Who's Afraid of Labour Market Flexibility?

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Executive Summary

- Labour market flexibility is said to be essential for economic success. Yet precisely what is meant by "flexibility" is not always clear. Some commentators talk about limited regulation, low unemployment benefits with tight conditions, weak trade unions and low coverage of collective bargaining, but the reality is that countries with very different labour markets have performed equally well suggesting that there is no single route to full employment.

- The OECD's 1994 *Jobs Study* has set the frame of reference for the debate about economic policy over the last decade. Indeed, with some notable differences, New Labour's programme is broadly consistent with these prescriptions. The *Jobs Study* is a rather curious hybrid that draws on elements of orthodox Keynesianism (deficit spending in recessions, fiscal consolidation in booms), endogenous growth theory (particularly the emphasis on investment in skills, R&D and innovation) and a rather conventional analysis of the role of trade unions. Twelve years on the OECD are about to publish a comprehensive review and their preparatory work suggests that they now accept that very different labour market models can deliver equally good results. In one sense this is unsurprising, simply because the standard account of what makes for good labour market performance cannot explain the relatively good records of some small countries in Europe – Denmark, Sweden, Austria and the Netherlands.

- It is particularly important to understand that *bundles* of policies are responsible for good outcomes. Simply put, the following seem to be particularly important in explaining why some European countries have done well:

    - A high degree of wage flexibility, often in the context of strong trade unions and high coverage of collective bargaining, where the co-ordination and centralisation of negotiations ensure that wages respond to changes at the macro level and sustain non-inflationary growth.
    - Open markets with a relatively low level of product market regulation
    - "Moderately strict" employment protection legislation that legitimises change but does not act as an impediment to necessary restructuring.
    - Significant investment in Active Labour Market programmes (ALMPs) to improve the skills of the unemployed to help them back into work.

- An "activation" approach to the benefits system so that high benefits are married with tight conditions, limited durations and job search obligations.
- A high level of "functional flexibility" at enterprise level where workers have a wide range of generic skills so that they can be redeployed from one activity to another.

- It is wrong to believe that "flexibility" is a necessary response to the "threat of India and China" or that there is an inevitable "race to the bottom" with an attack on strong welfare states with progressive systems of taxation. The experience of the "low unemployment" countries in the EU 15 (excluding the UK and the Republic of Ireland) show that it is possible to combine social justice and economic dynamism. Similarly, while it is clear that some of the big European economies (France and Germany in particular) face major employment challenges, it would be wrong to believe that the only response is a hefty dose of labour market deregulation.

- Countries need to consider the appropriate policy mix given their specific circumstances. This must include an appropriate monetary and fiscal policy stance alongside, where necessary, the reform of labour market institutions. The objective must be to secure the balance of flexibility and security that has been successfully achieved elsewhere. The OECD make clear that the inter-dependencies between different areas of policy are not always well understood. Policy makers should therefore take care not to rush to judgment and identify either a single reform (like the first employment contract in France) or a package focused on one area of policy (like the Hartz reforms to the unemployment benefits system in Germany) in the belief that such initiatives can carry the full weight of expectations. A more comprehensive and sophisticated approach is needed which explains where change is necessary but also makes clear that some fundamental principles – strong welfare states and progressive taxation – are not under threat.

- The UK is often said to have a "flexible" labour market as conventionally defined, which explains our good employment performance. Yet experience elsewhere suggests that a rather different balance between flexibility and workplace justice can be achieved without any adverse impact on employment. It would therefore be possible to have somewhat tighter regulation the UK *and* retain our highly prized flexibility. Amongst the measures that might be considered are:

- a higher level of compensation for redundancy;
- reducing the qualifying period for a redundancy payment;
- a review of the penalties and sanctions imposed on employers who fail to properly inform and consult about threats to employment and redundancies;
- the development of “sector forums” in low pay, low skill, low productivity industries to improve productivity and increase pay;
- an improvement in the level of out-of-work benefits so that the unemployed are not the victims of a catastrophic collapse in income following job loss;
- increased investment in active labour market programmes to get the socially excluded back to work

Who’s Afraid of Labour Market Flexibility?

1 Introduction

It is now part of the conventional wisdom that labour market flexibility is essential for economic success. This was at the heart of the programmes of successive Conservative governments in the UK in the 1980s and 1990s, it was the golden thread running through the OECD’s 1994 *Jobs Study*, it remains an essential element in New Labour’s approach to labour market regulation and is apparently one of the themes in the Lisbon strategy for improving Europe’s growth and employment performance.

Some proponents of the flexibility argument say that the evidence is very clear. Lightly regulated labour markets, with low unemployment benefits, tight benefit conditionality, weak trade unions and low coverage of collective bargaining deliver higher levels of growth and employment than more regulated systems. The USA is hailed as a beacon of success and “sclerotic Europe” as a calamitous failure. Of course, the truth is somewhat more complicated, even though these statements are accepted as axioms by right wing newspapers and have found their way into mainstream political rhetoric.

We must begin of course by defining what we mean by “flexibility”. An obvious place to start is the OECD Jobs Study, which has been highly influential in shaping public policy over the last decade and a longer discussion of their recommendations can be found in Section 2. But perhaps the best definition in the UK context can be found in HM Treasury’s (HMT’s) research review published to coincide with the five tests assessment for euro membership in 2003. This is the most developed statement we have of the government’s views and the most sophisticated analysis so far of the flexibility of the UK’s labour market.

HMT explore two related conceptions of labour market flexibility. First, the way in which the labour market adapts to a period of disruption through a combination of adjustments in wages, the supply of labour and the demand for labour. This means that in a “flexible” labour market workers will be rapidly redeployed between industries, occupations or regions – in other words employment will shift from declining sectors or regions to growing sectors or regions so that “any disturbance to the labour market is short-lived"[1]. The intention is to identify the factors that enable the labour market to respond rapidly so that the risks to employment are minimised.

Second, flexibility is defined in relation to the institutional factors that determine the "structural" level of unemployment – in other words the level of unemployment that is consistent with low and stable inflation, sometimes called the "natural" rate of unemployment or, to use a more technical expression, the "non-accelerating inflation rate of unemployment" (the NAIRU). Central to the analysis is the belief that the nature of labour market institutions can influence the "natural" rate and in this HMT largely follow the analytical framework of the *Jobs Study* [see Box 1].

Box 1: Defining the Elements of Labour Market Flexibility – The Treasury's View[2]

HMT identify the following factors as contributing to labour market flexibility[3]:

- Relative wage flexibility: movements in wage differentials between different regions and sectors
- Real wage flexibility: how rapidly "real wages" (the pay of individuals adjusted for the rate of inflation) respond to "imbalances between labour demand and labour supply"
- Nominal wage flexibility: the extent to which "nominal wages" (the pay of individuals excluding any adjustment for inflation) adjust, in particular when this demands *potential wage cuts*
- Geographic labour mobility: the ability/willingness of workers to commute or move house to find work
- Employment flexibility: two elements are important here, the composition of work on offer and the degree of flexibility in working time.
- Functional flexibility: the ability to switch workers from one task to another because they have a wide range of generic and problem-solving skills

Important institutional factors include:

- The tax and benefit system

[1] *EMU and Labour Market Flexibility*, HMT (2003)
[2] Ibid, Chapters 2 and 4
[3] Ibid, para 2.7

- Active labour market policies (like the New Deal in the UK)
- Employment protection legislation, including minimum wages and working time regulations
- Product market regulation
- Collective bargaining institutions

HMT argue that the UK has a "flexible" labour market on most of these dimensions, which helps to explain both strong employment performance and sustained non-inflationary growth. In their view wage flexibility is especially important, particularly when combined with an institutional environment that "makes work pay" and ensures, through a mix of incentives and penalties, that the unemployed are encouraged to return to work.

