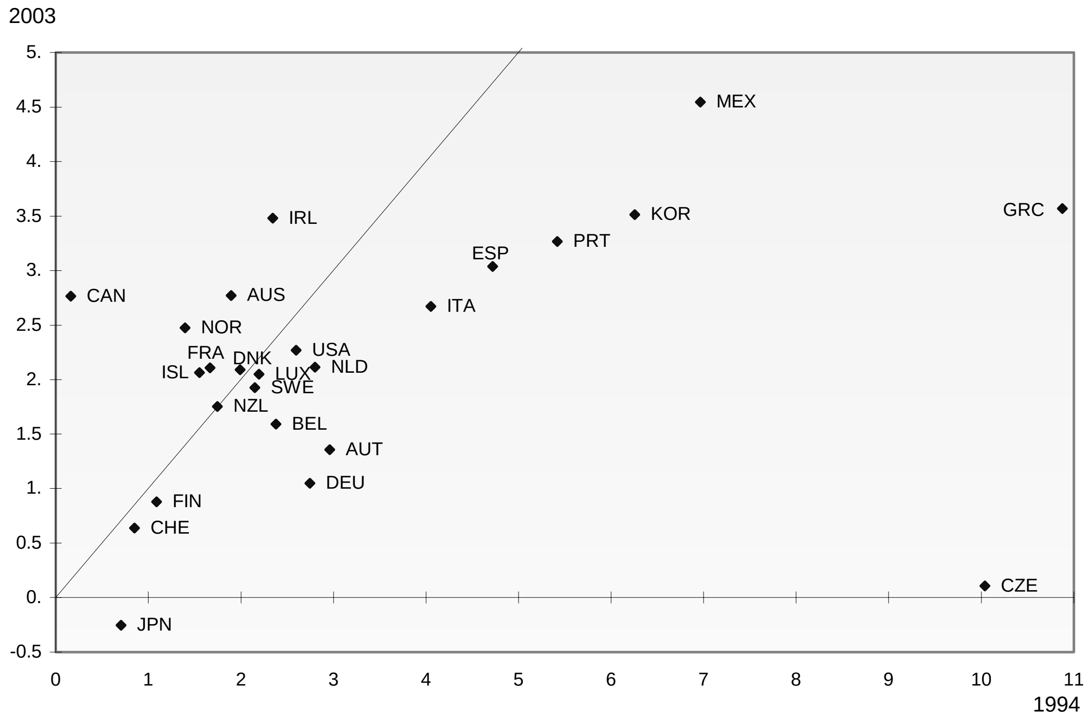
3.3 Macroeconomic policy

41. The JS recommended "to set macroeconomic policy such that it will both encourage growth and, in conjunction with good structural policies, make it sustainable, *i.e.* non-inflationary" (OECD, 1997a). Price stability and sound budget balances contribute to lower real interest rates and this, in turn, affects labour market performance through at least two channels: first, by stimulating investment and capital accumulation, raising labour productivity and employment; and second, as falling real interest rates increase the rate and diffusion of innovation, there is an additional gain of labour productivity growth that may boost employment. A possible third channel is that a lowering of the cost of capital by reducing overall production costs may act in a manner similar to a tax wedge cut by increasing the consumption real wage relative to the production real wage. Over and above the effects arising through real interest rates, a more stable macroeconomic environment with more limited fluctuations in activity reduces the scope for hysterisis-type mechanisms that turn cyclical unemployment into structural unemployment. A recent study on the sources of economic growth (OECD, 2003a) has confirmed empirically the importance of macro policy settings on growth, in particular as concerns inflation and price stability. At the same time, there is growing recognition that the functioning of labour markets can be impaired when inflation is very low or prices falling because of the downward stickiness of nominal wages. Under such circumstances, real

product wages may increase with general adverse impact on labour demand, and relative wages become rigid, with detrimental impact on the allocation of labour resources. Furthermore, the scope for monetary policy to act to stabilise inflation and activity can become circumscribed at low levels of inflation.

42. The 1999 follow-up of the Jobs Strategy highlighted the significant progress that had been made in attaining the goal of price stability (defined as inflation rates ranging from zero to two per cent) and this progress has largely been maintained in the past five years. This has generally taken place in the context of a shift towards forward-looking monetary policy, often accompanied by explicit medium-term inflation targets. For the participating countries in the European Monetary Union, the move towards price stability coincided with the abandonment of national monetary policy, implying that monetary policy can no longer be used to respond to country-specific shocks in the euro area. Overall, inflation rates are lower now than during the early 1990s in 21 OECD countries. Moreover, the number of countries with high inflation rates -- above 4 per cent a year -- has dropped from 11 in 1994 to only 4 now (Hungary, Mexico, Slovak Republic and Turkey). Accordingly, there has been a clear pattern of convergence in inflation rates across OECD countries (as illustrated by the sharp reduction of their standard deviation, see Figure 30).

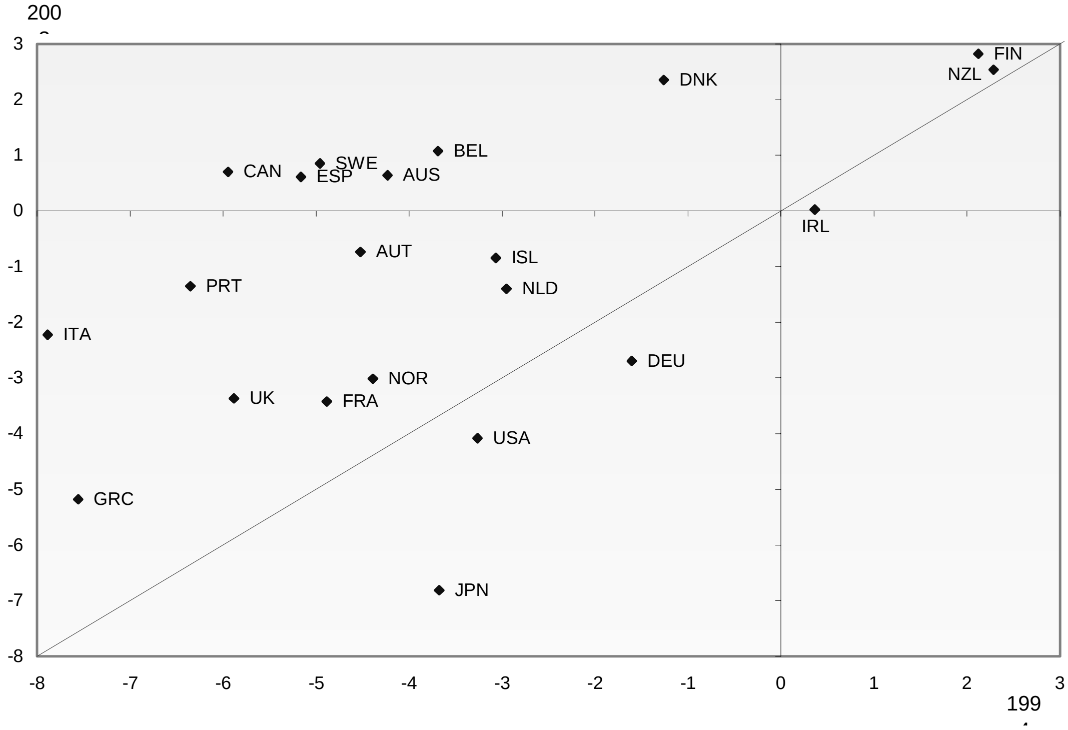
Figure 30. **Evolution of inflation[1] rates, 1994-2003**



