NEW MODES OF GOVERNANCE PROJECT

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Summary

This work looks at different sides of the link between macroeconomic policy, the link between policy frameworks and the labour market and the performance of economies. In particular, this paper reports on work in four EU Member States: France, Germany, Sweden and the UK, two of which were in the first wave of membership of the euro area, while two have remained outside.

Two main issues are explored in this paper, both of which reflect evolution in the modes of economic governance. The first is what has determined employment performance of the four countries studied, recognising that this performance is affected both by factors specific to the labour market and by broader macroeconomic effects. Second, the paper considers whether the inter-actions between labour market policies and macroeconomic policies have been mutually coherent.

The paper was presented at the workshop on *EMU and the labour market*, ETUC, Brussels, 16th July 2008.

Contents

Figures and Tables

I. Introduction[1]

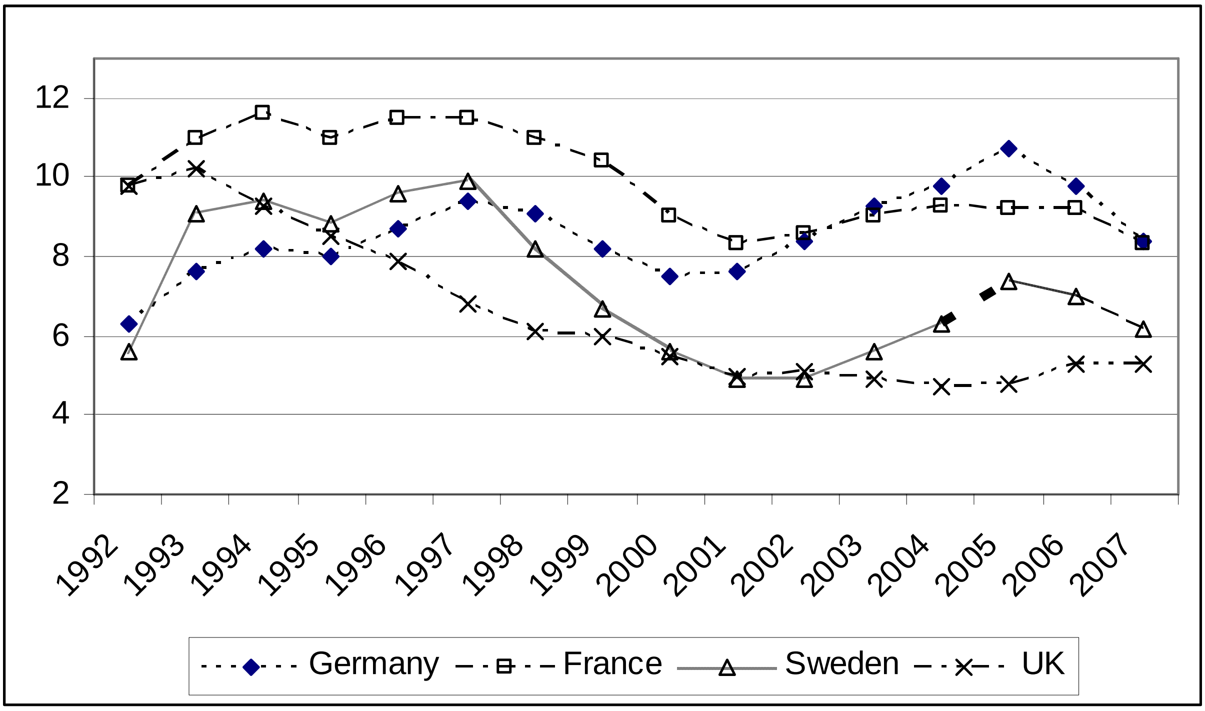
This paper synthesises work done by the author under the NEWGOV project and a SALTSA-IRES comparative study of economic and employment policies in Europe[2] in which the author participated. This work has looked at different sides of the link between macroeconomic policy, the link between policy frameworks and the labour market and the performance of economies. In particular, this paper reports on work in four EU Member States: France, Germany, Sweden and the UK, two of which were in the first wave of membership of the euro area, while two have remained outside.

Two main issues are explored in this paper, both of which reflect evolution in the modes of economic governance. The first is what has determined employment performance of the four countries studied, recognising that this performance is affected both by factors specific to the labour market and by broader macroeconomic effects. Second, the paper considers whether the inter-actions between labour market policies and macroeconomic policies have been mutually coherent. An immediate problem in any attempt to assess employment performance is that different indicators tell different stories that can, on occasion, seem mutually inconsistent as can be seen by comparing figures 1 to 3. France has had a persistent problem of high unemployment and has had a poor record in improving the employment rate, yet has managed to create substantially more jobs than Germany or Sweden since the mid-1990s. On all three indicators, the UK appears to have performed well, but has a known problem of inactivity.

1 The author is grateful for funding from the Integrated Project 'New Modes of Governance' (www.eu-newgov.org), financially supported by the European Union under the 6th Framework programme (Contract No CIT1-CT-2004-506392) and from SALTSA.

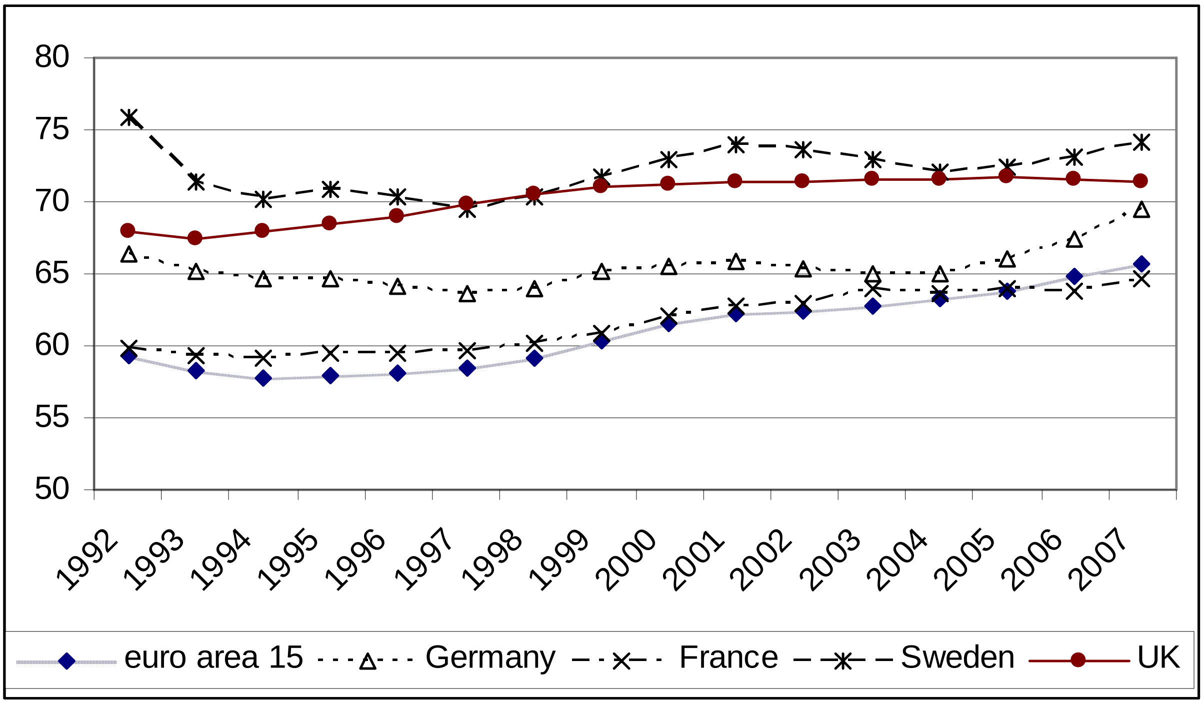
2 The other contributors to the SALTSA-IRES study were Jacky Fayolle, (formerly director of IRES and now at the cabinet Groupe Alpha), Michel Husson and Florence Lefresne (researchers at IRES), and Odile Chagny (formerly of IRES, but now at DARES, Paris). This paper has drawn extensively on the work of these other contributors to the project, but none can be held responsible for any errors and they do not necessarily agree with the interpretations or conclusions. Husson was responsible for a chapter on 'transversal issues'; Chagny and Husson for the chapter on Germany; Fayolle for the chapter on France; Lefresne collaborated on the UK chapter.