These views remain controversial with some economists, although there is a strong case for saying that the "flexibility" argument is the new conventional wisdom. Simply put, the purpose of this paper is to explore some of the assumptions behind the case for "flexibility" and offer a critical assessment of today's policy architecture. We want to "clear the ground" and inform a more sophisticated discussion about the roots of strong labour market performance. In particular, we want to explore whether this model of "flexibility" is the best explanation of the UK's relatively good employment performance. Our assessment is designed to inform that conversation by establishing "what we know", both as an antidote to popular misconceptions about flexibility and as a foundation for a better exchange about the policy options.

The analysis is driven by a strong belief that the time has come to take stock and, if necessary, adjust policy accordingly. A desire to do precisely that explains why, twelve years on, the OECD will shortly complete a comprehensive review of their 1994 recommendations, with a report to be published later this year.

Most importantly, perhaps, recent research suggests that the standard account of why "Anglo-Saxon" labour markets perform well is shot through with myths, half-truths and a cynical manipulation of the evidence. For far too long the proponents of a crude model of flexibility have had the best of the argument – even though an accumulating body of research suggests that rather different policy packages can produce equally good results.

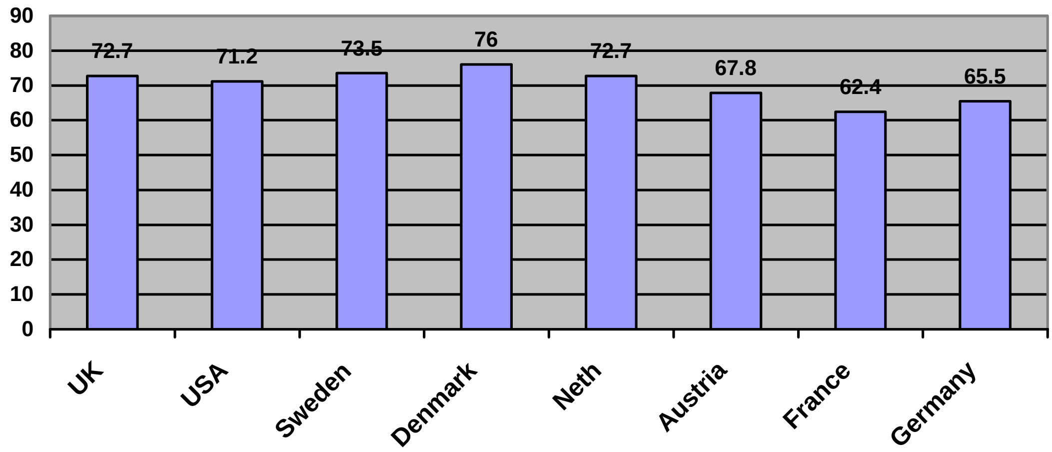
The supposed case for "flexibility" also goes right to the heart of the debate about the future of "social Europe". In particular, an assessment of comparative employment performance can help us to decide whether high taxes, strong welfare states and over-mighty unions are the cause of

"Europe's" supposed malaise. As a starting point we might note that the problems confronting "Europe" are by no means uniform. France and Germany may have high unemployment but Denmark, the Netherlands, Sweden and Austria do not, which suggests that a "one size fits all" programme of structural reform at EU level is neither necessary nor desirable; national problems demand national solutions. One can also be reasonably confident in asserting that there is no need for a wholesale dismantling of institutions or a comprehensive assault on systems of progressive taxation. The experience of some of the smaller countries proves conclusively that social justice and economic success are by no means incompatible.

Very different systems deliver good performance

We know therefore that countries with very different labour markets seem to achieve comparable levels of employment performance (see figure 1). For example, the UK, the Netherlands, Denmark and Sweden all have similar rates of labour force participation but only the UK is close to the conventional interpretation of what is meant by a flexible labour market.

Figure 1: Employment Rates in 2004 (% persons of working age in employment)



Source: OECD Factbook 2006

Equally, the Nordic countries and Holland all have either higher or similar rates of labour force participation to the USA, despite the supposed "inflexibilities" of the former.

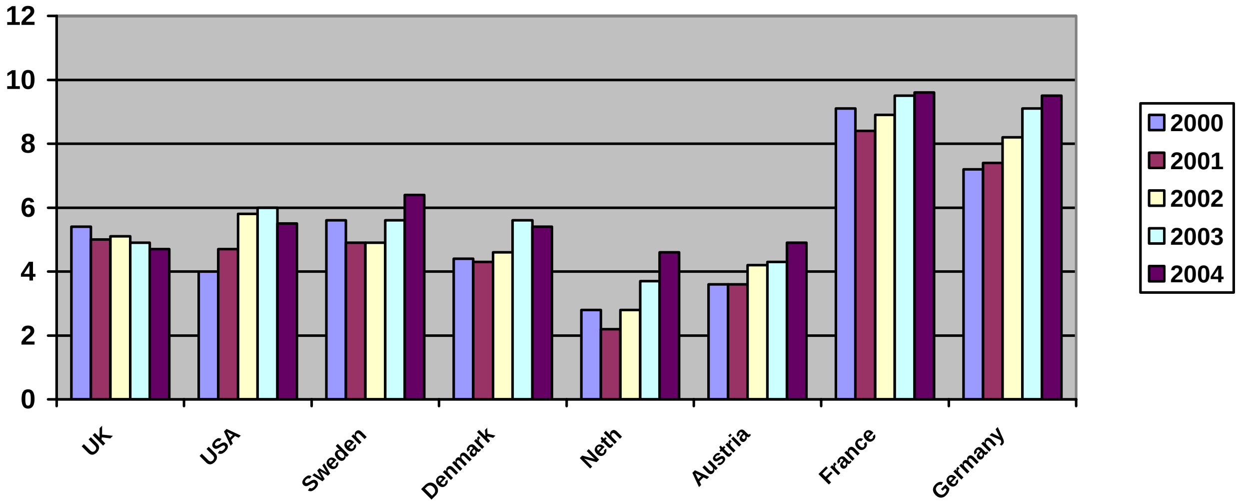
Moreover, the present government has introduced measures that constitute a significant re-regulation of the UK's labour market. For example, the *Jobs Study* suggested that inappropriately high minimum wages damage employment prospects, but the UK has introduced a rather successful minimum wage that is rapidly rising up the OECD league table. Similarly, the qualifying period for unfair dismissal protection has been reduced and compensation increased. Standard employment rights have been extended to part-time workers. Employers are now required to comply with extensive information and consultation obligations. Working time has been subject to comprehensive regulation for the first time (even though employees can "opt-out" from the 48 hour limit on the average working week) and employees have statutory rights to paid holidays.