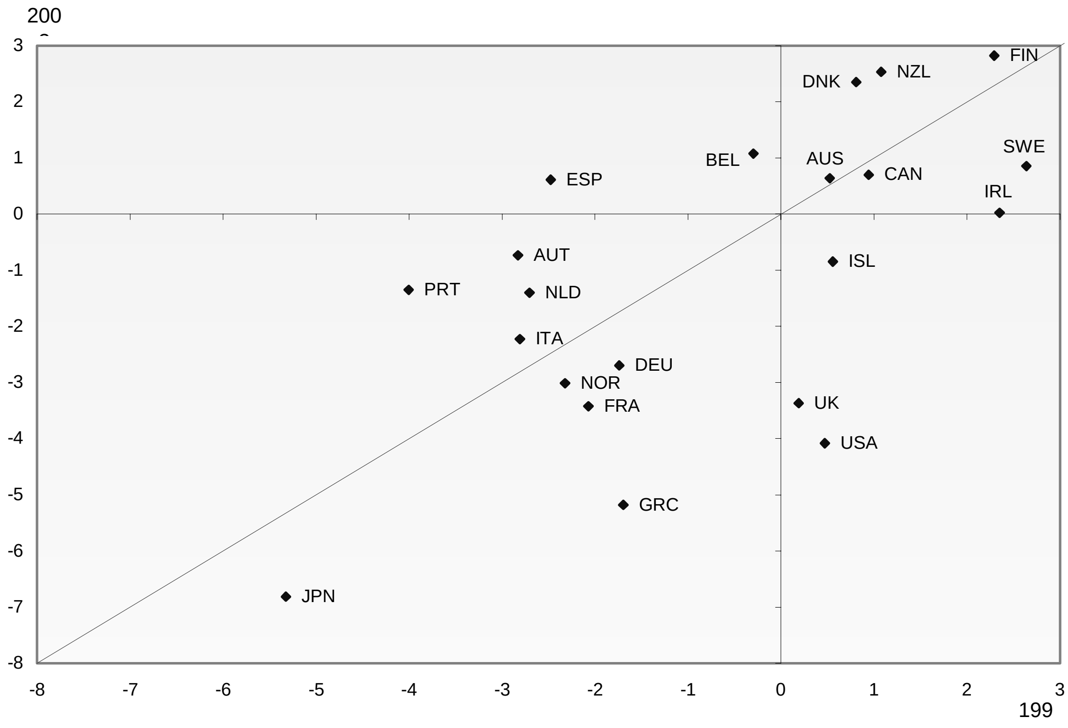
Standard deviation for 1994 (excluding Turkey): 7.0
Standard deviation for 2003 (excluding Turkey): 1.7
Some countries are out of scale: Hungary (1994: 18.9, 2003: 4.7), Poland (1994: 33.2, 2003: 0.8), Slovak Republic (1994: 13.4, 2003: 8.6) and Turkey (1994: 105.2, 2003: 25.3).
1. Measured by the consumer price index.

Figure 31. **Evolution of government structural budget balances**

Panel A. **1994 and 2003**



Panel B. **1998 and 2003**



43. On the other hand, some countries have been faced with actual deflation, or the risk of deflation, over the past five years. This is notably the case in Japan, which has experienced a continuous fall in aggregate price levels since 1998, notwithstanding reduction in policy-determined interest rates to zero and a subsequent large-scale liquidity injection into the financial system. With inflation still relatively low at the onset of the most recent downturn in the world economy, the negative shock risked pushing inflation below zero in a few countries. With the experience of Japan showing the difficulties for policy to tackle deflation once it had taken root, the monetary authorities in the United States took pre-emptive action, lowering the interest rate to its lowest level in decades. In the event, deflation has been avoided in all countries but Japan.

44. With respect to public finances, the progress made in the latter part of the 1990s has been partially offset in the past few years in some countries (Figure 31). In the United States, after the cyclically-adjusted general government budget balance strengthened by the equivalent of more than 6 per cent of GDP in the 1992-2000 period, it has subsequently weakened by more than 5 per cent of GDP. Though it has been significant in Germany and France, the slippage has been much smaller in the euro area as a whole, and the area-wide structural deficit is significantly lower now than 10 years ago. Japan was already confronted with a very large budget deficit in the latter part of the 1990s and it has tended to rise still further in the past five years. Overall, there has been a clear deterioration in public finances in the OECD area as a whole since the last follow-up of the JS (Figure 31, Panel B).

SECTION 4. REFORM STRATEGIES AND LABOUR MARKET PERFORMANCE

45. This section compares countries' recent labour market reform strategies along a number of dimensions such as their intensity, comprehensiveness and the influence of the initial labour market situation, based on illustrative indicators characterising the reform process. It also attempts to shed tentative light on the reasons why certain policy packages have typically been more frequently implemented than others. Finally, a very preliminary illustration of the possible links between reforms and labour market performance is provided in the form of a simple correlation between the changes in unemployment and employment rates and a rough indicator of the intensity of reforms.

4.1 Recent reform strategies in OECD countries

4.1.1 An illustrative quantification of the intensity of recent labour market reforms

46. In order to get a rough overview of cross-country differences in reforms efforts, Table 8 presents illustrative indicators of reform intensity within each of the seven policy areas discussed in Section 3 as well as at the aggregate level. These indicators are based on a quantitative evaluation of the reforms, following a methodology discussed in Annex 3. The exercise is similar in spirit to previous OECD work carried out as part of the 1999 follow-up of the Jobs Strategy (OECD, 1999), for which a scoring method was developed aimed at assessing progress in implementing country-specific OECD recommendations by calculating "follow-through" indicators. Indeed, a similar indicator has been calculated in this study (see Box 2). However, in characterising countries' reform approaches more weight is put on the broader indicator of reform intensity that takes into account any reform implemented by a country over the period considered[26] regardless of whether it corresponded to a specific EDRC recommendation. The resulting indicators for the whole period 1994-2004 incorporate all legislated reforms up to mid-2004, even though some of these may not yet be fully implemented (*e.g.* some aspects of the Agenda 2010 in Germany and the 1995 pension reform in Italy which will be phased in very gradually).

26. The indicators for 1994 to 2004 reported in Table 8 are obtained by aggregating two indicators calculated for the two sub-periods 1994-1999 and 2000-2004.

