European Employment and the Flexicurity Option

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Introduction: the status of European labour markets

Until recently, the general consensus was that European labour markets were characterised by excess rigidity and low performance. However, a more careful observation of labour markets regulations and outcomes in Europe over the last two decades suggests how diverse the experience of European countries has been and that the picture of a homogeneously rigid and underperforming Europe does not entirely fit the data.

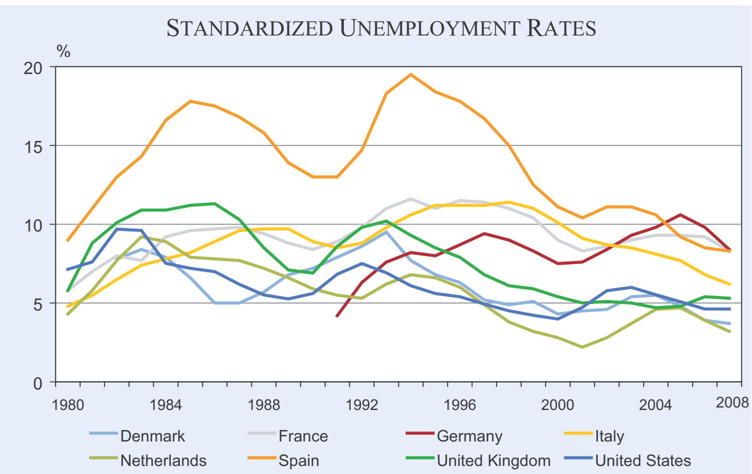
European labour markets have witnessed an apparent reversal in their performance in the last few years preceding the global financial crisis (Boeri and Garibaldi 2008). In some cases the reduction in unemployment has been striking, as shown in Figure 1.

However, there still remain important differences across European countries and in comparison with the United States. Figure 2, for example, shows the incidence of long-term unemployment, i.e., the ratio of those who have been unemployed for more than 12 months to total unemployment. We notice how European countries are characterised by a much higher proportion of long-term unemployment than the United States. Still, all countries in the Figure have experienced more or less pronounced negative trends with Spain and the United Kingdom exhibiting the greatest decrease in long-term unemployment.

The encouraging performance of European labour markets has been accompanied (but not necessarily or entirely explained) by two major labour market reforming strategies. One model, mainly adopted by continental European countries with rigid employment protection, has focused especially on partial reforms of short-term contracts regulations, leaving permanent employment protection largely unaffected. Another model, adopted, for example, by Denmark and the Netherlands, has instead focused in particular on implementing moderately loose regulations on permanent contracts accompanied by generous and rigidly enforced unemployment benefit provision and effective use of active labour market policies. It is this second approach to labour market regulations that is referred to as flexicurity.

In what follows I will briefly examine the premises and consequences of both approaches to the labour market, bearing in mind that each model representation is by definition a useful but limited rhetorical simplification of the diverse and complex experiences of European countries.

Figure 1



Source: OECD Main Economic Indicators.

Partial labour market reforms in Europe

In most continental European countries, the debate on the need for increasing labour mar-

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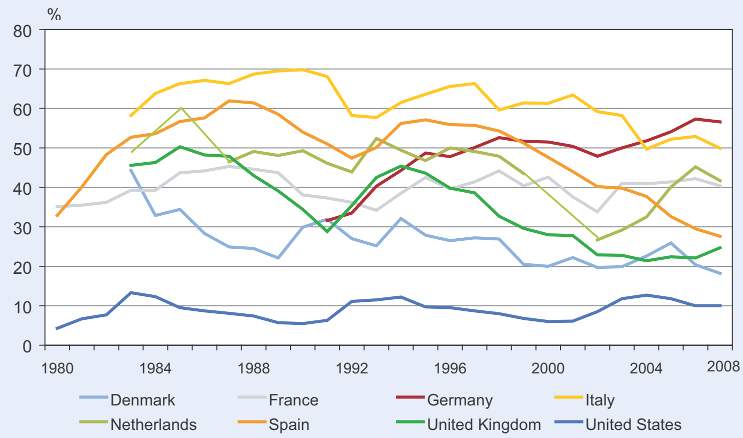
Figure 2

Incidence of Long-term Unemployment



Source: ILO Key Indicators of the Labour Market.

ket flexibility has resulted in a widespread loosening of employment protection legislation, concentrated primarily on temporary contracts regulations.