Despite all measures, which might be taken to be rigidities by a neo-classical economist, the UK's labour market has performed well, inflation has remained low and employers, while they have complained about the burden of "red-tape", seem to have adapted without too much difficulty to the new environment.

What all this suggests is that the conventional narrative about labour market flexibility, or at least its popular interpretation, is a rather crude analytical tool of little assistance in the development of policy. The relative success of the Nordic countries, the Netherlands and Austria in keeping unemployment low (see Figures 2 and 3) is inexplicable when viewed through a standard neo-liberal lens. All these countries have higher taxes than the UK and the USA, larger states, more extensive welfare systems, strong trade unions, moderately tough employment laws and extensive coverage of collective bargaining.

It is important to understand these rather simple and straightforward facts. The "European" story is not simply a tale of high unemployment in France and Germany. Nor is it a story of widespread deregulation leading to better employment performance.

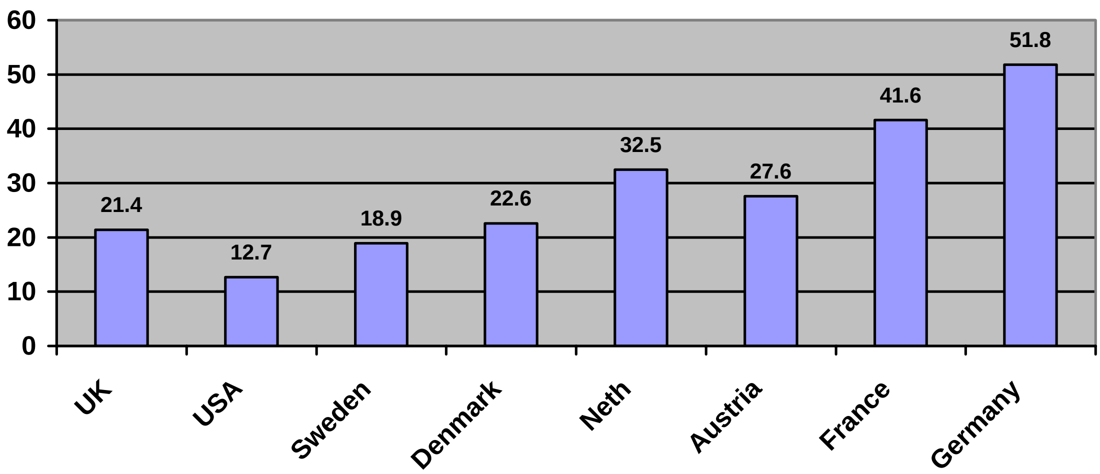
Figure 2: Unemployment 2000-04 (% of the labour force)



. Source: OECD Factbook 2006

Figure 2 shows the level of unemployment over the 2000-04 period and confirms that while the UK and the USA performed well, other countries did too. Only the UK had consistently falling unemployment over the period (although there has been a rise since that time), but Denmark, the Netherlands and Austria consistently outperformed the USA *and* achieved better social outcomes with higher life expectancy, better general health, less income inequality and a lower level of in-work poverty

Figure 3: Long-Term Unemployment in 2004 (persons unemployed for 12 months or more as % of total unemployed)



Source: OECD Factbook 2006

These European countries may have performed less well than the USA in reducing long-term unemployment (Figure 3). But the UK, Sweden and Denmark, with their very different labour market models, have all achieved very similar outcomes. It has also been suggested that the USA's low level of long-term unemployment may not be the significant advantage that many suppose. Indeed, one commentator argues that low wage, low productivity workers in the US are just as much of a drag on GDP growth as the unemployed in France or Germany. The argument runs as follows: low benefits of limited duration force American workers to take *any* job that happens to be available – hence the higher level of in-work poverty. People are moving rapidly from unemployment into jobs that they really should not take, when it would be better for them and for the economy generally to wait a little longer, improve their skills, achieve a better "job match", work more productively and earn higher wages. The net result is that workers employed in "bad jobs" in the USA make a very limited contribution to the economy (in other words, their marginal product is close to zero). This is not because these workers produce nothing, but because they produce "negative effects on others at work", reducing overall productivity[4].

Notwithstanding these observations, it is self-evident from the data that unemployment in France and Germany has proved stubbornly resistant to policies designed to get the labour market moving again. However, we would be unwise to conclude that a hefty dose of labour market deregulation is the most effective remedy. Perhaps we need to look beyond the standard story of "euro-sclerosis" to explain the reasons for poor performance in France and Germany. Of course, there is an issue about the cumulative impact of labour market institutions (trade unions, employment protection laws, unemployment benefit rules) on employment performance, but as the OECD is honest enough to admit, the relationships between the various elements are poorly understood. What can be said with confidence however is that some of the smaller countries of the EU15 (and to some degree the UK) have achieved good labour market performance by deliberately eschewing policies to *deregulate* the labour market. Simply put, two labour market models seem to work well: the "Anglo-Saxon" model and the "Nordic" model – with the UK as an "idiosyncratic hybrid". As we will see, these approaches have many differences and few similarities, suggesting that there is no single route to the achievement of full employment.

All of these issues will be explored further in this paper. It examines the recommendations of the original *Jobs Study*, discusses HM Treasury's (HMT's) own assessment of the flexibility of the UK labour market, considers whether the OECD has "recanted" and then explores some of the issues of special relevance to the EU – more precisely, the relationship between the flexibility story, the Lisbon process (intended to make the EU the most dynamic "knowledge economy" in the world by 2010) and the problems of unemployment in France and Germany. Finally, it draws some lessons for UK labour market policy and considers whether we are really witnessing the emergence of an "Anglo-social model".

[4] For a more developed discussion see p 40 below. The argument was initially advanced by Peter Lindert in *Growing Public* (Vol 2) (2004) p 118

2 The 1994 OECD Jobs Study

The OECD *Jobs Study*, published in 1994, has set the terms of reference for the public conversation over the last decade. Indeed, one might say that it is perhaps the most influential document that the OECD has published in recent times. The investigation was inspired by a ministerial mandate handed to the secretariat in 1992, following the rather bumpy economic ride of the previous twenty years. Oil price shocks, stagflation, persistently high unemployment and growing earnings inequality conspired to create an economic environment that was believed to demand a new departure in policy.

The OECD's principal concern was to develop a better understanding of those factors that explained good (or bad) employment performance. Their task was to identify those interventions most likely to return the developed economies to a stable growth path with falling unemployment and an absence of inflationary pressure.

It is quite reasonable to describe the OECD's approach as "neo-liberal" simply because high levels of unemployment were assumed to be "structural" and a consequence of inappropriate labour market or welfare policies. Central to the analysis was the view that an increase in aggregate demand might reduce unemployment somewhat, but the presence of " structural weaknesses" meant that any boost to the economy would be short lived, inflation would soon reappear and governments would need to adopt restrictive monetary and fiscal policies to return the system to equilibrium. "Structural reform" became the mantra of politicians looking to find reasons why unemployment remained high.

This was not so much a rejection of Keynes on ideological grounds as an assertion that the traditional instruments of demand management had proved to be ineffective. Orthodox Keynesians found it difficult to respond to "stagflation" in the 1970s (rising unemployment and high inflation) and new orthodoxies, monetarism in the UK and supply-side economics in the USA, took to the field.