Figure 1: Unemployment rates in the four countries



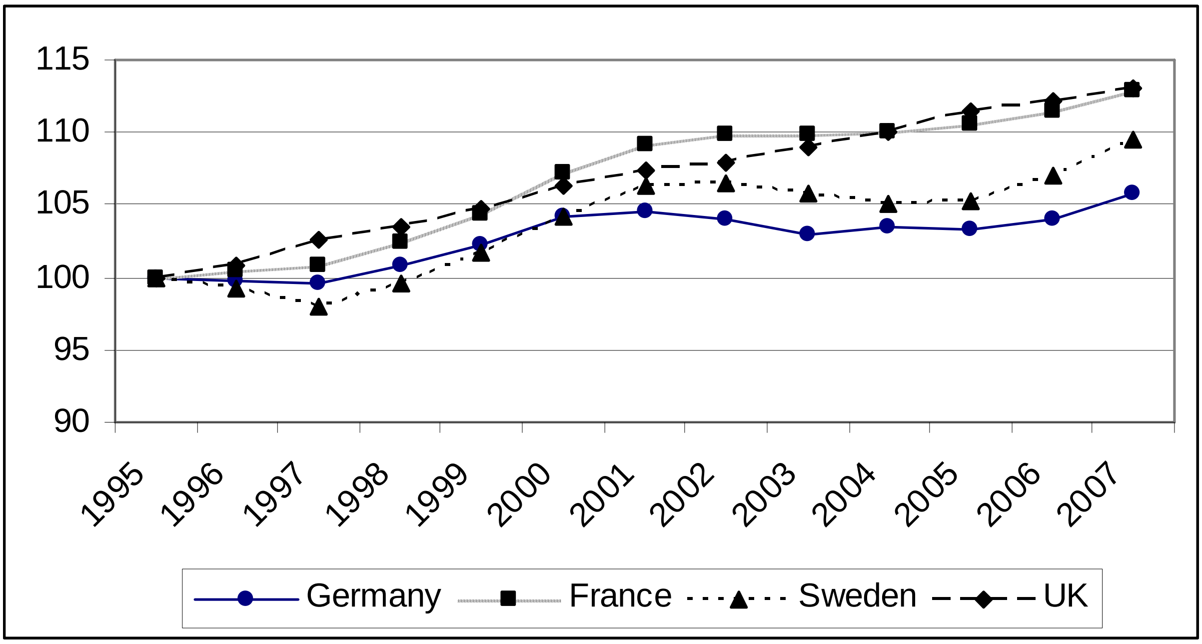
Source: Eurostat. Note series break for Sweden in 2005

Figure 2 Employment rates in the four countries, % of working age population



Source: Eurostat

Figure 3: Employment change in the four countries (1995=100)



Source: Eurostat

An underlying question for this paper is whether EMU has resulted in a qualitatively different evolution of the macro-economy that has, in turn, blighted employment performance. The evidence is hard to interpret, although the recently published report on EMU@ten (Commission, 2008) provides some clues. It shows that business cycles in the euro area became more synchronised during stage 2 (1994-98) when countries sought to accede to EMU, but have not altered much since, while also noting that the synchronisation between the euro area and the rest of the world has increased over the same period. The record of the euro area in terms of jobs creation is considerably better than is often appreciated. Indeed, table 1, taken from the Commission's (2008) report, shows that in the period since 1999, employment in the euro area grew more rapidly than in the US or in the 'control group' of the three EU-15 member States that stayed out (Denmark, Sweden and the UK). However, the corresponding data for productivity and for unemployment are much less encouraging with the euro area recording only half productivity growth of the US and lagging further behind the control group, while unemployment averaged 8.3% in the euro area, compared with around 5% in the peer group.

It is the slow productivity growth that lies behind the relatively slow growth of GDP in the euro area compared with the control group – a case, perhaps of *growthless jobs*, rather than the more usual concern about *jobless growth*.

Table 1: Comparative macroeconomic performances

		Euro area		Denmark, Sweden, UK		United States	
		1989-1998	1999-2008	1989-1998	1999-2008	1989-1998	1999-2008
Real GDP	% rate of change	2.2	2.1	2.0	2.7	3.0	2.6
Real GDP per capita	% rate of change	1.9	1.6	1.7	2.2	1.8	1.6
Real GDP per capita	index, US = 100	73	72	74	76	100	100
Employment	% rate of change	0.6	1.3	0.1	0.9	1.5	1.0
Labour productivity	% rate of change	1.6	0.8	1.9	1.8	1.5	1.6
Unemployment	% of labour force	9.3	8.3	7.9	5.2	5.8	5.0
Inflation	%	3.3	2.2	3.4	1.7	3.3	2.8
Fiscal balance	% of GDP	-4.3	-1.7	-3.6	-0.9	-3.3	-2.5
Gross public debt	% of GDP	68.6	68.6	48.7	43.0	67.8	60.7
Long-term interest rate	%	8.1	4.4	8.6	4.9	7.1	4.8
Real-long term interest rate	%	4.7	2.4	4.2	3.3	4.3	2.4

Source: Commission (2008)

There are, however, diverging views (and were when the euro was still an ambition) on whether the single currency's advent would accelerate or inhibit structural reforms. One school of thought was that the inability to use exchange rate movements to cushion shifts in competitiveness would lead governments to focus more carefully on structural solutions, while the opposing view was that the removal of exchange rate risk (and much of the inflation risk) would make it easier for governments to avoid such reforms. The conclusion reached in the EMU at ten report is that it is hard to discern a clear impact either way, but it notes that the incentives to accelerate structural reform are weak. As Arpaia and Mourre (2005) stress, there are also endogeneities between labour market reforms and macroeconomic performance that have to be seen as an aggregate reform effort and not just piecemeal changes, and they note the importance of policy design in shaping these interactions. A clear policy implication is that if one component is out of kilter with others, the system as a whole will be sub-optimal. It is against this backdrop that developments in the four countries are assessed.

II. Four case study countries: overview of change

In this section some of the main features of change in the four countries studied are presented. For the most part the analysis concerns the period from the early 1990s up to 2006 and thus misses the significant changes that have occurred since the summer of 2007 because of financial instability and the backwash from the US sub-prime crisis. Thus far, the euro area has weathered these storms fairly well, whereas the outlook for the UK is looking increasingly ominous, suggesting that a phase of evolution in economic governance may have come to an end, possibly presaging further shifts in comparative performance.

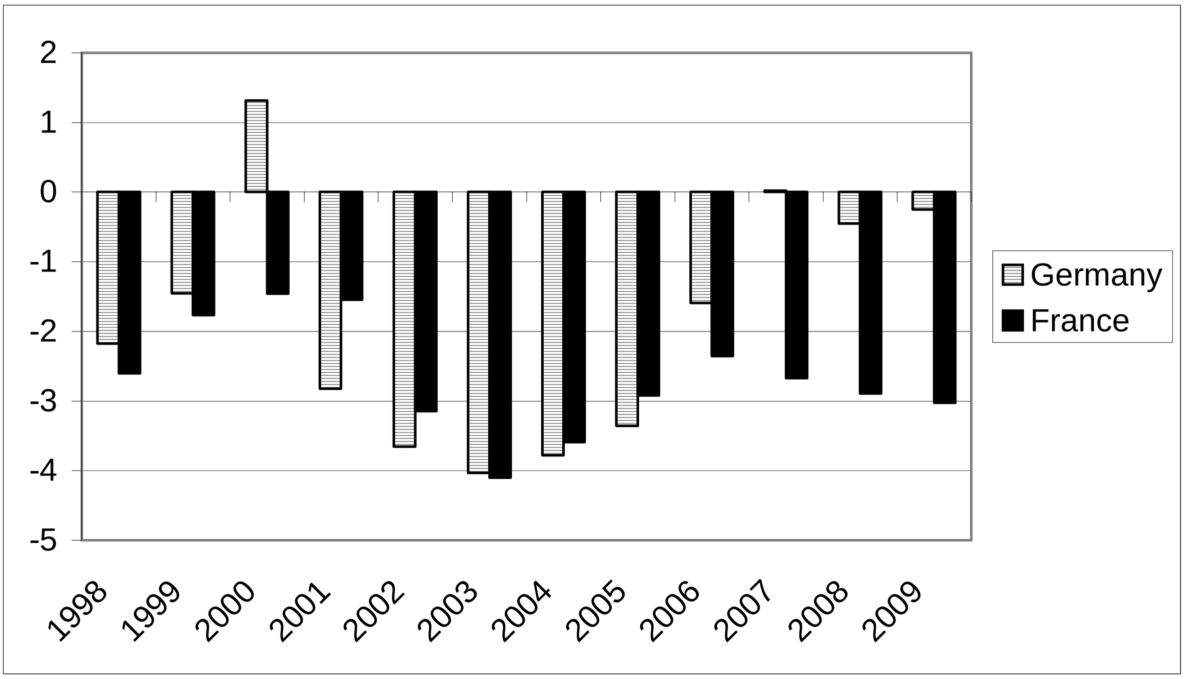
In governance terms, there is much in common between the four countries, all of which have variants on stability orientated macroeconomic policies. All have independent central banks (now the norm in most developed countries) and the preferred monetary policy strategy is one which focuses hierarchically on price stability and, only once that has been attained, on real economy variables. There are minor differences between the ECB approach and those of the Bank of England and the Riksbank, but it is a moot point whether they affect the policy approach.