Box 2. **Follow-through of EDRC recommendations**

The 1999 follow-up of the Jobs Strategy (OECD, 1999) developed a scoring method aimed mainly at assessing progress in implementing country-specific EDRC recommendations. Scores were assigned based on ERDC assessment of reform progress, and the resulting “follow-through indicator” measured the degree of compliance to recommendations. A similar indicator has been calculated in the context of this study by applying the same methodology used for deriving the reform intensity indicator described in Annex 3, but only covering reforms that correspond to specific EDRC recommendations. This follow-through indicator expresses the magnitude and comprehensiveness of reforms following EDRC recommendations by using quantitative institutional indicators whenever available.

The following table reports the aggregate follow-through indicators covering all policy areas and the corresponding country ranking. The measure suggests that Ireland, Italy and Australia have acted on EDRC recommendations to a greater extent than other countries. By contrast, action to follow up with recommendations has been limited in Iceland, Japan, Norway, Poland and Spain. Norway in particular has one of the lowest follow-through rates among OECD countries while its reform intensity indicator indicates a medium reform effort, suggesting its reforms occurred mainly in areas for which no specific recommendation to act had been received from the EDRC. Looking at average follow-through rates by main policy areas shows that OECD countries have been more willing to follow EDRC recommendations about active labour market policies, while recommendations that concerned EPL and wage formation and industrial relations have been followed to a much lesser extent.

Aggregate country follow-through rates

	Follow-through rates	Ranking
Australia	43.8	3
Austria	23.8	17
Belgium	34.2	7
Canada	42.1	4
Czech Republic	22.5	18
Denmark	39.0	5
Finland	28.4	12
France	25.0	14
Germany	31.6	8
Greece	22.2	19
Hungary	27.5	13
Iceland	19.2	23
Ireland	54.5	1
Italy	44.1	2
Japan	15.4	27
Korea	30.0	11
Luxembourg	22.1	20
Mexico	13.9	29
Netherlands	36.0	6
New Zealand	31.6	9
Norway	16.7	26
Poland	18.5	24
Portugal	20.6	21
Slovak Republic	14.3	28
Spain	17.5	25
Sweden	20.5	22
Switzerland	25.0	14
Turkey	7.7	30
United Kingdom	31.3	10
United States	25.0	14
Unweighted average	26.8	

Follow-through rates for main policy areas

Active labour market policies[1]	46.1
Taxes and social security contributions[1]	20.8
Employment protection legislation[1]	9.8
Unemployment benefit system[1]	29.4
Wage formation and industrial relations[1]	3.5
Working-time flexibility and part-time work[1]	21.4
Early retirement, invalidity and old-age pension schemes[1]	22.4

1. Unweighted average.

Table 8. **Aggregate reform intensity indicator, reform intensity indicators by area**

	Summary reform intensity indicator		Reform intensity indicator by area						
	Score	Ranking	Active labour market policies	Taxes and social security contributions	Employment protection legislation	Unemployment benefit system	Wage formation and industrial relations	Working-time flexibility and part-time work	Early retirement, invalidity and old-age pension schemes
Australia	21.0	7	53.8	25.0	-6.7	19.2	27.3	0.0	16.7
Austria	17.8	8	15.4	31.3	13.3	23.1	2.3	16.7	33.3
Belgium	21.4	6	40.4	43.8	10.0	15.4	4.5	33.3	16.7
Canada	15.2	13	38.5	12.5	0.0	23.1	0.0	16.7	16.7
Czech Republic	6.2	28	17.3	0.0	-3.3	11.5	-4.5	-16.7	33.3
Denmark	29.3	1	55.8	12.5	10.0	42.3	27.3	16.7	25.0
Finland	25.0	3	48.1	12.5	13.3	34.6	0.0	16.7	50.0
France	14.5	16	42.3	31.3	-6.7	0.0	-4.5	33.3	41.7
Germany	23.9	4	57.7	12.5	16.7	19.2	9.1	16.7	25.0
Greece	13.8	17	42.3	12.5	6.7	11.5	4.5	16.7	-8.3
Hungary	12.3	19	30.8	25.0	-6.7	19.2	-9.1	0.0	33.3
Iceland	3.6	30	19.2	-37.5	0.0	19.2	0.0	0.0	8.3
Ireland	17.4	9	46.2	87.5	-10.0	15.4	-13.6	0.0	0.0
Italy	21.7	5	30.8	56.3	23.3	-11.5	4.5	33.3	50.0
Japan	8.7	25	23.1	-12.5	13.3	3.8	0.0	33.3	8.3
Korea	12.3	19	26.9	0.0	25.0	7.7	0.0	16.7	8.3
Luxembourg	14.9	15	32.7	37.5	0.0	3.8	-4.5	33.3	33.3
Mexico	4.3	29	7.7	0.0	0.0	0.0	13.6	16.7	0.0
Netherlands	25.7	2	55.8	25.0	13.3	11.5	13.6	33.3	41.7
New Zealand	12.3	19	42.3	18.8	-13.3	15.4	-4.5	0.0	33.3
Norway	15.2	13	46.2	-18.8	10.0	26.9	0.0	16.7	8.3
Poland	11.2	23	28.8	0.0	-3.3	15.4	4.5	16.7	25.0
Portugal	15.9	12	23.1	25.0	16.7	7.7	4.5	33.3	16.7
Slovak Republic	13.0	18	11.5	25.0	14.3	19.2	0.0	16.7	8.3
Spain	10.5	24	7.7	18.8	16.7	7.7	6.8	0.0	8.3
Sweden	17.4	9	50.0	12.5	13.3	11.5	4.5	0.0	8.3
Switzerland	8.7	25	23.1	6.3	0.0	15.4	0.0	16.7	0.0
Turkey	6.5	27	3.8	0.0	12.5	7.7	0.0	33.3	8.3
United Kingdom	16.7	11	50.0	56.3	-10.0	11.5	-9.1	0.0	25.0
United States	11.6	22	19.2	50.0	0.0	11.5	0.0	0.0	0.0

47. Although aggregate quantitative indicators are useful to characterise the general thrust of reforms in countries when individual policy actions differ in intensities and even direction, the reform intensity indicators reported in Table 8 are inevitably subject to a considerable degree of uncertainty. The scoring of individual policy reform is not straight forward even if it can be based on quantitative measures (such as tax wedges), and becomes much more difficult and subjective when dealing with inherently qualitative data which can be interpreted in different ways (such as for some aspects of ALMPs).[27] The selection of weights associated with each policy measure to arrive at an aggregate for each area or for all areas together compounds the uncertainty. In principle, the weights should reflect the relative impact of the different policies on the policy objective in question. However, labour market performance is multi-dimensional and different weights should be applied for each of the different dimensions. In the absence of comprehensive empirical studies that can be used to assign weights and the multi-dimensional nature of the policy objective, the approach adopted here is to assign identical weights to each of the 44 individual policies. As shown by the sensitivity analysis reported in Annex 3, the ranking of countries with respect to reform

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27. Scoring reforms involves several other inherent problems: i) the degree to which a given reform is actually enforced may differ widely across countries; ii) no account is made for the possibility of non-linear policy effects (i.e. the possibility that a given reform may have different impact on labour markets depending on the initial policy stance in the area considered); and, iii) policy complementarities, which have long been recognised as important for labour market outcomes (Coe and Snower, 1997; for empirical evidence, see Elmeskov, et al. 1998; Belot and Van Ours, 2000), are also omitted.

intensity is sensitive to the weights used, especially for countries ranked in the middle. As a result of all these caveats, the indicators presented in Table 8 should be regarded as providing some information as regards the overall intensity of recent labour market reforms across OECD countries rather than a reliable ranking. This information is aimed at supporting the ensuing discussion of reform strategies.