However, it is also important to understand too that the *Jobs Study* represented a break with the "New Right" economics of the 1980s. There was nothing in the OECD's work to suggest that the control of monetary aggregates was the route to successful macro-economic policy – indeed, pure monetarism had been largely abandoned in the UK by the mid-1980s, simply because the money supply (the infamous Sterling M3 was the government's preferred benchmark) proved hard to measure and even harder to control.

Similarly, the rather austere OECD economists never gave any real weight to the arguments of Arthur Laffer and the supply siders. By the end of the 1980s it was clear that the core of the theory – that tax cuts for the rich would prove an engine of growth, leading to higher tax receipts *and* higher incomes for the less affluent – was nothing more than the "voodoo economics" described by the first George Bush (shortly before he accepted Ronald Reagan's invitation to run for Vice-President on a supply siders platform). Indeed, the fiscal stance of the Clinton administration was deliberately designed to undo the damage wreaked on the US economy by over enthusiastic supply siders. Tax cuts and lavish defence spending had led to huge (and growing) deficits rather than the increased tax receipts and faster growth that Laffer and his acolytes predicted. After a decade of boom and bust fiscal responsibility was back in fashion.

We should therefore interpret the *Jobs Study* exercise as an effort to use empirical evidence to identify the sources of strong labour market performance. As we will see it is something of a hybrid, drawing upon elements of orthodox Keynesianism (deficit spending in recessions, fiscal consolidation during booms), insights from endogenous growth theory (particularly the emphasis on innovation, training and skills) and a continued desire (consistent with the Thatcher-Reagan model) to have wages determined by free markets rather than agreements between employers and unions.

It is worth setting out the central recommendations of the *Jobs Study* in some detail, both to illuminate the "hybrid" nature of the model and to avoid a crude characterisation of "neo-liberalism" [see Box 2] [5].

Box 2: Recommendations of the 1994 *OECD Jobs Study*

The recommendations focused on the following:

- Sound macroeconomic policies
- Enhancing the creation and diffusion of technological know how
- Increasing working time flexibility
- Nurturing an entrepreneurial climate
- Increasing wage and labour cost flexibility
- Reforming employment security provisions

[5] *The OECD Jobs Study: Facts, Analysis, Strategy*, OECD (1994)

- Expanding and enhancing active labour market policies (ALMPs)
- Improving labour force skills and competences
- Reforming unemployment and related benefit systems

Sound macroeconomic policies: Macro policy should be oriented to faster non-inflationary growth of domestic demand when there is economic slack and the suppression of inflation when recovery is well under way. Fiscal consolidation should be a "medium term objective" to reduce budget deficits and levels of public debt. Public spending should be refocused on the creation of new firms and on active labour market policies rather than passive measures of income support. These are principles that a Keynesian could wholeheartedly endorse.

Enhancing the creation and diffusion of technological know-how: These recommendations drew on the insights of endogenous growth theory and suggested that policies should be aimed at "improving the ability of societies to create and make effective use of new technologies which form the basis for high-productivity, high-wage employment". This required:

- investment in basic research;
- improved international co-operation to reap economies of scale;
- the international protection of intellectual property rights;
- market driven institutions to diffuse and apply new technologies;
- market driven institutions to diffuse and apply new technologies;
- promotion of investment through the removal of regulatory barriers to market access.

Increasing working time flexibility: This recommendation was mostly focused on fostering freely chosen part-time work and encouraging older workers to participate in the labour market. The OECD were not apparently suggesting the wholesale dismantling of well established working time regimes. Their objective seemed to be the promotion of more diverse working patterns, so that employees had more than a simple choice between a "full time" or a "part-time" job and employers were able to offer a wide range of different working time arrangements which suited both employees' desires and business needs. Some legislative change might be required (for example to allow temporary agency work), but this fell short of an argument for comprehensive deregulation.

Nurturing an entrepreneurial climate: It was asserted that broadly based policies were needed to encourage vigorous enterprise creation in the private sector. Specific reference was made to removing regulations that impeded entrepreneurship alongside public education campaigns and legislative change to remove the stigma of business failure. In addition government should provide appropriate support for SMEs in the fields of business planning, training, technology and export credit guarantees.

Increasing wage and labour cost flexibility: Policy recommendations included:

- a reassessment of the role of statutory minimum wages (indexing to prices rather than earnings and allowing for variations by region and age);
- reducing non-wage labour costs by reducing taxes on labour (particularly in Europe);
- removing obstacles to part-time work from the tax and social security system; and,
- reducing taxes on those with low earnings to "make work pay".

Over the medium term it was suggested that sectoral collective bargaining should be restructured to allow for negotiations at a lower level. Measures that provided for the "extension" of collective agreements across a sector should be repealed. Competition in product markets should be intensified through deregulation, lowering tariff barriers and privatisation so that firms and employed "insiders" were less able to "exploit rent sharing at the expense of employment opportunities for unemployed outsiders".

Reforming employment security provisions: While it was suggested that unfair dismissal restrictions protections should remain, it was also said that there was a powerful case for regulatory reform to make it easier to dismiss workers "for economic reasons". Furthermore, it was suggested that those countries that currently prohibited fixed term contracts should remove this prohibition. Protection of long-term employment should be kept "light", particularly in the early stages of an employment relationship.

Expanding and enhancing active labour market policies (ALMPs): This recommendation was focused on a reorientation of the role of government employment services ensuring that placement, counselling, the payment of benefits and the management of ALMPs were under the control of one agency. Where government employment services had a monopoly position this should be removed. Employers ought to be involved in the design of training programmes. Job creation measures should be targeted on the most vulnerable groups, with unemployment compensation set at a level below market rates to maintain an incentive to seek paid employment.

Improving labour force skills and competences: This required:

- the improvement of initial education (including pre-school programmes for those from the most disadvantaged groups);

- better "staying on" rates at secondary schools;
- more scope for parents to choose schools;
- better incentives for teachers (like performance pay) and improved programmes for continuing professional development.

Furthermore, it was proposed that governments should focus on better school to work transitions and more incentives for business to encourage workers to continue learning. One positive recommendation suggested that skill levels ought to be reflected in company accounts so that human capital could be seen as an investment rather than a cost.

Reform of unemployment and related benefit systems: It was suggested that unemployment insurance (UI) systems should be reformed so that benefits were restricted in those countries where they were currently of long duration. This should be matched by a higher level of UI benefit conditionality. Measures should be taken to ensure that low paid workers were better off in work than on benefits. However, withdrawal rates should not be so high to discourage a woman from working part-time if her husband/partner was unemployed. Long-term benefits should be conditional on participation in active labour market programmes – especially for those who had just left school. In addition, it was suggested that mechanisms should be developed for detecting and minimising benefit fraud.

What is most striking perhaps is the breadth of these recommendations. Far from being focused only on labour market policy, they might be taken as a comprehensive set of broad economic policy guidelines for developed countries. Many of the recommendations will sound rather familiar to a UK reader, which reinforces the case that the OECD recommendations have had a profound influence on the approach adopted by policy makers and politicians of all parties. Indeed, one might say that New Labour's economic programme has been drawn (with some significant differences) from the *Jobs Study's* analysis and policy prescription. What we have here is a compendious statement of the new conventional wisdom.