Both France and Germany are, self-evidently, bound by the same constraints on macroeconomic policy through their common membership of the euro area and the constraints of the Stability and Growth Pact. It is also interesting to note that their fiscal indicators, at least until 2006 when Germany went much further in consolidating its public finances, had followed surprisingly similar paths from 1998 (see figures 4 and 5). Sweden and the UK are also subject to the provisions of the Maastricht Treaty which established the blueprint for the governance of macroeconomic policy in the EU (see Buti, 2005) in regard to excessive deficits, though not to the SGP, yet despite their greater autonomy, their fiscal indicators have, thus far, been more favourable than those of France and Germany. The UK has, though, seen some slippage in recent years with its debt rising and is now deemed to be in a position of excessive deficit. In labour market governance, the four countries manifestly have diverse and contrasting traditions, and have undergone structural reform processes that have differed hugely in recent years in scope and timing. These differences potentially account for the diversities in performance, and are also reflected in wider societal changes.

II.1 Germany

In Germany, the shock of unification in the early 1990s coincided with a period in which the German authorities were trying to maintain a strong currency and to promote the idea of a strong single currency. There is general agreement that the German real exchange rate by 1998 was high, and possibly significantly over-valued, and already from the mid-1990s onward, the German corporate sector had seized on union weakness to promote restraint on real wage growth in an attempt to offset the high nominal value of the exchange rate. A further problem that Germany faced once in the euro area is that it entered with a budgetary position that only just met the Maastricht criteria, and its debt was rising. As such it was vulnerable to a downturn in the economy and its subsequent struggle to keep within the constraints of the Stability and Growth Pact is largely attributable to the lack of adjustment during the 1990s. Hence, by the time recession hit after 2000, Germany had lost room for manoeuvre in fiscal policy, leaving the labour market as the only remaining adjustment variable. France too, rapidly found itself in a very similar kind of vicious circle and has been slower than Germany to find a way out.

Figure 4: Budget positions (excessive deficit procedure, including proceeds of UMTS auctions), % of GNI

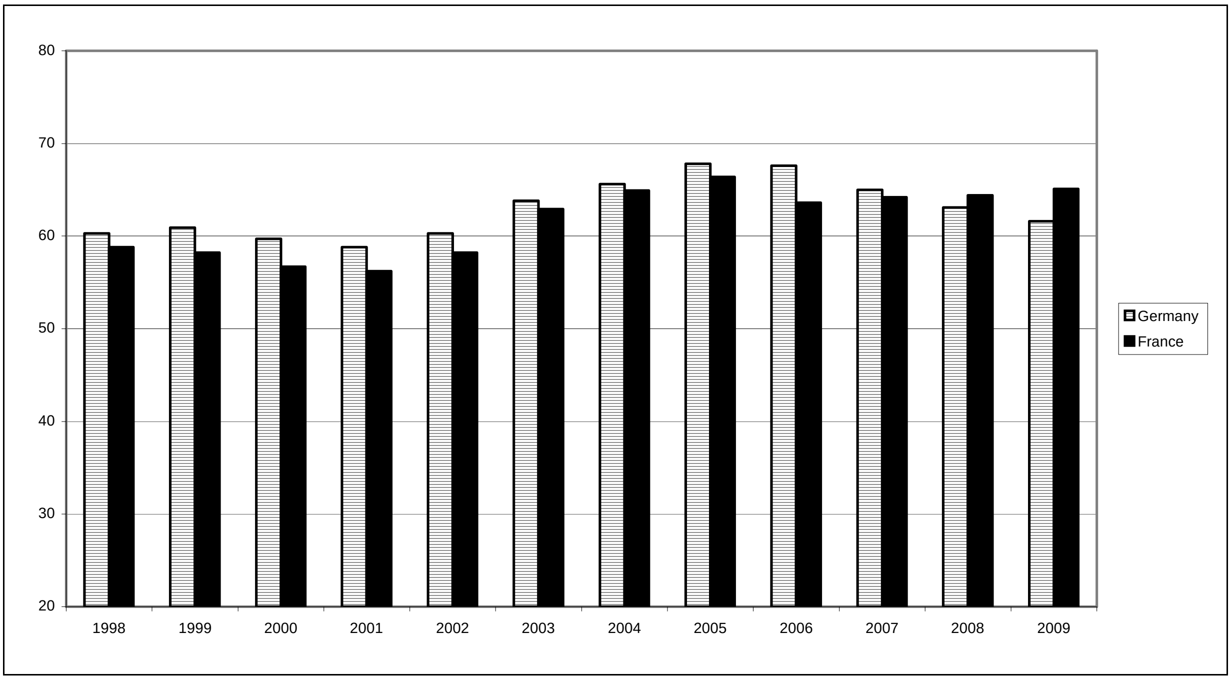


Source: Ameco database

In some respects the German approach was highly successful in restoring cost competitiveness and the impact continues to be visible in the strong trade surplus. Germany has also benefited from its relative specialisation in machinery that has been much in demand from emerging economies. However, there is a paradox at the heart of the German trajectory which is that the very wage restraint that has underpinned competitiveness also resulted in stagnating domestic demand. In turn, weak domestic demand has dampened employment creation and may have inhibited reform in ways that delayed recovery from the downturn of the early years of this decade. To some extent, therefore, a vicious circle may have occurred.

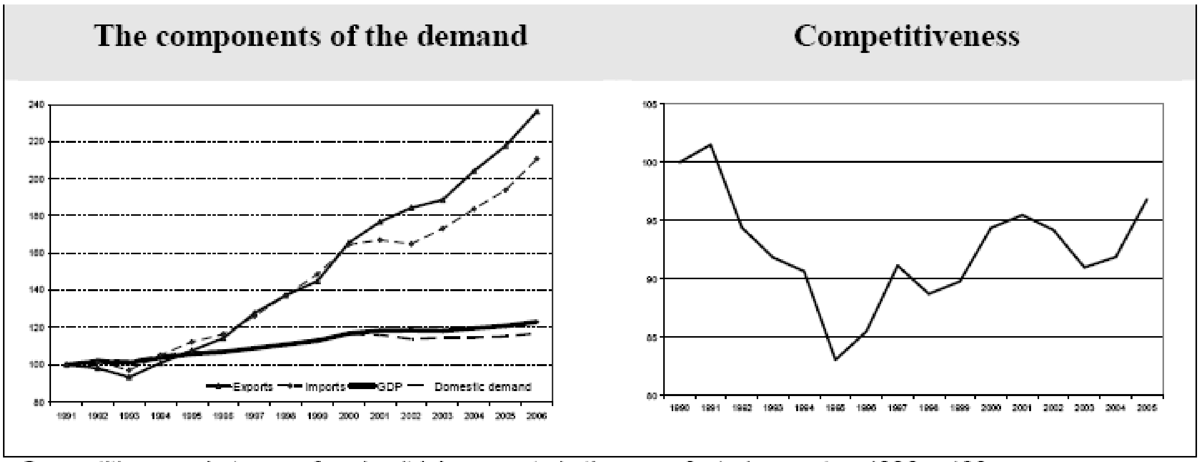
The first panel of figure 6 shows that German domestic demand has grown more slowly than GDP, largely because of the stellar performance of exports, manifestly facilitated by the substantial improvement in competitiveness implicit in the trend in real unit labour costs since the mid-1990s. Looking at different components of growth, table 2 shows that the fall in real compensation of employees contrasts starkly with the export growth.

Figure 5: Gross public debt (EDP procedure), % of GNI



Source: Ameco database

Figure 6: Demand and competitiveness in Germany



Competitiveness in terms of real unit labour costs in the manufacturing sector. 1990 = 100.