In Figures 3 and 4 a comparison of the summary indicators provided by the OECD on employment protection in Europe for regular and temporary contracts in 1990 and 2003 (latest data available) indicates how most European countries have adopted reforms aimed mainly at increasing flexibility at the margin rather than reducing employment protection for insiders. This approach can be explained by political economy considerations: the European median voter is part of the insiders' pool, and the unemployed have less impact at the political level than the employed (Saint-Paul 1996).

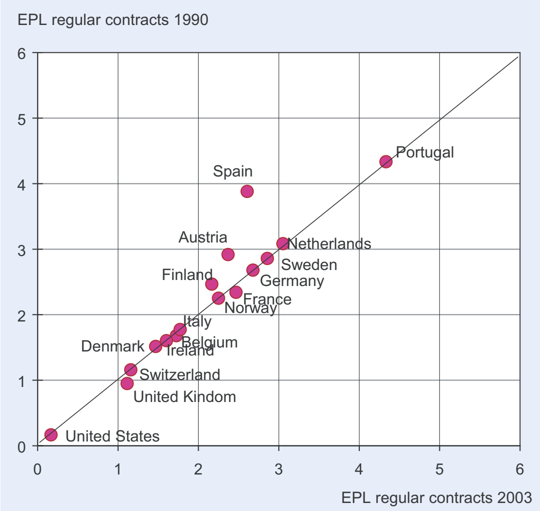
Looking at the data in Figure 5, the percentage of temporary employees has been rising steadily in the major 12 European countries since the late 1980s. In 1987, only nine percent of employees between 15 and 64 were working under a temporary contract against 14.5 percent in 2006 – a 60 percent increase in 20 years. These numbers more than double if we look at young workers, with more than 40 percent of young employees on average being employed under a temporary contract in 2006. In several countries, more than half of the young workers are employed under a temporary contract, and this phenomenon is not only confined to low-skilled workers.

More flexible regulations regarding short-term contracts are not necessarily at odds with permanent employment. Temporary contracts may in principle play a relevant role in the employers' screening process and may be a viable stepping stone to permanent employment. However, they may also lead to an inefficient allocation of human resources and a suboptimal investment in training.

Much research has pointed out that the main factor behind the widespread adoption of temporary contracts is the rigidity in permanent employment protection regulations. As a result, in some countries the regulatory reforms governing short-term contracts seem to have contributed to the creation of a dual labour market, with perverse effects on specific categories of individuals, mainly new entrants, and with debatable effects on career prospects and the accumulation of skills for those employed under atypical contracts (see, for example, Booth, Francesconi and Frank 2002; Blanchard and Landier 2002; Nunziata and Staffolani 2007; Autor and Houseman 2005). According to Kvasnicka (2008), temporary employment has the primary function of providing access to work for the unemployed, without increasing or decreasing the chances of subsequent entering into permanent employment. This mechanism could therefore partly explain the reduction in unemployment experienced by several European countries adopting flexible regulations for temporary contracts.