Looking specifically at the UK policy context, the recommendations on macro stability are exemplified by the Chancellor's fiscal rules and the commitment to the Bank of England's constrained discretion on monetary policy. The objective of fiscal consolidation can be seen in the use of the 3G mobile phone auction proceeds to repay debt.

The Chancellor has consistently emphasised the need for more investment in R&D and the Lambert review explored the need for better business/university links.

Measures to “promote entrepreneurship” have been included in almost every budget since 1997 and recent changes to insolvency legislation have been designed to remove the “stigma of failure”.

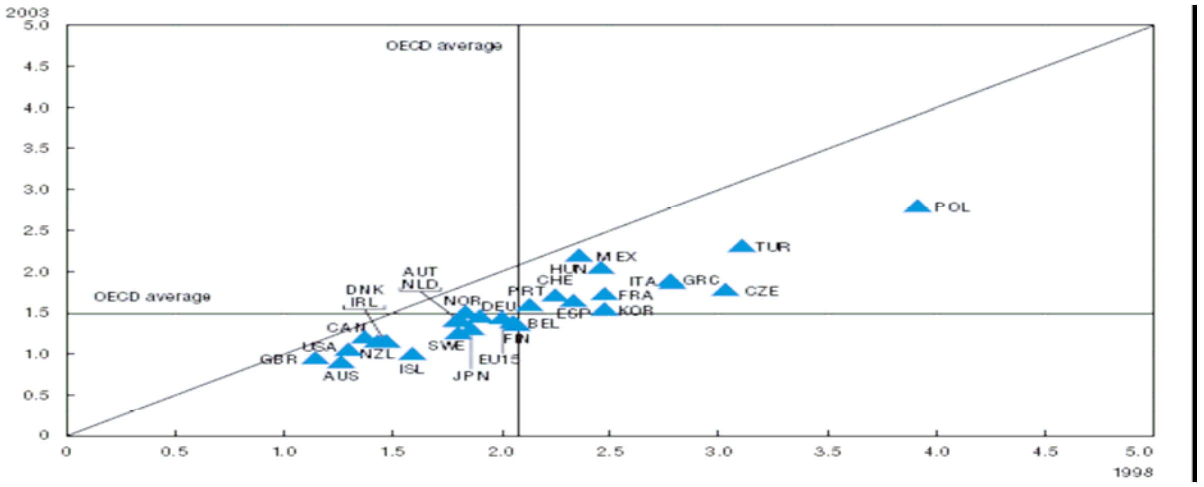
The government have continued to promote part-time work and more diversity in working patterns at the same time as they have resisted the regulation of working time.

While less has been said in public about wage flexibility – although HMT published a detailed discussion of the issue as part of the euro assessment in 2003 (see next section) – the approach to the implementation of the National Minimum Wage is consistent with the OECD’s strictures on the need for flexibility and responsibility in implementation. Even so, since 1999 the NMW has continued to rise in real terms (slightly ahead of average earnings growth), moving steadily up the OECD league table of minimum wage toughness.

Considerable emphasis has been placed on the need for product market competition as a driver of growth. HMT place a high value on the UK’s “world class” competition policy framework and the OECD have continued to point out that the UK (along with Australia) has the least restrictive regime of product market regulation (see figure 4)[6].

Figure 4: Product Market Regulation

Scale of 0-5 from least to most restrictive



Source: OECD Structural Indicators 2006

[6] See *Productivity in the UK 6: Progress and New Evidence*, HMT (2006) p43 et seq. *OECD Structural Indicators 2006.*

On employment protection legislation the government has resisted any changes beyond the 1997 manifesto commitments, although they have been required to accept, albeit reluctantly, some EU level legislation like the Information and Consultation Directive. More generally, however, their stance is best expressed in the Chancellor's statement that:

> *The flexibility we need is not just in Britain but in Europe. The best contribution we pro-Europeans can make to the cause of Europe is by ensuring that in Europe we face up to rather than duck the difficult decisions about economic reform - resisting the kind of inflexibility being added into directives like the working time directive, the agency workers directive, the investment services directive and the transparency directive*[7]*.*

The New Deal shows that the government has taken seriously the refocusing of labour market policy and the creation of JobCentre Plus is entirely in line with the OECD's recommendation – as is the suggestion that an element of "contestability"" should be introduced into the provision of public employment services. We might also note that the DWP has made a determined effort to involve the both the private and voluntary sector in the provision of services to the "hardest to help" groups, through organisations like *Working Links*.

Even though one might criticise some aspects of the government's training policies, Sure Start is consistent with the objective of improving the situation of pre-school children from disadvantaged backgrounds, parental "choice" has been a central theme of the Prime Minister's education policies (and is at the heart of the current Education Bill) and offering free tuition for those working towards level 2 alongside the National Employer Training Scheme represents a desire to intensify the nation's training effort.

Improving corporate reporting so that "human capital" is properly accounted for was taken forward by the Kingsmill review of human capital accounting. Similarly, the government initially proposed that companies should prepare an "operating and financial review" that would give a broad overview of social, employment and environmental issues – although these provisions have subsequently been watered down following pressure from the CBI.

[7] Rt Hon Gordon Brown MP, speech at the *Advancing Enterprise* Conference, 26/1/04

Reform of the UI system can be seen in the retention of the sanctions attached to the Job Seekers Allowance and the “no fifth option” element of the New Deal for Young People. The government’s tax and benefits policies have been designed principally to “make work pay”. Measures have been taken to crack down on benefit fraud.

So far, this account of the Jobs Study recommendations may have seemed rather technocratic and dull, but we would do well to remember that the analysis was (and remains) hugely controversial. Not surprisingly organised labour was unwilling to accept that national collective bargaining and industry wide agreements had anything to do with high levels of “structural” unemployment. Equally, the *Jobs Study* could be read as suggesting that the unemployed were responsible for their own plight and that more sticks than carrots were needed to get them to take job search seriously. Perhaps most importantly, unions argued that governments were abdicating their responsibility to adopt counter-cyclical policies in recessions. It was all too easy to blame labour market actors for problems that were the result of poor macro policies, or suggest that macro policy was powerless in the face of structural rigidities. What unions really wanted in the early 1990s was the reinstatement of full employment as one of the primary goals of economic policy across the OECD.

In the period following the *Jobs Study* the US experienced a sustained boom and the UK’s economic performance also improved. Growth in the large countries of continental Europe remained sluggish and unemployment continued to be high – although this was not a universal experience and some smaller countries enjoyed employment performance as good as or better than the UK’s. The empirical question therefore is whether good performance in the USA and the UK can be directly attributed to implementation of the OECD’s prescription (of which more is said below).

3 Whose Flexibility? The Reality of Social and Political Choice

We saw in Chapter 1 that a number of countries had performed well without applying the full range of *Jobs Study* recommendations. But in Chapter 2 it appeared that the UK government had embraced almost all of the OECD's proposals as a template for public policy. This chapter tries to draw these threads together and reconcile what might appear to be a huge contradiction between the theoretical model of labour market flexibility and the unavoidable fact that Denmark, Sweden, the Netherlands and Austria are anything but economic basket cases.

The best account of the UK government's views can be found in HMT's report *EMU and Labour Market Flexibility*[8]. Recent work from the OECD is contained in the *Employment Outlook* for 2004 and 2005, both of which confirm a modification of their stance.