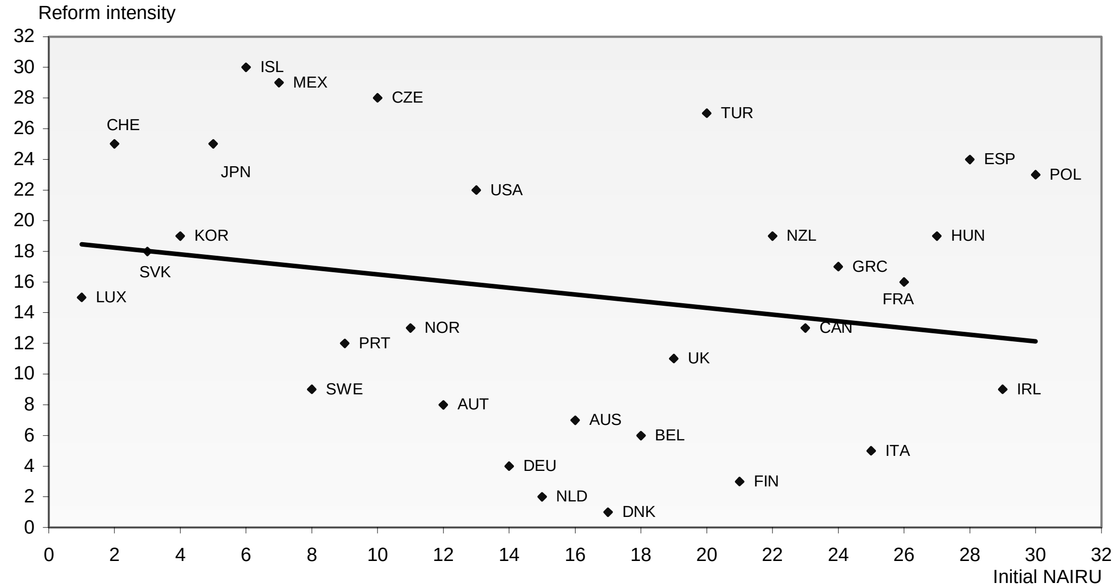
4.1.2 Reform patterns with respect to initial conditions

48. A country with a weak initial labour market performance is more in need of reforms than a country with better labour market outcomes and could therefore be expected to be more active in introducing performance-enhancing changes. In the mid-1990s, reforms were most needed in a number of poorly performing European countries, where structural unemployment rates had risen with every economic cycle since the early 1970s and inactivity rates were high. By contrast, a favourable initial labour market situation, in *e.g.* Japan and the United States, meant that reforms were less pressing in these countries. In some other countries (United Kingdom, the Netherlands and New Zealand), significant reforms had been implemented in the 1980s and early 1990s even if they had not fully showed up in better performance by the mid-1990s, and this also lessened the need for additional reforms.

49. In order to examine the link between starting positions and the strength of reforms in a systematic manner, simple correlations are presented in Figure 32 between the illustrative indicator of reform intensity discussed above and two alternative indicators of initial performance, namely NAIRUs and (cyclically-adjusted) employment rates in 1993. Both correlations are found to be insignificant, pointing to the lack of any clear association between initial conditions and reform intensity. On the one hand, a number of countries started from a favourable labour market performance and engaged in few reforms (Iceland, Japan and Switzerland), while the opposite was the case in others (Belgium, Italy). On the other hand, many countries took only moderate action despite a poor starting point (Greece, Hungary, Poland, Spain, and, to a lesser extent, France) while others undertook important reforms even though their initial situation was already relatively favourable (Denmark, the Netherlands and, to a lesser extent, Australia, Austria and Sweden).

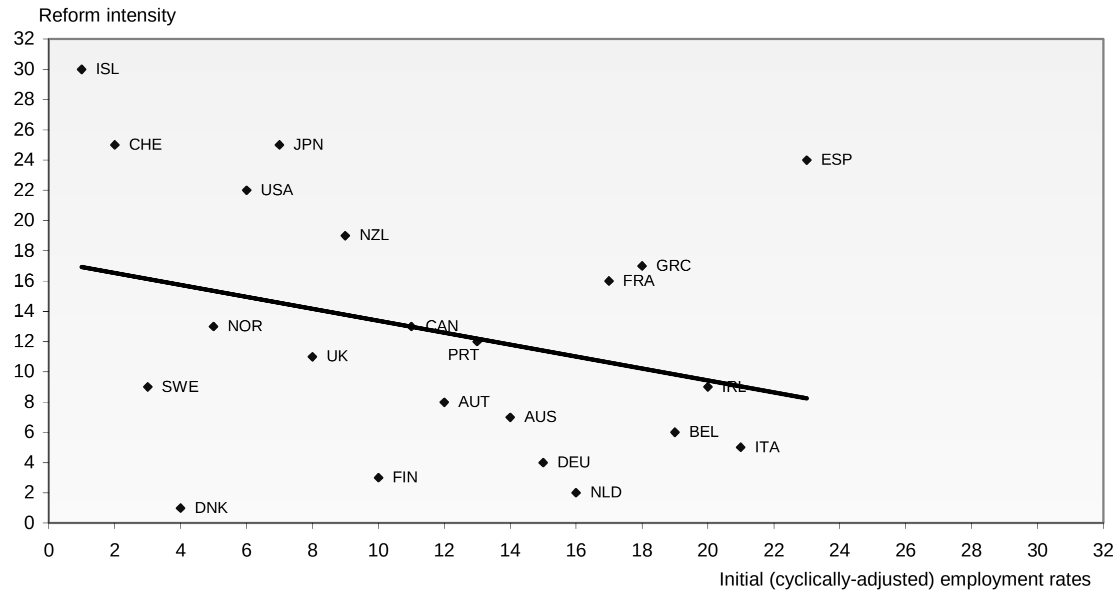
Figure 32. **Initial conditions and intensity of labour market reforms**

Panel A. **Ranks of initial NAIRUs[1] and ranks of reform intensities over 1994-2004[2]**



(Spearman's rank) correlation coefficient: -0.22

Panel B. **Ranks of initial (cyclically-adjusted) employment rates[2] and ranks of reform intensities over 1994-2004**



(Spearman's rank) correlation coefficient: -0.31

1.Nairu estimates for 1993 (1992 for Denmark, Greece, Iceland, Luxembourg, Netherlands, Portugal and Turkey). In the absence of NAIRU estimates for Czech Republic, Hungary, Poland and Slovak Republic, actual unemployment were used.