Source: OECD, quoted by Chagny and Husson (2008)

Table 2: Annual rate of growth in Germany(%) 1998-Q4 - 2005-Q4

Real Total Compensation per Employee	- 0.4
Exports of goods and services	6.9
Gross Domestic Product	1.2
Final Domestic Demand	0.4
Private Consumption	0.8

Source: OECD

Chagny and Husson (2008) note differing interpretations of these data, one being that slow growth in domestic demand was the price that had to be paid to absorb the low productivity of East Germany, while the competing view is that the slow growth is the result of policy errors that eschewed Keynesian solutions. These authors also point out that preferred form of flexibility in Germany is internal (that is to reduce hours of insiders), rather than external through workforce adjustments. In parallel, Germany resorted increasingly to temporary contracts for outsiders, including the very low wage jobs promoted by the 'Hartz' reforms (see table 3)

Chagny and Husson (2008) also note that prior to the reforms of the first half of this decade, there were characteristics of the German social protection system that distinguish it from other Member States, such as the high replacement rate for long-term unemployed claimants and the long time for which benefits could be claimed by older workers. Although spending on ALMP was just above the EU average, these features may have militated against increases in the employment rate, particularly of older workers.

Various attempts to diagnose the problems of the German labour market were carried out, leading to some key points that can be summarised as follows (for more detail, see Chagny and Husson, 2008), recognising that the unions, especially, did not accept all these propositions:

- Too high labour costs, aggravated, but not exclusively caused by increased social charges associated with the costs of unification
  Result: high structural unemployment
- Few low productivity jobs, especially in the service sector
  Result: low employment rate for poorly qualified individuals
- Perverse incentives from social protection
  Result: fiscal sustainability challenges
- Poorly performing public employment service
  Result: poor matching of vacancies and unemployed
- Ineffective ALMP
  Result: low labour mobility and fiscal sustainability problems
- More emphasis on internal flexibility within companies than on changes in level of employment
  Result: limitations on means of adjustment and bias against 'outsiders'

Table 3: Structure of employment

	1991	1995	2000	2005	variation 1995-2000 (thousands)	variation 2000-2005 (thousands)
Total employment (thousands)	38,623	37,599	39,144	38,778	1,545	-366
Independent workers (%)	9.1	10.0	10.0	11.2	163	439
Part-time (%)	15.7	18.8	24.5	28.9	2,500	1,606
Mini jobs – (Low-wage jobs) (%)	- (1)	- (1)	10.4	12.2		660
Fixed-term contracts (%)(2)	10.1	10.4	12.7	12.6	954	-137
Temping (%)(2)		0.5	0.9	1.2	162	90

(1) Separate records of the figures for the workforce with mini jobs (low-wage jobs) were introduced in 1999.
The total 2000 employment figures from the National Accounts were retropolated to include low-wage jobs.
(2) As a percentage of paid employment.

Sources: Arbeitsagentur, Eurostat, Statistisches Bundesamt, author's own calculations.

The succession of 'Hartz' reforms addressed several of these perceived problems and have to be seen as a package of detailed measures rather than a shift to a radically different mode of governance. Nevertheless, three broad trends can be discerned, namely correcting the adverse incentives in the unemployment benefit system, activating the unemployed through a series of measures ranging from mini- and midi-jobs to improving the employment service, and making EPL more flexible, including the removal of restrictions on temporary employment. The rapid decline in German unemployment since it peaked in 2005 suggests that, despite initial evidence that the short-term effects were negative, these measures have had rather more success than many critics foresaw. It may, therefore, be that there has been something of a j-curve effect. Yet the evidence adduced by Chagny and Husson (2008) from interviews with labour market stakeholders also suggests that macroeconomic developments may have inhibited some of the benefits and delayed the gains.

II.2 France

In France, the relatively slow rate of growth over the last two decades has contrasted with its dynamism in the first three decades after the second world war. For many commentators, this recent trajectory has called into question many of the established features of the economy. In particular, there have been growing doubts about the viability of the form of state capitalism that has prevailed throughout the 5th Republic. Yet it is all too easily forgotten that France achieves high labour productivity, has companies which are global players, attracts its fair share of inward investment and has enviable infrastructure and public health services.

Even so, there is an evident malaise that has given rise to a search for change. In the work of the Commission chaired by Attali looking into the way forward for the French economy, the strengths and weaknesses of the French economy in the face of the challenges of globalisation are carefully assessed. The report notes that throughout Europe sometimes painful reforms have been undertaken and, while highlighting a number of continuing advantages that France has, argues that France is lagging behind in its reforms. One of the more telling comments is that France has been slow to recognise that its highly-successful post-war model has failed to adapt sufficiently. In particular, the extent of top-down control by the state and the continuing relative growth of the state (with France now having the highest share of public expenditure among the OECD countries as a proportion of GNI) are highlighted as a major problem.

Drawing on a series of interviews with stakeholders carried out as part of the SALTSA/IRES study and issues highlighted by the Attali Commission, the following points emerge:

- France suffers from a specialisation structure that has not been employment friendly. Large companies seem to operate with successful ‘internal’ labour market and are often able to cherry-pick the best qualified workers
- By contrast small firms are often deterred from hiring by onerous provisions in the legal code governing employment contracts. This has hampered the growth of sectors that, in other countries, are more entrepreneurial and able to foster new specialisations. Instead, it is state employment creation schemes that have had to be take the lead in providing employment.
- Despite extensive debate on reform of employment contracts, the various solutions on offer have met considerable resistance, slowing the pace of reform.
- The social dialogue is deeply embedded in the French approach to change in the labour market, despite the very low union density.
- The extent of labour utilisation is low with the apparent paradox that even though the average French worker is 5% more productive per hour worked than the average American, over the working lifetime, the French worker’s output will be 35% lower. Research by Bourles and Cette (2006) suggests that if French productivity were measured with comparable employment rates (that is, if the less productive workers currently not employed were included), the US productivity would, in fact, be higher than French.
- There is a proliferation of rent-seeking
- Shortcomings are evident in the French university and research systems with few attaining world excellence standards

- The minimum wage has had an effect in squeezing pay differentials at the lower end of the scale in a way that may have inhibited labour mobility
- There is what the Attali report calls the ‘scandale absolu’ of youth unemployment which averages 22% and affects up to half of the age cohort in some localities
- More generally, there is the fact that slow growth and declining competitiveness have pushed France down the league tables of prosperity and trade performance

The Attali report sets out a series of ambitions and key decisions that need to be taken to restore French dynamism and argues that, provided the full package is adopted, France can recover. Whether deliberately echoing the EU’s single market programme or not, the report puts forward some 300 measures needed to achieve these aims.

Although the report attracted such a barrage of criticism that it has no visible traction in French politics, an irony is that many of the measures within it are now being taken forward in differing guises.

II.3 Sweden

The Swedish labour market and the social accommodations that it encompasses are often put forward as positive examples that other EU Member States should seek to emulate. Typically, such endorsements are offered in the context of advocacy of the ‘Nordic’ social model, with its supposed combination of flexibility and security as captured in the expression ‘flexicurity’. In fact the Swedish model has a long and distinguished, but also distinctive history and even cursory examination of the detail of the various Nordic labour market models rapidly makes it clear that there are significant differences between them, as well as obvious common traits.

In understanding policy developments in Sweden in the last fifteen year, perhaps the major influence was the severe recession that hit the country in the early 1990s, which had repercussions in a number of domains. Before 1990, Sweden had enjoyed a very high employment rate and low recorded unemployment. Data quoted by Anxo and Niklasson (2006) show that in 1990, Sweden’s employment rate was above 83% and its unemployment rate was just 1.6%, adding-up to an activity rate of 84.8%. When the recession struck between 1990 and 1993, there was a ten percentage point fall in the employment rate, while unemployment rose fivefold to 8%, an implication of which was that inactivity increased sharply as some of those who lost their jobs withdrew from the labour force. Anxo and Niklasson suggest that most of the increase in inactivity can be accounted for by an increase in numbers in education and on active labour market programmes.

<u>Key features of the contemporary Swedish labour market</u>

- Sweden’s labour market has a number of distinctive characteristics:
- Despite the shakeout of the early 1990s, the employment rate is still among the highest in the EU, at 73% in 2006[3], and has been consistently so over the last decade. Moreover, Sweden achieves a high female employment rate of 71% which is only four percentage points lower than for males and is some thirteen points above the EU-15 average; only Denmark has a higher female employment rate. Sweden’s employment rate of 70% for older workers is by far the highest in the EU where it averages just 43%.