However, it is important to be clear that in some areas there has been no change of mind and the analysis of the following issues has scarcely changed:

- The importance of macro economic stability.
- The importance of R&D, innovation and the more widespread use of ICT.
- The need to nurture an entrepreneurial climate
- The requirement to improve skill levels.

In all the other areas of policy there have been some significant adjustments in the OECD's approach. Wage flexibility is still said to be important, but it is also accepted that this dimension of flexibility is quite compatible with high levels of collective bargaining coverage and co-ordinated centralised negotiations. Equally, it is accepted that in some countries corporatist models of governance have produced good labour market outcomes. The simplest way of expressing these findings is to say that the OECD make no case for convergence or a "one size fits all" approach to labour market policy [9].

Indeed, the OECD believe that they have identified two demonstrably successful policy packages, which might be summarised as follows:

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[8] *EMU and Labour Market Flexibility*, op cit
[9] The author has had sight of some internal working papers, which confirm and amplify these conclusions. OECD officials have been making their case on public platforms over the last year so the findings will not come as a complete surprise when they reach the public domain

The Anglo-Saxon Model: This is characterised by strong product market competition, low welfare benefits, relatively low levels of taxation and "light" EPL. Trade unions are weak and collective bargaining plays a limited role. The result is a high employment rate achieved at a low cost to the taxpayer. But these countries have also experienced rapidly growing earnings inequality and a high level of in-work poverty.

The Nordic Model[10]*:* These countries are characterised by a strong emphasis on collective bargaining and social dialogue. They offer generous welfare benefits but impose stringent job search requirements and limited durations. EPL is more restrictive than in the Anglo-Saxon countries. Taxes are higher to fund a more generous welfare state. Earnings inequality is narrower and there is a relatively low level of in-work poverty.

The only element common to both approaches is the emphasis on competition and low levels of product market regulation – otherwise everything else is different – taxes, the strength of employment protection laws, the role of trade unions, the generosity of benefits and the importance of government funded active labour market programmes. How might these apparently contradictory results be explained?

The *Jobs Study* review is an evidence-based exercise and the approach adopted is rigorously empirical. This is of great importance because it means that we have a clear and dispassionate assessment of the foundations on which successful labour market policy has been built. To that extent it is a useful corrective to the standard case for labour market flexibility, which is often associated with the need for low taxes, a small state and downward pressure on wages so that the UK (or indeed any developed country) can "meet the challenge of India and China".

HMT's paper looks specifically at the importance of labour market flexibility should the UK join the single currency, but perhaps the most important point for our purposes is that they place a high value on labour market flexibility *in all circumstances*. Even though other policy instruments are available while the UK continues to use sterling (an effective devaluation or other monetary and fiscal policy interventions), there can be little doubt that policy makers are deeply committed to the view that labour market flexibility is a highly prized feature of the UK economy.

[10] Some of these features can be found in other countries – the Netherlands is the most obvious example – and the expressions "Anglo-Saxon" and "Nordic" should be understood as shorthand for these policy bundles.

At the heart of HMT's analysis is the proposition that the labour market will need to bear the burden of adjustment to an external shock in the single currency zone. In other words, the labour market will need to be *even more* flexible because monetary policy will no longer be available to the government as an instrument of adjustment and the room for manoeuvre in fiscal policy is constrained by the Stability and Growth Pact. HMT argue therefore that the UK labour market must be sufficiently flexible to guarantee both growth and employment in the very different circumstances of the eurozone.

Labour Market Flexibility in the UK

This then leaves us with a very clear, if rather parochial, question: just how flexible is the UK's labour market? HMT offer a comprehensive answer, suggesting that the UK has made real progress on most dimensions of flexibility, but the extent of wage flexibility is relatively untested which, in this context, is given as the reason why, in 2003 at least, the UK failed the "labour market flexibility" test for membership of the single currency [see Box 3]

Box 3: How Flexible is the UK's Labour Market? – HMT's Assessment

In a comprehensive review of the extent of labour market flexibility in the UK, HMT reach the following conclusions:

- The UK has a high level of relative wage flexibility – which reflects the decentralised nature of collective bargaining.
- Real wage flexibility has improved in the UK since 1997 – essentially, wages are now more responsive to increases in unemployment.
- Nominal wages are flexible because most pay settlements are annual. HMT also comment that in other EU member states stricter employment protection legislation, high union coverage and generous unemployment benefits make workers resistant to wage cuts. Presumably the absence of these factors in the UK is to be celebrated.
- Wage flexibility has not been fully tested in recent years – any decision to join the euro "would put an additional emphasis on real and nominal wage flexibility".
- While in theory geographic labour mobility is an important element of flexibility it plays a limited role as a source of adjustment in other single currency zones (the USA for example) and greater flexibility on other dimensions can compensate for a lack of geographic labour mobility.

- The UK has a high level of employment flexibility demonstrated by the high level of part-time work and the adoption of flexible working practices – this can offset limited geographic mobility.
- Progress on the skills agenda since 1997 means that the UK has achieved a higher level of functional flexibility.
- The tax and benefit system has been redesigned to "make work pay". The tax wedge in the UK is low for the lower paid. OECD data suggests that the UK continues to offer benefits at low replacement rates.
- ALMPs have improved the supply of labour and improved labour market performance.
- The NMW has not been a source of rigidity in the labour market. Nor have the working time regulations, which were implemented flexibly. The UK has the most flexible product market in the EU. EPL in the UK is less "heavy handed" than elsewhere and more conducive to labour market flexibility.
- The decentralised system of collective bargaining in the UK is an advantage. International evidence suggests that the most effective bargaining systems are either highly centralised or highly decentralised, but in both cases need to be co-ordinated.

There are a number of observations that we might make about these conclusions. First, the recent slowdown in the economy has not led to any *significant* increase in unemployment, suggesting that wages must be bearing the burden of the adjustment. One might tentatively conclude that wage flexibility is probably more extensive than HMT would allow in 2003.

Second, in HMT's view the UK has the best institutional environment supporting labour market flexibility in the EU15. But if this is the case one might reasonably ask why, in 2003, this was not seen as a suitable counterweight or as a reinforcing mechanism to compensate for the relative weakness of real wage flexibility? Indeed, the evidence presented below (see figure 5) suggests that real wages in the UK are as flexible as wages in Austria and more flexible than in any other EU15 member state except the Netherlands.

Third, we might note that HMT's assessment of the role of collective bargaining in the UK is not entirely consistent with the theoretical model (and some of the empirical evidence), which shows that bargaining co-ordination (and centralisation) can improve employment outcomes:

> *The UK system of industrial relations is one that appears conducive to wage flexibility. The decentralised and uncoordinated nature of collective bargaining means that relative wages can adjust to conditions across industries, sectors and regions. The decline in collective bargaining over the past two decades also supports aggregate wage flexibility.*[11]

Translated this means that a declining trade union movement has been good for labour market flexibility. There is certainly little doubt that wage determination in the private sector is principally in the hands of employers. Although this is hardly a surprise when national collective agreements have largely collapsed and collective bargaining covers less than twenty per cent of the private sector workforce (and an even lower percentage if the formerly nationalised industries are stripped out). Even where unions still have collective bargaining rights their ability to extract a wage premium has been reduced as a result of intensifying product market competition[12].