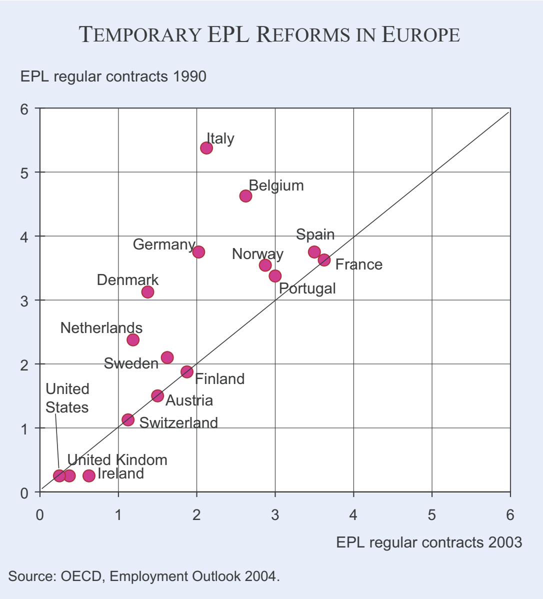
Figure 3

Permanent EPL Reforms in Europe



Source: OECD, Employment Outlook 2004.

Figure 4



Source: OECD, Employment Outlook 2004.

However, easy access to temporary employment does not necessarily solve some of the most relevant implications of labour markets rigidities. For example, strict employment protection legislation has been shown to have a depressive impact on productivity growth (Bassanini, Nunziata and Venn 2008), whereas partial reforms, aimed only at loosening temporary contracts regulations, do not have a significant impact on efficiency and technological change and cannot therefore be considered as substitutes for comprehensive employment protection reforms.

The quest for optimal institutions: the flexicurity option

One possible alternative approach to reforms at the margin is the so-called flexicurity model, meaning an optimal combination of flexibility and security. This implies moderately flexible employment legislation on regular contracts, generous and efficient benefit provision for the unemployed and high spending on active labour market policies.

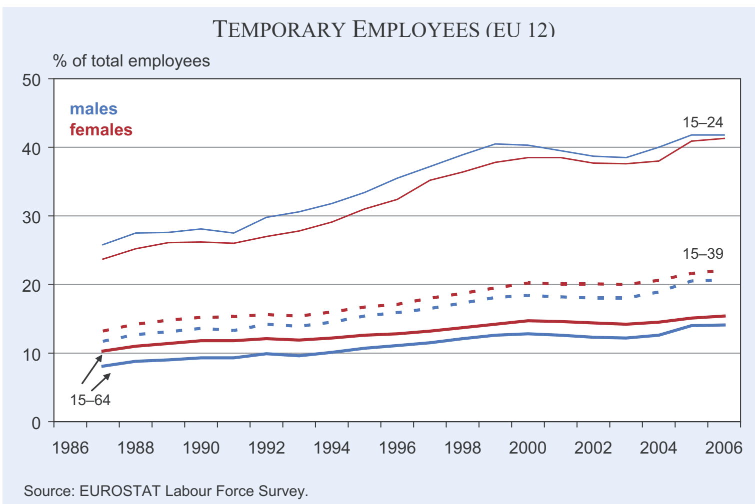
This approach to labour market reforms has received wide attention from commentators and policy-makers, partly arising from the observation that countries characterised by a combination of some degree of flexibility and security, namely Denmark and the Netherlands, were also more successful than others in achieving good labour market performance. As economists, we know that correlation is not synonymous with causation or that a positive outcome in terms of some variables of interest is not necessarily an efficient outcome. Nevertheless, despite questions remaining about the effectiveness of these policies in terms of productivity or about the exportability of such a model in countries characterised by different general institutional environments, the recent debate on the design of optimal labour market policies and regulations has been largely influenced by the discussion of the flexicurity option.

Within a flexicured world, workers benefit from effective unemployment insurance and active labour market policies in exchange for looser employment protection. In other words, a flexicurity system puts more emphasis on the protection of workers rather than jobs.

Flexicurity should not be viewed as a clearly defined regulatory model but as a philosophy behind the regulation of the labour market, according to which flexibility does not necessarily mean lack of security and governments take an active role inpromoting jobs. Accordingly, labour market reforms should be achieved by securing job protection at optimal, moderately loose levels, while at the same time improving the administration, management and enforcement of the unemployment benefit system and assuring a certain provision of active labour market policies.