[3] According to Eurostat data; Swedish national data use a different definition which suggests a significantly higher employment rate of close to 80%

- However, an enduring problem is the extent and persistence of inactivity, a facet of the labour market that loomed large in the 2006 elections and has since given rise to a number of policy shifts aimed at pushing inactive individuals towards employment.
- There is also a problem of social exclusion, not least among immigrants and, more disturbingly, Swedish born children of immigrants who arrived in earlier decades after the second world war. Among newly arrived immigrants, exclusion is most pronounced for those who arrived from outside Europe, many of whom are either asylum seekers or refugees.
- There is a heated debate in Sweden about the true unemployment rate. The official figure for unemployment excludes those on ALMP schemes and thus tends to be some 2 percentage points lower than the harmonised Eurostat figure. But there are also arguments for including those on sick leave, parental leave and early retirement.
- A very specific problem is the high level of absence of work because of sickness. It is suggested that this may be attributable to the moral hazard associated with relatively generous sickness benefits, not least because other data suggest that Swedes have generally become healthier and are employed in less hazardous jobs. As Freeman et al. (2006: 12) observe: ‘despite several changes in the rules governing insurance for sickness absence Sweden still struggles with attaining a balance between aiding those truly unable to work and discouraging those who exploit the system’.
- It has a high rate of unionisation, with union density at 80% and a coverage of collective agreements reaching 90% (data quoted by Anxo and Niklasson, 2006). Moreover, these ratios have been remarkably stable despite the turbulence in the Swedish economy after 1990.
- Gender equality has been a long-standing policy aim, and is reflected in the high female employment rate and the low rate of female long-term unemployment (1.0% in 2005, compared with an EU-15 figure of 3.7%). Yet according to Eurostat data, the gender pay gap is above the EU average. Part of the explanation is the high proportion of female employment in (relatively low-paying) public services[4] and in hours worked.
- An important feature of wages in Sweden is the compressed wage distribution, an outcome which reflects the aims central to the Rehn-Meidner model. Inequality has risen somewhat since the 1980s, but Sweden still has a much more equal income distribution than nearly all other EU Member States.
- The negotiated minimum wage in Sweden is high relative to many other EU countries (including those where it is statutory), at some two thirds of median manufacturing wages
- There is quite strict employment protection which is highlighted by the OECD (2007) as one of the potential obstacles to Sweden reaping the benefits of globalisation. This high level of employment protection differs markedly from the much weaker arrangements in Denmark.
- A particular feature of employment protection is the hostility to temporary contracts, although these have been allowed since 1997, as a result of which the OECD considers that the country has significantly eased its protection of temporary workers compared with earlier decades. As in other countries where EPL is strong, temporary work has been the tactic adopted by employers, leading to something of a dual labour market

[4] Freeman et al. (2006) cite evidence that employment in local government in Sweden tripled between 1964 and 1993 and that women account for 90% of the (large) increase of some 800 thousand workers

- Private sector service employment is on the low side

Macroeconomic framework

The contemporary macroeconomic framework in Sweden is very much a stability orientated one. Thus, the Riksbank became independent in 1999 and has a mandate to assure price stability, as well as a safe and efficient payment system. The Riksbank's interpretation of price stability is a low and stable rate of inflation and it has adopted a 2% inflation target, using a consumer price index as the benchmark. In fact, inflation targeting in Sweden was initiated in 1993, the last year of severe recession, but the approach to monetary policy has since been refined, notably following the granting of independence to the central bank.

Following a change introduced in a budget law in 1996, fiscal policy is also now subject to rules with an underlying target of a surplus of 2% of GDP over the economic cycle, a value set to reflect the need to build up net public assets in anticipation of rising pension demands. The fiscal framework implemented since the beginning of 1997 has a number of distinctive features (see Hansson, Brusewitz and Lindh, 2005, who describe it as a ”top-down” budget process led by the Ministry of Finance). It has targets for both general government expenditure and for the budgetary balance. There were also procedural innovations, including a rolling multi-annual framework and a two-stage decision-making process setting the aggregate first then apportioning spending under 27 headings. Any increase in spending in one area must, therefore be balanced by a cut elsewhere, a device that may have contributed to greater discipline. The new system proved to be robust to the slowdown of 2001-3, though the surplus averaging 5% of GDP in previous years fell to close to balance, with the main reason being discretionary spending, rather than just the operation of automatic stabilisers.

Wage moderation has also been restored, marking a sea-change from the 1980s. Commenting on the long-run trend of wage agreements in Sweden, Fregert and Jonung (2006) observe that the period since 1995, which they characterise as 'the inflation-targeting regime', has been one that stands out. Since 1995, four three year collective agreements have been negotiated, representing the most stability since pacts were first introduced in 1908. Moreover, in contrast to the twenty-year period up to 1990, the do not include indexation. An inference to draw is that the stability orientated policy is highly credible and has exerted a strong influence on bargaining. Fregert and Jonung also draw attention to the fact that the 1995 agreement predated the major institutional reforms affecting fiscal policy and central bank independence.

As the OECD notes in its 2007 survey of Sweden, the transformation since 1993 in the macroeconomic position of Sweden has been impressive. Public debt had reached 73% of GDP in 1994 (when the deficit – aggravated by the downturn - attained 11% of GDP), but by 2006 had fallen to 47%. There has been a structural surplus in the public finances since the late 1990s, with most of the budgetary improvement having been achieved by lowering public expenditure. Even so, the tax rate is still above 50%, some ten percentage points above the EU-15 average. Table 1 presents a range of summary indicators.

Despite the macroeconomic recovery, the rate of job creation in Sweden had been comparatively slow until recently, although it is set to accelerate. According to the web-site of the Swedish *Konjunkturinstitutet*, the Swedish economy was in a 'highly expansionary phase' in 2007, and the projections suggest that the employment rate (on the will attain 80.3% in 2008, with unemployment dropping to 4.5%. Unlike in many other EU countries, low-skill jobs in services are noticeably less prevalent. Real wage growth has been low, and has lagged behind productivity growth, allowing falling unit labour costs. Sweden has, latterly, enjoyed an export boom that has seen its current account surplus grow to exceed 7% of GDP. The OECD

(2007) suggests that migration may have exerted a moderating effect not only by increasing labour supply, but also by providing workers willing to work in lower productivity service industries.

Together with competitive pressures from imports, wage moderation has helped to keep inflation low and it has undershot its 2% target in most years since the target was set after the reforms of 1993. However, one apparent weakness is that although there has been job creation, Sweden has not recovered the jobs lost in the crisis years of the early 1990s and unemployment has remained above the rates experienced prior to 1990.There are, in addition, conflicting views about the true level of unemployment, and also of the degree of slack in the labour market. It has been argued, in particular, that counting those on ALMP programmes, students seeking work and a sizeable proportion of sickness benefit recipients as inactive disguises higher unemployment.

According to OECD estimates, Sweden was among the European countries with the highest levels of employment protection (EPL) in the late 1990s, in stark contrast to its neighbour, Denmark. Indeed in its most recent survey of Sweden, the OECD (2007a) states that its EPL is second only to France's in its intensity. A result has been that insiders tend to have a significantly greater say than elsewhere in labour market institutions and policies, giving rise to pointed political debate about 'outsiders'.

II.4 UK

The UK economy has enjoyed an improved performance since the early 1990s, notably by comparison with the other major EU countries, but also compared to its own history. The improved performance is seen in all the main indicators: higher growth, a low rate of unemployment, stable prices and successful management of public finances. Annual average growth was below 2% in the 1970s, and there were major recessions at the beginning and end of the 1980s. Since 1992, when the last full-blown recession ended, the UK has had continuous, albeit variable, economic growth and its GDP per head relative to the EU average (measured in PPS) has moved up from 93.6 of the EU-15 average in 1992 to an estimated 108.1 in 2006. According to the latest European Commission forecasts, the UK economy will have grown by an annual average rate of 2.5% from 2001-7, comfortably above the rate of 1.7% registered by the euro area. The improved macroeconomic performance has been accompanied by relatively favourable labour market trends, but does not seem to have fuelled inflation as in previous upturns.

During the 1980s, a series of legislative and other measures transformed the labour market in the UK. The broad directions of these changes are well-known: reduced employment protection, curbs on trade union activity (notably the effective abolition of secondary picketing) and a range of other measures designed to increase flexibility. Tax and other supply-side reforms – many of which brought market principles to bear widely on policy - were also implemented during the 1980s and, like much of the labour market reform, have remained largely intact since the change of government in 1997.