Nevertheless, it would be wrong however to read HMT’s account as a reworking of the standard *Jobs Study* story. There are some genuine analytical subtleties here, suggestive of a different frame of reference, which might lead to a rather different set of policy prescriptions in the UK. Equally, the OECD’s work on the *Jobs Study* review has opened up a similar range of options for the future.

We have already seen, for example, that there are three other countries in the EU with employment performance that is as good as or slightly better than the UK’s. Sweden, Denmark and the Netherlands (and Norway outside the EU) all have comparable levels of labour force participation to the UK, they all enjoy relatively low unemployment, have benefited from low inflation and, over the course of the most recent economic cycle, have witnessed similar levels of economic growth. The point however is that in most cases their labour markets are much less “flexible” in conventional terms. They have less wage flexibility (apart from the Netherlands), stricter EPL, much more powerful trade unions and much higher levels of benefits.

Drawing on both HMT’s work and the OECD’s initial findings from the Jobs Study review enables us to reach the following conclusions.

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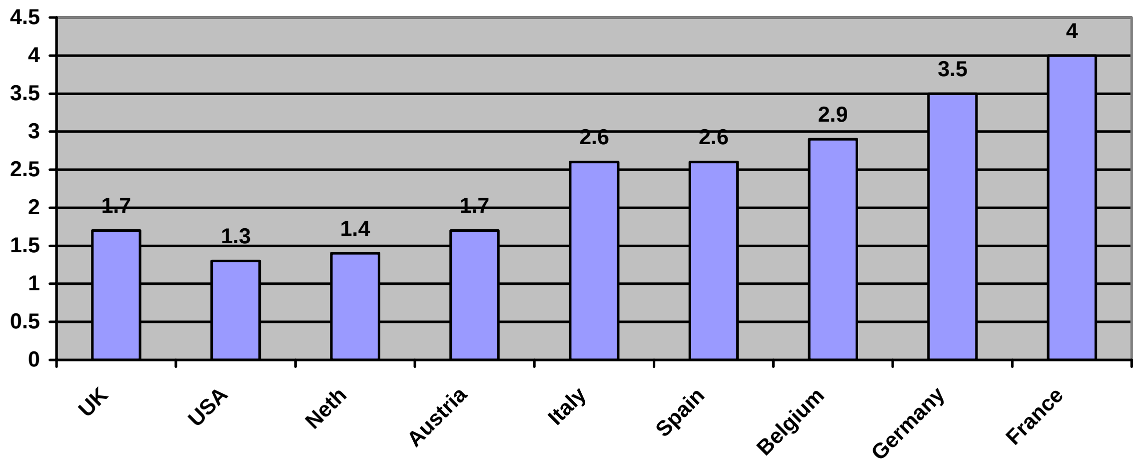
[11] Ibid, para 4.72
[12] Metcalf, *British Unions: Resurgence or Perdition?* (2004)

Real Wage Flexibility and Collective Bargaining

Only the Netherlands has a higher level of real wage flexibility than the UK[13]. This can partly be explained by the centralised nature of Dutch collective bargaining, which allows negotiators to take macro-economic factors into account in the wage formation process. Some emphasis should also be placed on the effectiveness of national social dialogue between employers, unions and government. Austria performs relatively well on this flexibility measure too (wages are as flexible as in the UK), despite the supposed impediments of strong trade unions and corporatist forms of governance.

Figure 5: Real Wage flexibility*



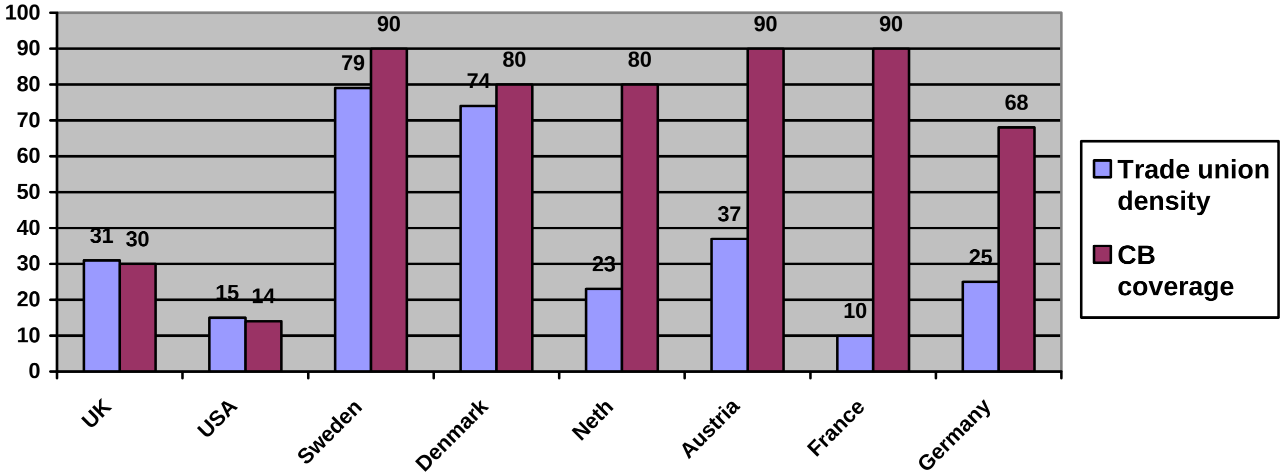
Source: OECD, 1999

* Years required for real wages to complete half the adjustment towards their long-run equilibrium level

Union density in the Netherlands is comparable to the UK although the coverage of collective agreements is much higher (Figure 6). Both coverage and membership are at levels of 70% or more in both Sweden and Denmark. Although some of these countries have modified their collective bargaining structures in recent years they all still fit fairly closely with the centralised-coordinated bargaining model rather than the decentralised uncoordinated model in the UK (Figure 7).

[13] For these purposes "real wage flexibility" is defined as the rapidity with which wages respond to imbalances between labour demand and labour supply, adjusting for changes in the price level.

Figure 6: Union Density and Collective Bargaining Coverage 2000 (% of the workforce)



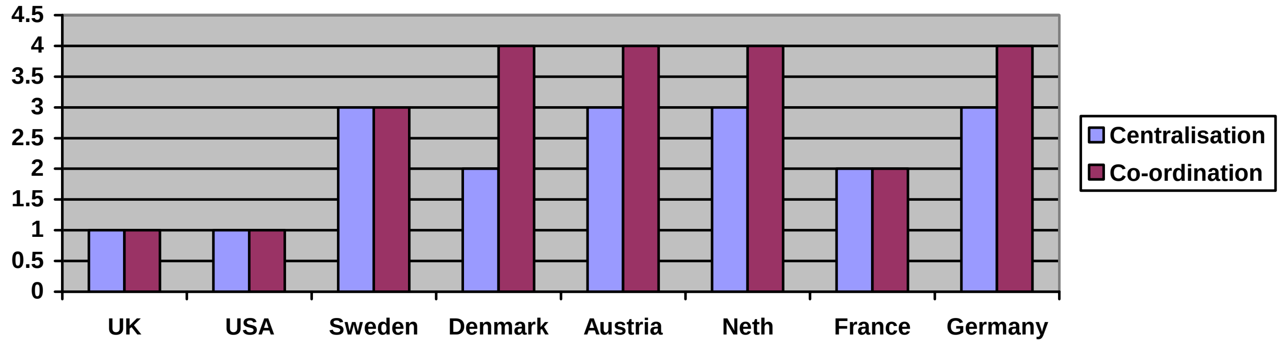
Source: OECD Employment Outlook 2004, Table 3.3