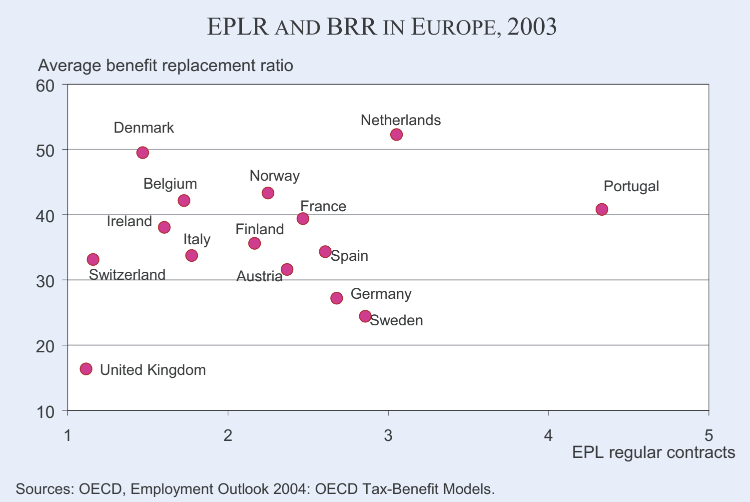
Figure 6 shows the diverse combinations of strictness in employment protection legislation of regu-

Figure 5



Source: EUROSTAT Labour Force Survey.

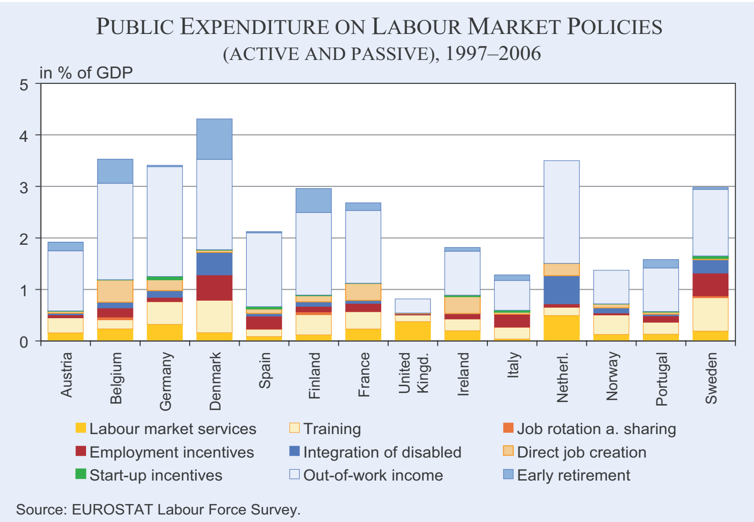
Figure 6



insurance (Boeri, Conde-Ruiz and Galasso 2003).

lar contracts and generosity of unemployment benefits measured by the benefit replacement ratio, i.e., the ratio of the average benefit on the average wage in different European countries in 2003. In contrast Figure 7 shows the spending on labour market policies (active and passive), expressed as a percentage of GDP, broken down by components. The characteristics of European countries with respect to these institutional dimensions are quite diverse. We can see how the generosity in active labour market policies is correlated with generous unemployment benefits, but not necessarily with strict employment protection. If we exclude Portugal, the United Kingdom and the Netherlands, the data also seem to suggest a negative correlation between employment protection legislation and the benefit replacement ratio, providing some evidence in support of the hypothesis suggested in the literature of a possible trade-off between these two alternative forms of labour market

Figure 7



A look at the components of the flexicurity agenda

The effects of reducing permanent employment protection legislation

Historically, employment protection legislation was typically designed to increase job stability by reducing job destruction. Analogously to unemployment benefits, firing restrictions may be rationalised in the presence of financial market imperfections which limit the ability of risk-averse workers to get insurance against dismissal (Pissarides 2001). However, employment protection restricts the firm's ability to adopt optimal employment levels and by inhibiting efficient job separations it indirectly reduces efficient job creation (Mortensen and Pissarides 1994). The literature provides ambiguous results on the effects of employment protection on unemployment. In general, stricter employment protection may affect employment variability along the cycle by reducing the speed of adjustment towards equilibrium, with a resulting significant effect on unemployment persistence but not on the average level (Garibaldi 1998; Mortensen and Pissarides 1999; Nickell, Nunziata and Ochel 2005 among others). In addition, strict employment protection for regular contracts is found to have a depressive impact on productivity (Bassanini, Nunziata and Venn 2008).