However, in the decade after 'New' Labour came to power in 1997, further extensive changes in many aspects of UK economic governance were implemented. First, a new macroeconomic policy framework was established in which monetary policy was delegated to an effectively independent Bank of England, complemented by fiscal policy rules that included a 'golden rule' approach to public investment. Second, a far-reaching programme of 'welfare to work' was introduced with the express aim of activating and rewarding unemployed and inactive people. Third, the government, especially in its second term, substantially increased public expenditure. In addition, many further measures of labour market reform were introduced, some of which restored, though in a different form, rights that had been taken away by the previous government.

It is, however, important to stress that tough decisions were also taken about reforming the macroeconomic framework, cutting the budgetary deficit and pursuing a stability-orientated policy. These initial macroeconomic reforms under Chancellors Lamont and Clarke were taken further when Gordon Brown took over in 1997. An early decision was to delegate monetary policy to an effectively independent Bank of England, though with an inflation target set by the Chancellor. Unlike the approach adopted by the European Central Bank, the target was a symmetrical one obliging the Bank to aim for 2.5% inflation (since changed to 2%) and to ensure that the actual rate did not diverge from the target by more than one percentage point – up or down.

The current fiscal framework relies on two principles: the first is the 'golden rule' that the State only borrows over the economic cycle to funding public investment. In other words, public investment is not sacrificed on the altar of budgetary rigour. Second, the sustainable investment rule requires public debt to be kept below 40%. There has been some concern in the last year or two about these rules being breached and a degree of political sophistry from the Chancellor about the definition of the economic cycle. Nevertheless, the combination of monetary and budgetary instruments has meant that growth and inflation have been maintained at satisfactory levels, ironically without the UK diverging much from the parameters of the euro area rules.

Unemployment has remained comparatively low since its last peak of just over 10% during the 1990-92 recession. The rate fell quite rapidly in the mid–1990s and has hovered around the 5% mark since the end of 1999. One of the main features of the UK labour market that became apparent in the recovery from the recession of the early 1990s is that unemployment responded more rapidly than in the past to the recovery in demand, emphasising the increased flexibility that has become a defining feature of the economy. In explaining relative levels of unemployment, 1992-1997 was a key period, as the rapid growth over those five years meant that the rate of unemployment dropped quickly. In 1992, the rate of unemployment in the United Kingdom was the same as that of France (9.8%), compared with 8.2% in the Euro Zone. In 1997, the rate of unemployment had fallen to 6.9% in the United Kingdom. The drop then slowed down, reaching 4.7% in 2005 and turning up slightly in 2006.

The employment rate is one of the highest in the EU according to Eurostat data based on the LFS, at 71.8% in the 1st quarter of 2005, compared with an EU average of 63.2%. [note: UK national statistics put the rate higher at 74.2] The UK labour market is one of the most female friendly ones, with an employment rate of 66%, a characteristic it shares with Sweden. Unlike most other Member States of the EU, the UK has tended to have lower unemployment rates for females than males and has also had a consistently high employment rate for females. As in the Netherlands, there is a relatively high level of part-time female employment which manifestly raises the employment rate. About a quarter of the labour force is in part-time employment and some 80% of part-time employees are female. Temporary employment is a relatively small proportion of the total at 5.5% in 2002 and is higher for females at 6.7% (4.7% for men).

The record of the last decade (unless otherwise stated, the data quoted relate to the period 1995-2005) has been generally positive for employees as can be seen from the data summarised in box 1, based on a recent overview compiled in a report by Fitzner (2006), with additional material derived from other sources.

Key features of the UK labour market:

- Pay in the private sector has grown at an annual rate, in real terms, of about 2.7%, compared to 2.4% in the public sector. Although some sectors, notably manufacturing, have enjoyed more rapid rates of pay, all major industries have recorded significant real increases
- There is no evidence of poorly paying jobs – typically in retail services – replacing higher quality jobs (manufacturing).
- Female pay, at an annualised rate of 3.2% in real terms, has risen faster than male pay (2.3%).
- The pay distribution has seen a shift in which the proportion of workers on low pay has fallen, more are on high pay and the number clustered around the middle has been stable, contradicting what Fitzner calls 'the thesis of a "disappearing middle"'.
- Despite the opposition of the UK government to the mandatory application of the 48 hour limit in the Working Time Directive, average hours worked have fallen to 32 hours per week., down from 33.5. Male full-time hours average 39, and females, 33.6.
- In addition, the proportion of full-time male employees working more 48 hours has decreased from
- Most part-time workers do not want longer hours and the number who work part-time because they could not find a full-time job has fallen from 13% to 8%
- Job turnover has been stable and, in 2006, the number of job losses due to redundancy fell to 6%, down by three percentage points since
- Temporary employment has fallen from a peak of 7.5% in 1997 to 5.5% in 2005, below the proportion in most other EU Member States
- The employment rate of target groups – the disabled, lone parents, ethnic minorities and immigrants - has increased more rapidly than that of the employed population as a whole

The UK labour market has quite a high annual rate of both inflows and outflows from jobs, with some 6 million moves each year, roughly one in five workers. The number of workers recruited tends to be fairly stable, while the number leaving is more affected by the economic cycle. The evidence shows that the proportion of outflows that is involuntary has been on a falling trend, declining from 37% in 1995 to 28% in 2005[5].

There are, though, continuing problems in the UK labour market which has, notably, long been characterised by poorly developed skills and other structural weaknesses. These include:

- Low productivity, certainly compared with the larger continental European countries, although this observation has to be tempered by the fact that the higher employment rate implies that more low-productivity workers are counted in the data.
- Wage inequalities:
    - The gender pay gap has narrowed, but still persists, especially for women employed part-time
    - There is also still evidence that, after controlling for other relevant variables, men from ethnic minority backgrounds and immigrant women from ethnic minorities are paid less well

[5] Involuntary includes the end of temporary contracts and 'voluntary' redundancy and may therefore overstate the true proportion (Fitzner, 2006)

- The number of working age people on incapacity benefit continued to rise up to 2004, but has now started to decline and is seen as the next key focus of policy action.

III. Interpreting the case studies

Several difficult questions flow from examining the comparative performance of the four economies. The first is whether the greater flexibility of retaining a separate currency has helped the UK and Sweden and imposed a constraint on France and Germany that has inhibited their performance. Second, and despite the common ground in the fiscal policy frameworks, have the differences between them contributed to better policy choices implying that the governance arrangements are more congenial? A third question is whether, and if so how, the institutional make-up of the labour market has facilitated adjustment and, as a corollary, whether the timing of labour market reforms has been critical. Fourth, it could be argued that the relative performances are also related to entirely different factors connected to the specialisations of the different economies.

Finally, a last question, and perhaps the most intractable one, is whether the relative performances are explicable more in terms of the transitional effects of adapting to the new modes of economic governance, as well as the structural reform agenda, than to the underlying features of the different governance models. In this regard, it is interesting to note that Sweden underwent a crisis driven transformation in the early 1990s, while the UK had a long period of structural reform in the 1980s, followed by significant re-casting of the macroeconomic framework during the 1990s. By contrast, both Germany and France only had to make limited adjustments during stage 2 of EMU in order to be founder members of the euro area – unlike other founder members which had to make substantial adjustments. The result has, arguably, been that these same two countries found themselves struggling to cope with the EMU policy environment they then found themselves in once in stage 3 of EMU after 1998. The EMU macroeconomic framework means that when economic adjustment is required, it is in the labour market that it has to occur, at least to a greater degree than hitherto (Ardy et al., 2006). Social protection budgets are also likely to come under scrutiny, if only because governments have to make hard choices in order to conform to the fiscal rules.