2. In the absence of cyclically-adjusted employment rate (estimated by controlling for the output gap and smoothed by using a Hodrick-Prescott filter), actual employment rates were used for the Czech Republic, Hungary, Korea, Luxembourg, Mexico, Poland, the Slovak Republic and Turkey.

4.1.3 Strength versus comprehensiveness of reforms

50. Given existing theoretical and empirical evidence of the importance of policy interactions for labour market outcomes,[28] a longstanding OECD policy recommendation has been that comprehensive reform packages should be preferred over less coherent, "piece-meal" reforms. The aggregate reform intensity indicator does not say much about this dimension of the labour market reform strategies adopted by countries during the past decade. For example, behind the broadly similar value of the indicator for Austria and the United Kingdom (Table 8) lie in fact two polar strategies, as Austria undertook moderate efforts spread over a wide range of areas while the United Kingdom carried out major reforms concentrated on two areas (labour taxes and ALMPs).

51. Figure 33 classifies OECD countries according to the breadth and depth of their reforms, in what may be regarded as a rough decomposition of the overall reform intensity indicator along two dimensions. The breadth of reforms is approximated here by the variability of reform intensities across areas within a country: the lower the variability, the more uniform reform intensities are and the broader the reform process is. Depth is defined as the magnitude of the reform effort in the main areas targeted by the country, measured as the average reform intensity across the three categories (among the seven covered in the aggregate reform intensity indicator) in which measured reform intensity is highest.[29]

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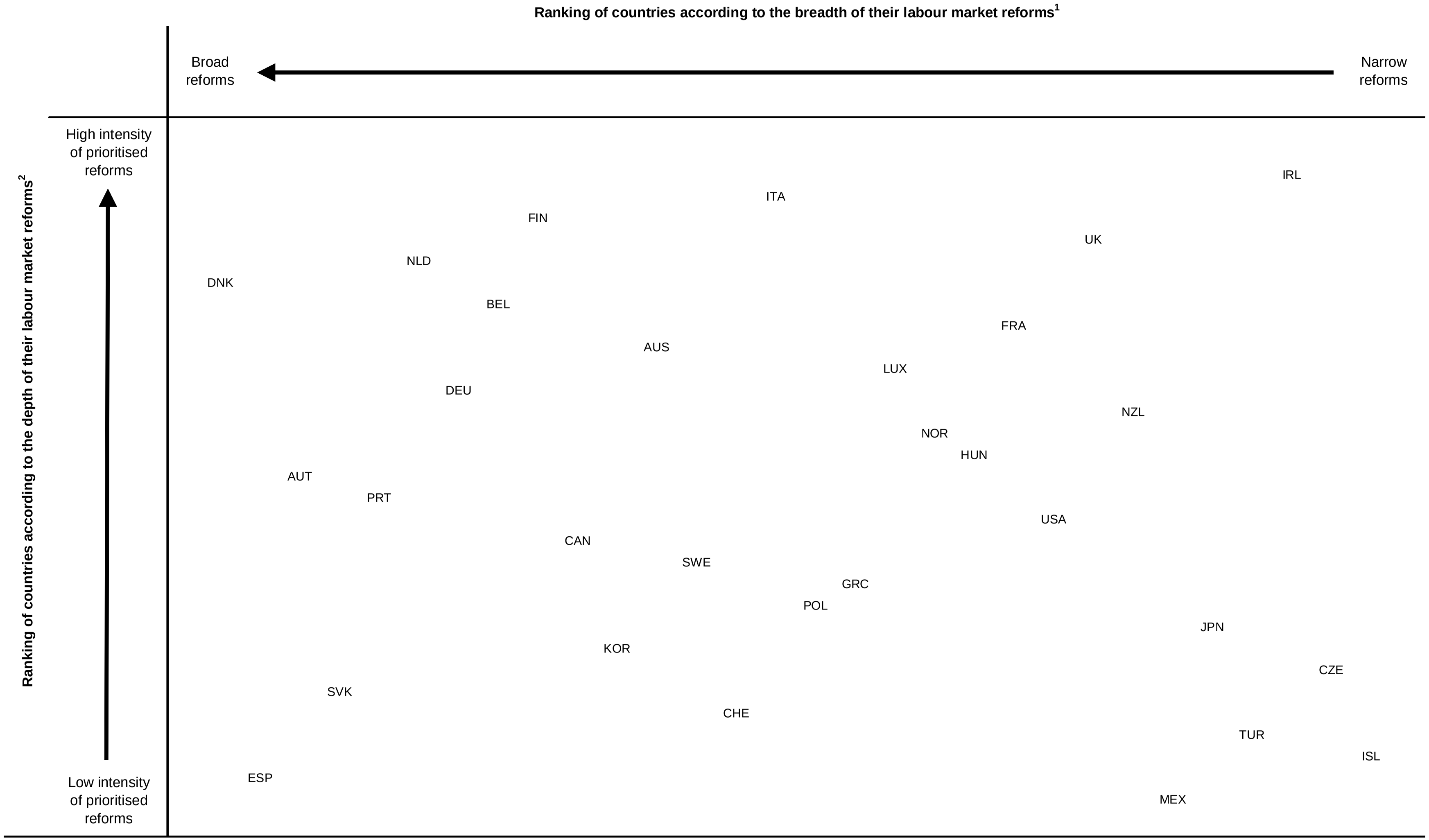
28. For a theoretical framework stressing the importance of policy interactions, see Coe and Snower (1997). For empirical evidence, see for instance Belot and Van Ours (2000) and Elmeskov *et al*. (1998).

29. Considering the two (rather than three) highest reform intensities would alter only marginally the ranking of countries in Figure 32.

Figure 33. **Depth and breadth of labour market reforms**



1. The breadth of reforms is measured as the normalised standard deviation of reform intensities across areas (the lower the standard deviation, the more uniform reform intensities are across areas).
2. The depth of labour market reforms is measured as the average reform intensity across the three areas in which the country's reform effort has been strongest.

52. According to these criteria, Denmark, Finland and the Netherlands stand out for having pursued far-reaching reforms in a wide range of areas since the mid-1990s, opening up for possible policy synergies.[30] Denmark and Finland reformed their unemployment benefit systems, improved the functioning of their ALMPs, tightened access to early retirement provisions, slightly relaxed their EPLs, eased constraints on part-time work and, to a limited extent, lowered marginal income tax rates and expanded tax credits for low-income earners. The Netherlands implemented a broadly similar program, putting however more emphasis on labour taxes and less on unemployment benefits. More recently, and to a lesser extent, Belgium and Germany have also followed a comparable path.