Belot, Boone and Van Ours (2007) provide a rationale for a strictly positive, welfare-improving level of employment protection, suggesting that contexts characterised by rigid employment protection may be beneficially affected by an optimal amount of deregulation in terms of growth performance. The contrary may be true for contexts where employment protection is too low. The optimal level of protection is dependent on other institutional dimensions such as wage rigidities and redistributive policies.

All these considerations point to the positive implications of implementing an optimal degree of employment protection for regular contracts, which would result in reforms focusing on increasing flexibility in the most rigid countries. According to the flexicurity paradigm, this increase in flexibility should be compensated by effective unemployment benefit provision.

Implications of generous, monitored and sanctioned unemployment benefits

Acemoglu and Shimer (1999) show how in an economy with risk-averse workers an efficient level of unemployment insurance may increase output and improve risk-sharing. At the empirical level, the impact of unemployment benefits on labour market outcomes is related to the generosity of compensation, the duration of entitlement as well as the coverage and strictness of the administering system. Most empirical research using aggregate data focus on the first two dimensions, given the available information about changes in provision across countries and over time. The generosity of unemployment benefits has been found to be positively correlated with unemployment via its effect on reservation wages and workers' wage bargaining power as well as job search intensity. However, this effect depends on the duration of entitlement (Nickell, Nunziata and Ochel 2005). In addition, financial incentives and sanctions embodied in the enforcement of the unemployment benefit provision by means of effective monitoring of abuses and policies pushing unemployed back to work are more effective in lowering unemployment than a reduction in the replacement rate (Boone and Van Ours 2006; Van den Berg; Van der Klaauw and Van Ours 2004; and Abbring, Van den Berg and Van Ours 2005).

In general, we may conclude that a limited dura-tion in the provision of unemployment benefits, conditional on effective job search induced by strict job search requirements and effective monitoring, may accelerate transitions from unemployment into employment. Nevertheless, the desirability of such a scheme will depend on the administrative costs of running a system based on monitoring and sanctions.

Active labour market policies

Active labour market policies include all forms of government programmes aimed at helping unemployed individuals find employment again. As seen in Figure 7 they include several categories of intervention that may have a different impact in terms of effectiveness.

The empirical evidence is mixed. For example in their discussion of the Danish labour market performance in recent years, Andersen and Svarer (2007) stress the importance of the shift from a passive to an active attitude to labour market policies during the 1990s. According to Calmfors, Forslund and Helmström (2004), the Swedish experience suggests that active labour market policies have reduced unemployment at the cost of displacing regular employment (excluding the effect of training), with no overall beneficial impact on job matching efficiency. The analysis of OECD data by Boone and Van Ours (2004) suggests that training has a larger beneficial impact on labour market outcomes than public employment services, while job subsidies do not seem to play any significant role. On similar lines and despite the heterogeneous experience across countries and types of workers, most micro-econometric evaluation studies indicate that active labour market policies generally have small or non-significant effects on labour market outcomes (Martin and Grubb 2001).

It is still difficult to provide general policy implications about the effectiveness of such programmes, especially considering the heterogeneous nature of each intervention. Most of the literature agrees, however, on the importance of an active role in administering unemployment benefits.

On the basis of what was outlined above, we may conclude that an effective route to reforming rigid labour markets may consist in reducing employment protection to optimal levels to be defined according to the institutional context and enforcing an efficient and monitored unemployment benefit system. However, there are still issues worth discussing about the implications of adopting such policies in different contexts.