III.1 Macroeconomic governance

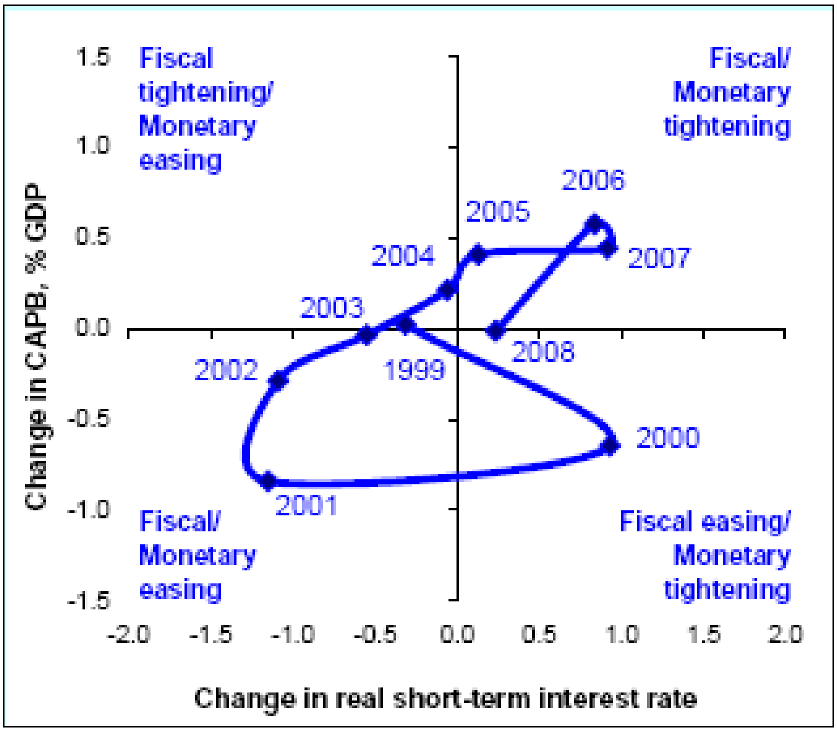
So far, the ECB has, by and large, delivered what it was asked to do, namely price stability. The consensus seems to be that the ECB has not been unduly severe in the priority it has given to stability, prompting the likes of Wyplosz (2006) to argue that the Eurosystem has been wise in its policy decisions and has not slavishly followed what its own statements indicated it might. An implication is that principles and action have, to some degree, diverged. In many respects the approach followed by the Riksbank is very similar to that adopted by the Bank of England. In particular, the use of a symmetrical target with a one percentage point range distinguishes the Riksbank and the Bank of England from the approach adopted by the European Central Bank.

Clearly, the EU has seen a strong convergence in inflation rates that reflects the priorities set for monetary policy both inside and outside the euro area, and the data show that inflation is now low across the EU although pressures from energy and food prices will be a test in the coming year. Volatility in the real economy has also declined, though towards steadier but lower growth rates. Whether this is because of the governance changes adopted with the aim of assuring stability (and not just in the euro area), the pressures of international competition or behavioural changes in societies that recognise that inflation is ultimately pernicious, is an unresolved research question.

Despite some improvement in the last three years, unemployment remains doggedly high in several Member States. According to Blanchard (2005) many explanations of unemployment in the EU are unconvincing and struggle to explain differences among countries. The received view that a wedge between labour costs and wages is to blame is specifically shown to be implausible. What is undeniable is that the EU as whole, despite achieving productivity levels close to those of the US, lags a long way behind in terms of GDP per head, adjusted for purchasing power. Arithmetically, the principal explanation is the significantly lower hours worked, but as Gordon (2006: 44) observes, 'but then the questions begin'. He reviews the evidence for whether the explanation is a preference for leisure, the effects of high taxes on labour, an overly generous welfare state or the effects of union power in restricting hours worked. Gordon finds the first of these explanations to be the most powerful, but also notes that the drift towards flexibility in Europe has reduced some of the gap in recent years. Another plausible explanation is the 'ETUC' one that stability has simply been overdone. It may well be the case that a whole policy emphasis has been created to fight a war against an enemy (inflation) that has disarmed.

Many commentators believe that much of the malaise confronting the EU economy, especially that of the euro area, is self-inflicted, with the fiscal policy framework singled out for the most blame. Others argue just as forcefully that there is nothing wrong with the framework and that it is the lack of budgetary discipline over many years that is at the root of many of the EU's economic difficulties. These perspectives are not necessarily incompatible. There is broad agreement that the fiscal laxity that characterised the 1980s and early 1990s was not sustainable (Allsopp and Artis, 2003) and that fiscal 'consolidation' had to occur. Given that it is never easy to effect such a consolidation, the correction was always going to be painful, irrespective of the Maastricht convergence criteria, the SGP or the multi-lateral surveillance exercised by the Commission. Nor is there much evidence that the fiscal-monetary policy mix has been inconsistent, as figure 7 suggests, apart from a spell in 2000-01.

Figure 7: Fiscal and monetary policy mix 1999-2007



Source Commission EMU@ten report (2008)

The fiscal problems, particularly with the incidence of the SGP, can thus be portrayed partly as a tension between short-, medium- and long-term aims. While the SGP functioned fairly well in the early years of the euro, it ran into problems as the economies of key Member States slipped into recession in 2001, prompting repeated calls for relaxation of the Pact. To a considerable extent it is in the three largest euro area countries that the conflict between stability and growth is most evident. An inference is that Germany, and (less so) France are in a sort of Catch-22 in which, if only they had been able to create space for fiscal policy to work, it would have helped them to solve many of their adjustment problems. The reformulation of the Pact in 2005 has, in fact, been widely interpreted as just such a relaxation, although it might be more accurate to view the changes as a (limited) restoration of political input into fiscal policy. For Gros (2005 and 2006) this re-orientation is to be regretted, since it is seen as allowing policy-makers to be less disciplined in a way that will weaken long-term stability, while Buiter (2006) argues that the SGP is effectively dead.

Although it is hard to find a convincing explanation for divergent employment trends in differences in the macroeconomic framework, there is more reasons to argue that policy choices have been influential. Quite simply, France and Germany had to contend with difficult fiscal positions in the early years of EMU, whereas Sweden and the UK had dealt with their difficulties at an earlier stage. Self-reinforcing macroeconomic trends may also have been important. In the early years of the New Labour government, public spending was held down and the result was a healthy budgetary position, with surpluses in each fiscal year from 1998-2001, a huge turnaround from the record deficit of 7.8% recorded in 1993. As a result, public debt (on the Maastricht definition) fell below 40% of GDP by 2001, having been over 50% as recently as 1996. This reduction meant a significantly lower burden of interest payment on public debt than in France and Germany where the debt has been well over 60% in recent years and also opened the way for a political decision in the UK to invest more heavily in public services, increasing the share of public expenditure in GDP significantly. At 44.6% in 2006, it was only two and a half percentage points below the EU-25 average and is now higher than in Germany as a proportion of GDP, although still well below that in France.

It is true that the country had a lot of catching up to do after years of under-spending, especially on infrastructure. But the catch up was spectacular: two thirds of jobs created between 1998 and 2005 were in the public sector with 224,000 in education and 300,000 in health and social services[6]. There are now more jobs in the latter sector in the UK than in France, although many more are part-time and there are far fewer established posts in the UK. This spending has been financed partly by tax increases and partly by allowing the deficit to expand, although it should be noted that, in EU terms, the UK only just moved into a position of excessive deficit in the period 2002-04 (reaching 3.3%) and brought the deficit back below the 3% threshold in 2005. In this respect the budgetary position of the UK has consistently been better than those of France and Germany. What is less easy to determine is whether macroeconomic policy decisions, as opposed to the framework, then interacted adversely with structural policies to aggravate the problems.

III.2 Labour market governance

Certainly, differences in labour market frameworks and reform in the four countries are considerable, but it is also difficult to identify clear messages about what has worked well and what remains problematic, not least because of the issue of the timing of reform. Some key issues are explored.

6 *Labour Market Review,* 2006, Office for National Statistics.

First, the apparent paradox of the French performance regarding productivity raises a strategic issue: how can raising the employment rate to meet the Lisbon strategy targets be reconciled with maintaining productivity growth, if raising the employment rate involves mobilising less productive people? Should priority be given to returning to full employment before making new progress on the productivity front (which is one way of understanding the American path in recent decades)? Table 3 show that there has been something of a turnaround in comparative productivity trends in the four countries studied, with previously lagging Sweden and the UK overtaking France and Germany in recent years.