53. By contrast, in some other countries, the reform process was narrowly targeted on specific areas where deep reforms were undertaken. Ireland and the United Kingdom rank very high in terms of the depth of their reforms, but their efforts have mainly focused on labour taxes and ALMPs, reflecting to some extent their already favourable position in a number of other areas. To various extents, Italy and with somewhat less intensity, Australia and France, have also implemented tax cuts on labour income and increased the effectiveness of their ALMPs. Each of these three countries has also taken action in an additional area, reflecting its specific policy priorities: Australia overhauled its industrial relations system, while Italy and France reformed their pension systems.

54. Other countries such as Portugal, Spain, and, to a lesser extent, Greece and Poland, engaged in relatively scattered and often hesitant reforms, resulting in a low value of the aggregate reform intensity indicators. Spain, in particular, relaxed its very strict EPL but policy changes were much more limited in other areas. Finally, in a number of countries where initial labour market performance was already favourable (Czech Republic, Iceland, Japan, Switzerland, United States), reforms have typically been weak and confined to a narrow area.

4.1.4 Reform packages

55. A related question is whether typical policy packages can be identified in those countries which undertook reforms in several areas. Such packages, if any, may hint at political and/or economic complementarities between certain policies. For this purpose, Table 9 presents, for all possible pairs of areas, the number of countries which have undertaken significant action in both areas as part of their recent reform strategies.[31]

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30. New Zealand would have fallen in the same category if the major reforms undertaken in the early 1990s, in particular within the context of the 1991 Employment Contracts Act, had been taken into account in Figure 32.

31. Countries are assumed to have undertaken "significant" action in a particular area if the value of the reform intensity indicator is above 20 per cent in this area. The choice of this threshold is largely arbitrary. However, changing it to 15 per cent (the average reform intensity across all countries) or to 25 per cent would only affect the number, but not the ranking of policy combinations.

Table 9. **Number of countries with high reform intensity in all possible pairs of areas**[1]

	Labour taxes	Employment protection legislation	Unemployment benefit systems	Active labour market policies	Early retirement	Industrial relations and wage setting	Working time flexibility
Labour taxes	..	2	1	10	7	1	6
Employment protection legislation	..	..	0	2	1	0	1
Unemployment benefit systems	..	..	..	4	3	1	0
Active labour market policies	..	..	..	..	11	2	7
Early retirement	..	..	..	..	..	1	4
Industrial relations and wage setting	..	..	..	..	..	..	0
Working time flexibility	..	..	..	..	..	..	..

1. Number of countries for which the value of the reform intensity indicator is above 20% in both of the areas considered.

56. The table confirms that a widespread combination of policy actions has been to engage in both labour tax cuts and a re-direction of ALMPs towards more effective job search and early activation, in an effort to stimulate the demand for and supply of labour. Countries which embraced a reform programme of this type include Australia, the Netherlands and the United Kingdom, but also a number of other countries where tax cuts were more narrowly targeted on low incomes and/or activation policies were often not as comprehensive and far-reaching.[32]

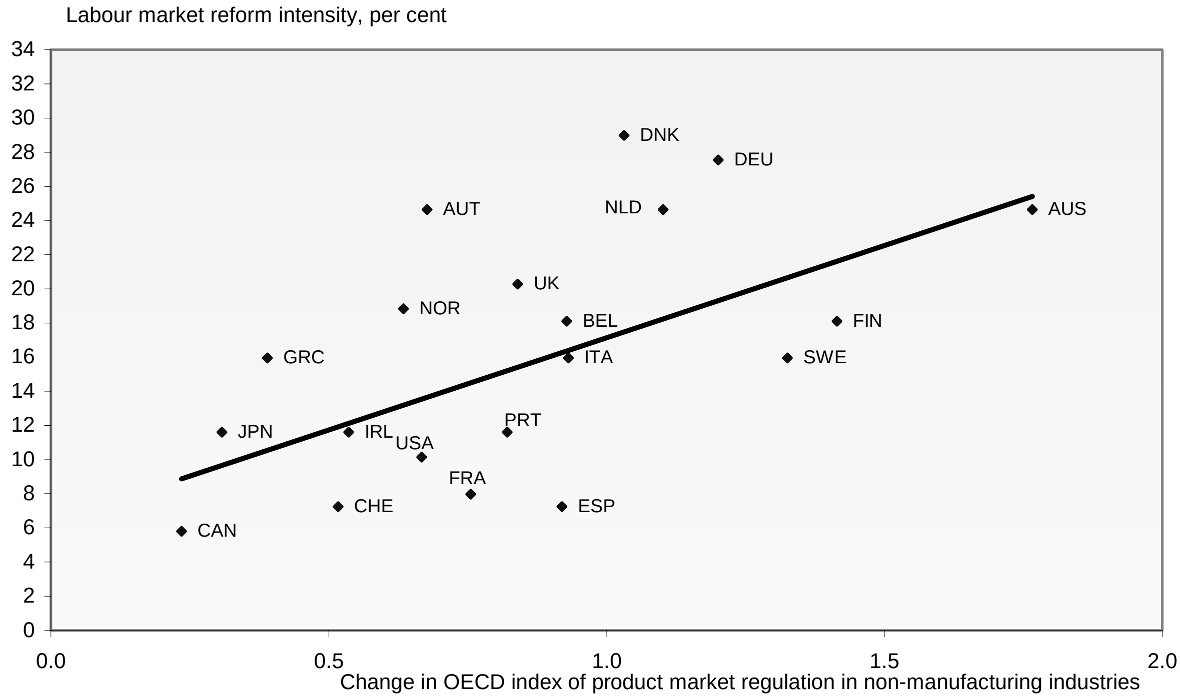
57. Reforms to pension systems and other pathways into retirement have often been concomitant with a mix of tax cuts on labour, improvements in the functioning of ALMPs and more flexible working-time arrangements –typically moving towards less rigid weekly work schedules and/or easing existing constraints on part-time work (France, Germany, Hungary, Italy, Luxembourg, Netherlands). Though such packages can be fortuitous, given that initiatives to raise effective retirement ages had to be taken anyway within the context of ageing populations, they may also be regarded as an effort made on the demand side to accommodate the labour supply effects of pension reforms. In order to enhance the flexibility of their labour markets, a number of OECD countries have also combined less strict EPL for temporary workers with more flexible working-time arrangements (Germany, Italy, the Netherlands and, to a lesser extent, Belgium and Denmark).[33]

32. This was the case in Belgium, Canada, Finland, France, Ireland, Luxembourg, Norway and Portugal.

33. However, this policy combination is not apparent in Table 9, because the assessment of EPL reforms is based on the overall strictness of EPL which has often been less affected by recent policy changes than the stance of EPL for temporary contracts only.

58. Finally, several countries which have undertaken labour market reforms recently had also deregulated their product markets beforehand, as suggested by the significant cross-country correlation between the value of the aggregate reform intensity indicator over the sub-period 1998-2003 and the (lagged) change in the OECD index of product market regulation for non-manufacturing industries over the previous sub-period 1993-1998 (Figure 34). One tentative interpretation of this correlation is offered by the political economy analysis of reforms (see below), according to which product and labour market reforms may be complementary, with the former paving the way to implement the latter.