Additional prerequisites and consequences of flexicurity

Wage inequality

Koeniger, Leonardi and Nunziata (2007) have found that labour market institutions are a key determi-

Table 1

Percentage change in male wage inequality (w90w10) if change in institutions to US levels

	AL	CA	FN	FR	GE	IT	JA	NL	SW	UK
Baseline	35	21	53	48	48	48	37	60	66	16
Interactions	34	30	61	66	72	68	64	84	65	27

Notes: The countries are Australia (AL), Canada (CA), Finland (FN), France (FR), Germany (GE), Italy (IT), Japan (JA), the Netherlands (NL), Sweden (SW), United Kingdom (UK). The simulations are calculated on a baseline model and a model including institutional interactions over the period 1973–98.

Source: Koeniger, Leonardi and Nunziata (2007).

nant of wage inequality. More specifically, our empirical results show that employment protection, unemployment benefit generosity and duration, union density and minimum wages are negatively associated with the male wage differential. The variation of the male wage differential linked to institutions is at least as high as the amount explained by a set oftrade and technology measures.

Table 1 presents the results of a set of simulations of the change in the 90th-10th percentile log-wage differential predicted by our models if regulations were changed towards US levels (most flexible scenario) in each country. The numbers are obtained using two alternative versions of the empirical model, either excluding or including interactions between institutions. The Table displays sizeable positive changes in the wage differential: an increase between 16 percent and 66 percent for the baseline model and 27 percent and 84 percent for the specification with institution interactions. Not surprisingly, Anglo-Saxon countries have the smallest positive changes since their institutional environment is more similar to the US.

From a political economy perspective, these results suggest that an increase in flexibility may generate inequality levels that may not be compatible with the political feasibility of these reforms.

Nevertheless, according to our model, the inequality effects of more flexible employment protection arrangements in the most rigid countries may be offset by an effective provision of unemployment benefits. These results confirm the view that reforms inspired by flexicurity standards may in principle be a viable way to gain support from the median voter in favour of increasing labour market flexibility. The effectiveness of these reforms should in any case depend on the ease of finding new jobs when unemployed. This, in turn, depends, among other things, on the dynamism of the product market.

Product market regulations

Labour market reforms should be accompanied by parallel reforms in the product market. There are two justifications for this claim. First, from a political economy perspective, a comprehensive strategy aimed at reforming both markets may increase the chances of favourable political support (Blanchard and Giavazzi 2003). Secondly, and equally importantly, less regulated product markets play a significant role in affecting labour market outcomes (Fonseca, Lopez-Garcia and Pissarides 2001).

Table 2 reports the effects of alternative labour and product market regulations on unemployment. The Table shows the implied effect of an adverse shock that would raise unemployment by one percent in a country characterised by mean values of all institutions. Keeping all institutions fixed except the one in question, it is possible to identify the impact of the shock in countries characterised by the lowest (most flexible) and the highest (most rigid) values in the column for that institution, controlling for country fixed effects (Blanchard and Wolfers 2000). Overall, we can see that product market regulations seem to be as relevant as labour market institutions in affecting unemployment, with the barriers to entrepreneurial activity having the largest effect on unemployment.

Accordingly, an increase in labour market flexibility should be accompanied by more competition in product markets. More specifically, removing barriers to entrepreneurial activity is likely to increase the rate of job creation, thereby providing more opportunities for the unemployed in an environment of less secure jobs.

Enforcement of flexicurity principles: judicial system, the public sector and civic attitudes

We have already stressed the importance of the enforcement mechanisms when discussing labour market regulations reforms. In particular, we have seen that the strictness at which the unemployment

Table 2

Change (ΔU) induced by a 1% unemployment increasing shock in countries with an average index

	Employment protection	Union density	Unemployment benefit ratio	Unemployment benefit duration	Bargaining co-ordination
ΔU in country with lowest index	1.02	0.66	0.60	0.69	1.38
ΔU in country with highest index	0.98	1.46	1.49	1.45	0.67

	Weakness of competition policy	Barriers to entrepreneurial activity	Product market barriers to trade and investment	Product market state control	Strength of product market regulation
ΔU in country with lowest index	0.84	0.42	1.23	1.01	0.60
ΔU in country with highest index	1.18	1.43	0.54	0.99	1.25

Note: Indexes increase with rigidity of regulations.