Table 4: Trends in productivity growth

	1970-1980	1980-1991	1991-2005
France	3.6	2.7	1.9
Germany	3.9	2.3	1.9
Sweden	2.3	1.2	2.4
United Kingdom	2.8	1.9	2.4

Source: OECD, quoted by Husson (2008)

Although the extensive use of active labour market policies is a hallmark of the Swedish model, some of the evaluations of the approach have raised concerns about their effectiveness. Calmfors et al. (2002), for example, observe that the policies ‘have probably reduced open unemployment, but also reduced regular employment’. An element in the low official unemployment figures for the UK is that the terms on which claimants could obtain benefits were tightened in 1996 to require more job search. In a recent study Manning (2005) finds little evidence that these changes resulted in an increase in the number of claimants taking jobs. Instead, the effect has been to reduce the count of unemployed by about eight percentage points, with the implication that previous claimants became non-claimant inactive. Manning’s analysis suggests that most of the change can be accounted for by outflows from claimant to non-claimant status, rather than any reduction of in-flows into claimant status. Indeed, there are now two and half times more incapacity benefit claimants than job seekers as the job seeker benefit system has been made increasingly more restrictive by successive reforms. This shifting of the unemployed towards other forms ofsocial assistance has, as in the Netherlands in the 1980s, been identified as a policy problem in Sweden and in the UK, and the implication is that there is a much higher volume of disguised unemployment than is revealed by the published data. Yet the high employment rate still testifies to a relatively successful labour market.

A common explanation for the favourable UK employment and unemployment rates is the flexibility of the labour market, albeit with the caveat that these results have been obtained at the expense of the security of workers. It is true that in the UK employment contracts are subject to few regulations and that there is no formal labour code, as in France. However, contrary to the cliché about it being easy to dismiss workers in the United Kingdom, individual dismissal is actually more costly in terms of notice periods and compensation in the United Kingdom than in France[7]. Nevertheless, in spite of the administrative procedures imple-

[7] See the World Bank’s study published in May 2004 on 85 countries: http://www.doingbusiness.org/ExploreTopics/HiringFiringWorkers.

mented in 2004, there seems to be few restrictions placed on employers wishing to terminate a permanent contract. Moreover, this is why there is very little recourse to temporary work (both fixed term contracts and temping) (6% of paid work compared with a European Union average of 17%).

On the whole, the changes in the UK unemployment position appear to be durable, despite the slight increase in unemployment since 2006 and the current difficulties. Estimates suggest that the short-run NAIRU in the UK peaked in the mid-1980s and has fallen since (Batini and Greenslade, 2006). Favourable international conditions that have diminished inflationary pressures are part of the explanation and may now be giving way to more hostile pressures, but structural labour market reforms have also been influential. The minimum wage is set nationally and thus does not reflect differences in cost of living in different regions. As a result, it is more likely to have an impact on the sustainable rate of unemployment outside the high-cost areas of South East England.

The UK employment rate for the working age population has grown almost three times more on a yearly average basis than in France. However, an accounting breakdown of this indicator shows that this relative advantage stems from, on the one hand, the GDP growth differential between the two countries and, on the other, from the quasi-stagnation of the labour force in the UK, although the surge in immigration since 2004 altered the picture.

IV. Concluding comments

The aim of this paper has been, principally, to assess how changes in governance have affected the inter-actions between macroeconomic policy-making and the labour market and a first conclusion on the 'new' governance systems, is that there is clearly much more in common between the macroeconomic frameworks of the four economies considered than separates them. The target or reference value for monetary policy is 2% HICP and, although the ECB does not have the same approach to transparency or symmetrical target. Strictly, the ECB is not an inflation targeter, but even though the ECB has appeared to be relatively less activist in its decisions on the policy rate, it is hard to distinguish it from the Riksbank or the Bank of England in terms of the overall stance of policy.

On the fiscal policy side, there is more to separate the governance structures in the four economies. The UK's fiscal framework has attracted envious glances from across the channel, yet it would also be fair to say that the UK's supposed rules have been stretched beyond breaking point as the economy has gone through more turbulent times. Moreover, the conjunction of rising public expenditure and increased consumer debt that contributed significantly to the maintenance of steady growth in the British economy may well prove, once the current credit crunch has unwound, to have been unsustainable. For Sweden, by contrast, the restoration of fiscal discipline after the crisis of the early 1990s was followed by a gradual toughening of fiscal rules that has established a system consistent with longer term commitments associated, notably, with ageing of the population.

The EMU governance system in aggregate has conspicuously not achieved the improved economic performance that was promised. Criticisms focus on the choice of monetary policy strategy (which some believe to be behind the state of the art), the overly rigid application of the SGP, the incoherence of supply-side policies and the wider shortcomings of the economic governance system (for recent overviews, see Pisani-Ferry et al., 2008 or Begg, 2008). Even the more sanguine report on EMU@ten produced by DG Ecfin (van den Noord et al., 2008) notes that governance challenges remain. Consequently new approaches could offer a different way forward. These might include a more fully-fledged form of *gouvernement économi-*

que or variants on closer co-operation among the willing in economic policy-making, designed to counter these constraints and weaknesses. Stability, carefully and properly pursued, may contribute to economic growth, but it does not guarantee it and should not be seen as an end in itself. Stability could also be associated with distributive shifts, but the reasons for these have to be sought in deeper shifts in norms and political preferences, rather than the macroeconomic policy stance.

Despite both being subject to the same SGP rules and soft governance procedures, France and Germany seem to have moved apart in the last three years in how they approach fiscal policy in practice. If the Attali Commission's warnings are to be believed, France now finds itself at a dangerous cross-roads where fiscal sustainability is at some risk., whereas Germany has taken several steps towards a more sustainable fiscal position. The lesson to draw is that it is not so much the framework as how it is implemented that counts.

Trends in the level of public employment have played a significant role in underpinning employment growth in the UK and, to a lesser extent, in France, in contrast to Germany and Sweden. Other sectoral differences have also been influential, notably the relatively low rate of job creation in private services in France, where the contrast with the UK is striking. Half the new jobs created in the UK since 2000 are in the public sector and the UK is the only EU country that has seen a sizeable increase over the last decade in public expenditure, which has risen to 44 % of GDP, and much of the job creation has been in the public sector.

In the labour market and in social protection, the comparisons among the four countries highlight the importance of the timing of changes. German employment languished in the early years of this decade then suddenly took off. The UK showed in the early 1990s that its labour market had become much more resilient, with the result that unemployment came down quickly after the recession. In Sweden, the increase in employment came much later and seems to have followed a period during which priority was given to productivity, whereas changes in France saw many more jobs in the late 1990s, but lacklustre productivity. Subsequently, the unemployment rate has remained low and the employment rate high, and latterly the economy absorbed a substantial surge in immigration without noticeable effects on the indigenous workforce. The record suggests a degree of flexibility that might imply harsh terms for workers, yet the reality is that the British labour market has evolved to embrace a range of governance innovations that have been, broadly, pro-worker. Indeed it is one of the ironies of the changes that have occurred that the UK stands out as the country which has seen a rise in the labour share, unlike the other three countries.

Finally, something can be said about underlying models. Sweden's approach to labour market governance has little in common with the UK, with the continuing strong role of the social partners in wage-setting and (in contrast to the Danish variant of the supposed 'Nordic' model) still quite tough EPL. Sweden's model is, however, distinctive in the way it brings together the labour market, a commitment to macroeconomic stability and a social policy that champions equality. Whether the current approach (especially since the change in government in 2006) still has the essential features of the Rehn-Meidner model that was central to Swedish governance from the 1930s onwards, despite losing its way during the 1980s, is something of an open question. A reasonable conclusion is that Sweden has managed to maintain much of its original model, in spite of having to recalibrate it. It has also taken effective steps towards dealing with those facets of the model that had broken down or become exaggerated. Yet the election, in the autumn 2006, of a government with a mandate to reform the Swedish model suggests that all might not be well. Some alarm bells are, in addition, sounded in the NBER study completed in 2006 (Freeman et al., 2006), which implies that structural problems may have been masked by possibly short-lived improvements in economic performance.

The UK labour market almost certainly does not correspond to the image it has in so many circles of being a neo-liberal free market one that offers few protections. The UK labour market has changed enormously over the last thirty years, helping to transform an economy justifiably labelled as the 'sick man of Europe' in the late 1970s into one of Europe's success stories. In the process, the UK has, arguably, developed a new model combining flexibility, activation and security that belies the increasingly misleading 'anglo-saxon' image derived from the work of Esping-Andersen (1990). While many of the reforms initiated during the eighteen years of the Thatcher/Major governments pushed unambiguously in the direction of market liberalisation and labour market deregulation, the last decade has seen considerable rebalancing in favour of social justice. Nor, however, is it an example of all that is best, as there are weaknesses that will continue to challenge policy-makers.

Consistency between policies affecting the labour market and macroeconomic policy are much harder to discern in the German and French frameworks. Germany, however, has made a range of adjustments that, taken together, constitute a quite pronounced shift in the governance of the labour market and may point to a rather different model. France, by contrast has proceeded more cautiously and it is clear that the political economy of change will be difficult. Even so, it looks as though it is on its way...

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