Figure 34. **Changes in product market regulation over 1993-1998 and intensity of labour market reforms over 2000-2004**



Correlation coefficient: 0.51
t-statistics 2.58 **

4.1.5 The feasibility of reforms

59. A common feature of recent reforms in many OECD countries has been the focus on those aspects of the JS that are perhaps more widely accepted by the population. Such political economy considerations may have contributed to shape recent reform patterns (Table 10).

- *Tax reforms*: Many countries have implemented tax cuts targeted at low incomes (Australia, Belgium, Canada, France, New Zealand, Sweden), but fewer have been able to reduce overall tax wedges, possibly because the latter put strain on public finances and therefore need to be accompanied by contested cuts in public expenditures in order to become permanent.

- *EPL reforms*: A number of countries have eased regulations on fixed-term contracts so as to increase the pool of temporary jobs available to labour market "outsiders" (*e.g.* youth or low-skilled women), but they have generally refrained from lowering EPL for permanent workers (Belgium, Denmark, Germany, Italy, Netherlands, Norway, Portugal).

- *Unemployment benefit reforms*: With some exceptions (Denmark, Finland, Germany more recently), reforms to unemployment benefit systems have been limited overall and have rarely affected the interests of "insiders". Countries which acted in this area often tightened eligibility criteria, conditioned benefit receipt on participation in training and/or reduced associated work disincentives, but they typically did not move far in terms of reducing benefit replacement rates and duration or enforcing stricter work-availability criteria (France, Italy, Portugal), even though some action has been taken on the latter front.

Table 10. **Intensity of recent labour market reforms in specific areas**

(per cent of maximum score)

	Labour taxes		EPL		Unemployment benefit systems	
	Overall	Targeted on low incomes	Regular contracts	Temporary contracts	Replacement rates and duration, work-availability criteria	Other
Australia	0	50	-11	0	7	33
Austria	25	38	11	20	21	25
Belgium	13	75	0	30	14	17
Canada	-25	50	0	0	29	17
Czech Republic	0	0	0	-10	7	17
Denmark	25	0	0	30	36	50
Finland	0	25	11	20	29	42
France	0	63	-6	-10	-14	17
Germany	0	25	6	40	36	0
Greece	13	13	-6	30	0	25
Hungary	50	0	0	-20	29	8
Iceland	-75	0	0	0	14	25
Ireland	88	88	-6	-20	21	8
Italy	50	63	6	60	-29	8
Japan	-25	0	6	30	0	8
Korea	-13	13	17	30	0	17
Luxembourg	25	50	0	0	7	0
Mexico	13	-13	0	0	0	0
Netherlands	25	25	6	30	14	8
New Zealand	0	38	-6	-30	14	17
Norway	-38	0	0	30	36	17
Poland	-13	13	6	-20	14	17
Portugal	13	38	11	30	0	17
Slovak Republic	25	25	6	30	29	8
Spain	25	13	22	10	7	8
Sweden	-13	38	11	20	7	17
Switzerland	13	0	0	0	14	17
Turkey	-13	13	11	10	0	17
United Kingdom	50	63	-11	-10	7	17
United States	63	38	0	0	0	25
OECD average	10	28	3	11	12	17

60. To some extent, political economy factors may also shed some light on several features of recent reforms mentioned earlier. Some of the most comprehensive work in this field raises in particular the following policy issues:

- The fact that efforts have not been consistently greater in those countries where initial labour market rigidities were the highest could partly reflect a "status-quo" bias,[34] namely that public support is stronger –and therefore restricts room for reform– for institutions that are already highly developed. For instance, stringent EPL may receive permanently higher support once implemented, because it helps to maintain some workers in jobs that may otherwise be destroyed.

- Another potentially relevant issue is why countries that have been able to carry out far-reaching reforms are typically small open economies (Australia, Belgium, Denmark, Finland, Netherlands, New Zealand in the early 1990s, Ireland though with less comprehensiveness). One possible explanation rests on the high trade openness and the resulting high labour demand elasticity in these countries (due to more intense competition in product markets), which limits the ability of insiders to set wages above market-clearing levels, resulting in lower rents and thus lower public support for existing institutions. High labour demand elasticities may also reduce concern that increased effective labour supply as a result of reform will not meet with higher labour demand.

- The feasibility of labour market reforms can be hindered by the fact that they often entail short-run costs, while their benefits typically take more time to materialise. In this context, reforms may be facilitated by a stability-oriented macroeconomic framework in which monetary policy is likely to react to a policy change that leads to lower structural unemployment. From this perspective, it may not be a pure coincidence that several countries where far-reaching reforms have been implemented recently also have an independent monetary policy (Australia and the United Kingdom). By contrast, such synergies between structural reforms and macroeconomic policies are likely to be more limited for individual members of the European Monetary Union.

- An open issue is whether the partial reforms that have been implemented in a number of OECD countries in recent years have paved the way for broader ones in the years to come. For instance, even though its direct impact on labour market performance remains subject to debate, less strict EPL for temporary workers may have indirect beneficial effects by gradually building up public support for subsequent reforms of permanent contracts, as illustrated by the case of Spain. In a similar vein, the regulation of product markets has been eased significantly in a number of countries (Belgium, France, Germany, Greece, Italy, and, to a lesser extent, Spain) where recent labour market reforms have been comparatively more limited. As already noted, by reducing the rents accruing to incumbent firms and their workers, these product market reforms may progressively curb the support for labour market institutions aimed at capturing some of these rents.[35]

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34. The concept of status-quo bias was first introduced by Fernandez and Rodrik (1991) in a different context.

35. This mechanism has also been suggested by Blanchard and Giavazzi (2003) and Ebel and Haefke (2004). Product market reforms may also create better conditions to ease EPL via two other mechanisms: i) they have a direct positive impact on overall employment (Blanchard and Giavazzi, 2003; Pissarides, 2001), thereby reducing the incentives for incumbent workers to protect their jobs through strict EPL (Koeniger and Vindigni, 2003); and, ii) they increase the marginal employment gains that can be expected from less strict EPL (Kugler and Pica, 2004).