Source: Estimation by the author.

benefits system is operated, at given levels of benefit, is a key determinant of unemployment duration. Accordingly, the efficiency of the legal system should also be considered crucial in determining the likelihood of success for labour market reforms. There is no point in introducing sophisticated reforms of legislation that underpins the functioning of the labour market if the legal system is not efficient enough to actually enforce these reforms. For example, as regards the strictness of employment protection legislation, all transaction costs related to litigation procedures depend on the ability of the legal system to act quickly for the benefit of the employee as well as the employer. These considerations may cast some doubts on the effects of flexicurity reforms in countries that are characterised by inefficient legal systems. In other words, labour market reforms along these lines should require parallel intervention in other crucial regulatory areas in order to be effective.

Similar considerations apply to the public sector in general. Institutions inspired by the flexicurity paradigm may be very costly in presence of an inefficient public sector, especially if we think about the administrative and monitoring costs associated with the provision of unemployment benefits contingent on the job searching effectiveness of the unemployed or the implications of implementing effective and costly active labour market policies.

Finally, even more doubts are cast on the exportability of such policies if we consider the role of civic attitudes in determining the success of labour market reforms based on flexicurity principles. Algan and Cahuc (2006) have shown that the efficiency of the Danish flexicurity model is based on a strong public-spirited attitude that is largely absent in other European countries. Those attitudes are not easily influenced by policy or by the economic environment since they are usually the product of historical and cultural legacies. As a result, policy makers should be very careful in exporting labour market policies from one country to another, without considering the consequences of the interaction with the overall social model prevailing in both the source and the target country.

Education and evaluation

The labour market is a social institution and alternative sets of regulations have consequences beyond its limits. It is therefore useful to go beyond a partial equilibrium approach in assessing the implications and prerequisites of reforms.

Perhaps one of the most important questions concerns education. Reforms leading to increased labour market flexibility are doomed to fail in the long run if not accompanied and supported by parallel investments in education at all levels aimed at upgrading skills and promoting innovation and creativity.

In addition, reforms aimed at reducing employment protection and increasing spending on unemployment benefits and active labour market policies are not budget neutral. It is not yet clear if the financial burden of these reforms may be more than offset by the benefits in terms of increased efficiency and capacity to quickly adapt to macroeconomic shocks, especially regarding the opportunity costs attached to active labour market policy spending. The effectiveness of reforms inspired by flexicurity principles should then always be rigorously assessed by a cost-benefit analysis and well designed evaluation studies with a particular focus on institutional complementarities.

Concluding remarks

When discussing the possibility of exporting flexicurity principles to European countries currently characterised by rigid employment protection regulations, the question should be raised as to whether there are not additional, hidden determinants that have led to the labour market successes in Denmark and the Netherlands. Furthermore, it is important to ask whether this model would actually work in a similar way under different circumstances. Indeed, institutions and regulations should be regarded as part of a comprehensive social model rather than single aspects separated from their context. Similar regulations may therefore have different consequences in another context and countries characterised by specific social, political and institutional features may respond differently to the same reform.

Bearing this in mind, policies inspired by the need for combining an optimal degree of employment protection for all, accompanied by efficient and effective unemployment benefit provision managed under active policy principles, constitute a potential alternative to partial reforms at the margin involving a widespread adoption of temporary contracts. The question for researchers and policy makers should therefore be about identifying viable ways of adapting such reforms to different contexts, focusing on the single institutional dimensions that seem to work effectively while putting less emphasis on the rest, and bearing in mind the limits of such interventions if we fail to look at the broader picture when designing labour market regulations.

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