4.2. Reforms and labour market performance: a preliminary illustration

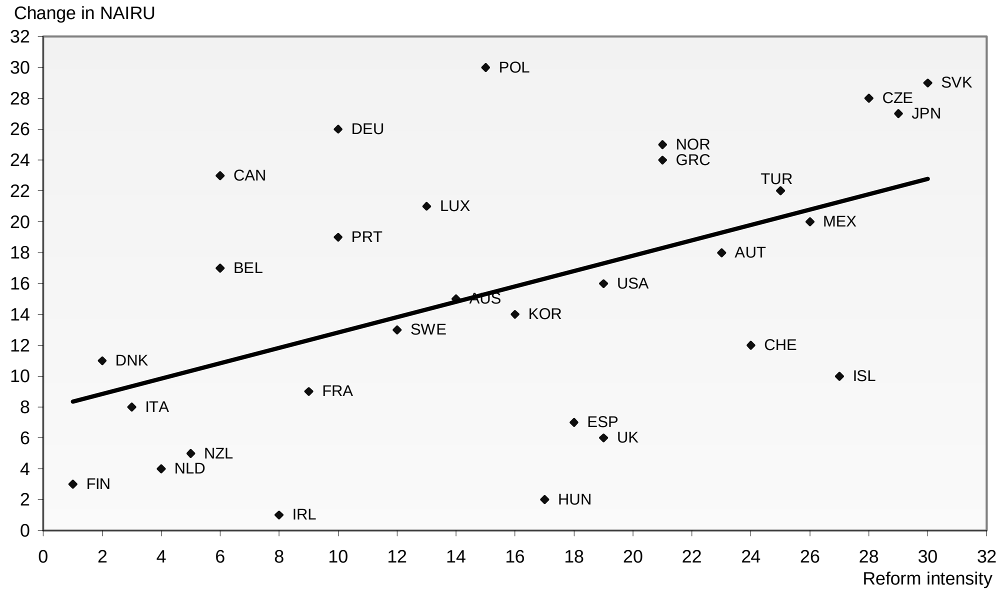
61. As a very preliminary check of the links between the strength of recent reforms and labour market performance, Figure 35 plots countries' ranks in the illustrative indicator of reform intensity over 1994-1998 against their ranks in the change in NAIRU estimates (Panel A) and cyclically-adjusted employment rates (Panel B) over the subsequent period 1998-2003. The use of a lagged rather than a contemporaneous correlation aims to control for the time needed for the benefits of reforms to materialise. Furthermore, focusing on an indicator of reform intensity over the whole period 1993-2003 would incorporate recently legislated reforms which have not yet come into force (*e.g.* the reform of the unemployment benefit system in Germany, pension reforms in several countries). Even so, there are a number of limitations to this type of correlation exercise. In particular, as already noted, the ranking of countries as regards the "overall" intensity of their reforms is sensitive to the relative weights assigned to each policy area, and no account is made for the possibility of policy complementarities and non-linear policy effects on performance. Furthermore, it is likely that reforms undertaken in the late 1980s and early 1990s (*e.g.* in New Zealand or the United Kingdom) impacted on labour markets throughout the 1990s, thereby possibly affecting the calculated correlation.

62. Bearing the caveats in mind, the lagged (Spearman rank) cross-country correlation between the illustrative indicator of reform intensity and the change in the NAIRU is found to be significant at the 1 per cent level. Since 1999, structural unemployment has declined more significantly in a number of countries where above average reform efforts had been made during the period 1993-1998 (Denmark, Finland, Italy, Netherlands and New Zealand). By contrast, it has remained unchanged or even slightly increased in other countries where reform intensity was much lower (Czech Republic, Japan, Slovak Republic), starting in some cases from an already favourable situation (Japan). The estimated correlation between reform intensity and the change in cyclically-adjusted employment is weaker, albeit significant at the 5% level.

63. The experiences of a few countries are at variance with the apparent positive link between the strength of reforms and labour market performance, which could reflect differences in reform strategies in addition to country-specific circumstances. For example, Germany has introduced reforms over the past decade but has still experienced a rise in structural unemployment. This may mirror that the key reforms in this country were not directed at the most important barriers to improved performance or that reforms were not sufficiently intensive. The long-lasting aftermath of the reunification shock may also have been a contributing factor. Spain is also an outlier, having managed to reduce its structural unemployment somewhat -- albeit from a very high level -- while implementing only limited reforms essentially targeted at one area. A highly tentative explanation for the Spanish experience could revolve around the existence of non-linearities in the impact of policies on labour market performance in combination with a particularly restrictive stance in a key area; under such circumstances, the move towards easing may produce larger employment gains than when similar easing takes place from a less-stringent level.

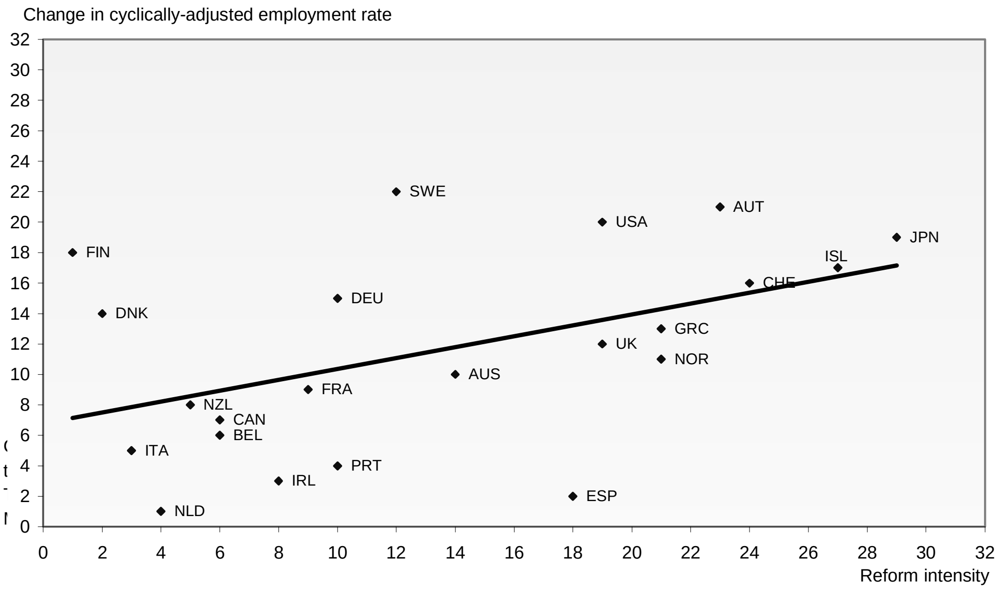
Figure 35. **Lagged cross-country correlations between reform intensity and labour market performance**

Panel A. **Ranks of reform intensities over 1994-1999 and ranks of NAIRU change[1] over 1998-2003[2]**



(Spearman's rank) correlation coefficient: 0.5 ***

Panel B. **Ranks of reform intensities over 1994-1999 and ranks of change in cyclically-adjusted employment rates[3] over 1998-2003**



(Spearman's rank) correlation coefficient: 0.48 **

1. The ranking of countries according to the decline in their NAIRUs is based on the change in the NAIRU in percentage points over the period considered. In the absence of NAIRU estimates for Czech Republic, Hungary, Poland, Slovak Republic and Turkey, the change in actual unemployment was used for these countries.
2. 1992 for Denmark, Greece, Iceland, Luxembourg, Netherlands, Portugal and Turkey.
3. The ranking of countries according to the decline in their cyclically-adjusted employment rates (estimated by controlling for the output gap and smoothed by using a Hodrick Prescott filter) is based on the change in the cyclically-adjusted employment rate in percentage points over the period considered. In the absence of cyclically-adjusted employment rate, employment rates were used for the Czech Republic, Hungary, Korea, Luxembourg, Mexico, Poland, the Slovak Republic and Turkey.

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