The OECD's current analysis of wage and labour cost flexibility presents a fascinating contrast to the *Jobs Study*[14]. Most importantly, it explores the relationship between collective bargaining and employment performance and concludes that, under certain conditions, strong unions are entirely compatible with high employment and strong jobs growth. It would have been difficult given the evidence to conclude otherwise, simply because Denmark and Sweden have very high levels of union membership, almost universal coverage of collective bargaining and amongst the strongest employment records in the OECD

Nevertheless, the overall assessment is somewhat tentative. So, for example, the 1994 diagnosis that "excessively high aggregate wages and/or wage compression" have had a negative impact on employment performance is confirmed as "plausible". On the other hand, while it is suggested that the organisation of collective bargaining can have an impact on employment performance it is also pointed out that the nature of the relationship is poorly understood – particularly the interaction of bargaining institutions and other aspects of public policy.

[14] *Wage Setting Institutions and Outcomes*, OECD Employment Outlook (2004), p127

Figure 7: Bargaining Centralisation and Co-ordination 1995-2000 (OECD Index 0-5)



Source: OECD Employment Outlook 2004, Table 3.5

One hypothesis that is inconclusively tested suggests that the degree of centralisation or co-ordination has an impact on both employment and macro-economic performance. But systems with similar levels of co-ordination seem to produce very different effects and these effects vary within countries over time. For example, Denmark, Austria, the Netherlands and Germany all have similar levels of co-ordination and high collective bargaining coverage but very different levels of unemployment (Figures 2, 6 and 7). This leads inevitably to the conclusion that the wage setting system cannot be seen in isolation and must be understood in the wider institutional context. As the OECD point out, different organisational forms may be capable of similar performance so that:

> *wage flexibility coupled with in-work benefits for low wage workers may be approximately equivalent to a more compressed wage structure combined with fiscal incentives to employers of low-skilled workers*.[15]

Precisely what this may mean for the UK is considered in the final chapter – although we might observe that there is more than one route to the achievement of the wage flexibility that HMT deems necessary if the UK is to remain prosperous in the future.

A central recommendation of the 1994 Jobs Study was that arrangements for the automatic "extension" of collective agreements to non-signatory employers in a sector should either be weakened or abandoned. The evidence presented above shows that some countries with extension mechanisms have enjoyed rather good employment performance, suggesting that the

[15] Ibid, p166

1994 analysis is not now congruent with the facts. Indeed, the OECD’s more recent review of the evidence supports this conclusion, suggesting that “extension” alone is not a problem – it all depends on the relationship with other labour market institutions. Once again, this reinforces the argument that there is no “one size fits all” recommendation about the optimal arrangements for wage formation.

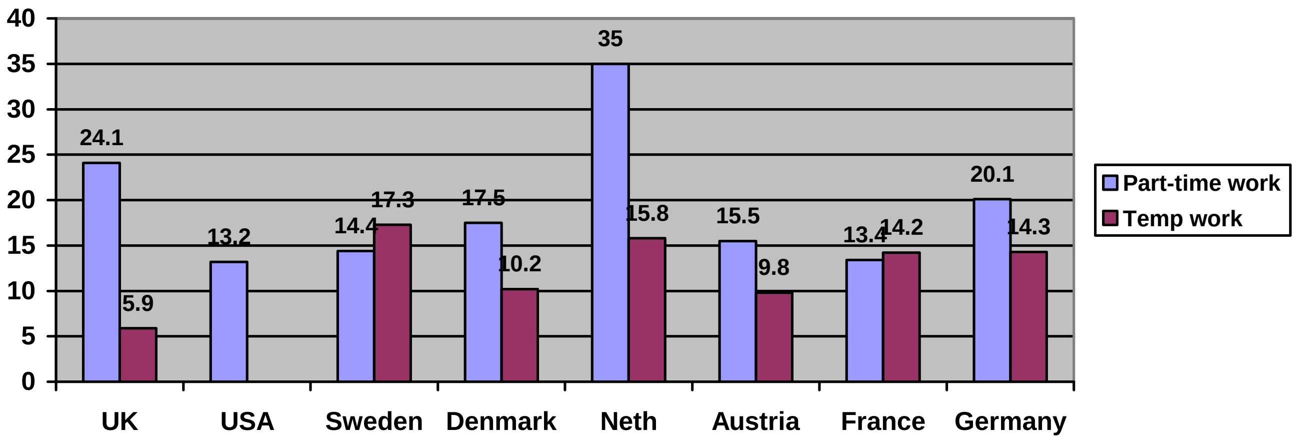
We might also note at this point that “corporatist” forms of governance, what we used to call “tripartism” in the UK, have in some countries accelerated the pace of structural reform. This is certainly the case in Denmark, Ireland and The Netherlands where the direct engagement of unions and employers has helped to legitimise otherwise difficult processes of change and ensured that collective bargaining takes place in an environment where all the parties have a shared understanding of the economic challenges. In each of these cases the unions accepted a degree of wage restraint in return for tax reform or improvements in the social wage (Ireland) or the promotion of more diversity in working time (The Netherlands). In both Denmark and Holland the unions agreed to changes in the welfare system that may not have been in the immediate interests of their members but were, in the medium term, employment enhancing – reductions in benefit durations combined with investment in ALMPs

Employment Flexibility

The Netherlands has a much higher level of part-time work than the UK. Denmark has about the same level and Sweden slightly less (see figure 8). Perhaps the most important point here is that all these countries have a higher level of part-time employment than the USA. Even supposedly “inflexible” Germany has a higher level of part-time work than the USA (sitting just below the UK in the index) and “sclerotic” France is marginally ahead. Contrary to popular perceptions there is less temporary work in the UK than in Denmark, The Netherlands and Sweden. Of course, this is not necessarily a positive phenomenon because employers may be reluctant to invest in the training and development of temporary workers. Similarly, by virtue of their lack of experience on the job in that particular organisation temporary workers may be less productive than their permanent colleagues.

Whatever one makes of these arguments, we can be confident in saying that the UK regulates temporary contracts less than these other countries (see figure 15 below). Indeed, both France and Germany have much more rigorous regulation than the UK and levels of temporary work that are more than twice as high. In this context at least regulation does not seem to be an impediment to the creation of temporary jobs. To the contrary, it might be suggested that the costs associated with permanent employment and the difficulty of dismissing individuals place obstacles in the way of the creation of permanent jobs. It may be reasonable to conclude that Denmark and the UK have achieved better results on this dimension, with the critical factor being the treatment of individual *dismissals* rather than any other aspect of regulation. Of course, the critical test is whether temporary work is either freely chosen as a long-term option or acts as a stepping-stone to high quality permanent employment. All that can be said at this stage is that the issue requires further research and that policy makers may wish to consider how they can reduce reliance on temporary employment in those countries where it embraces more than (say) ten per cent of the labour force.

Figure 8: Part-time and temporary employment rates (as % of total employment)



Source: OECD Factbook 2006 (part-time work); EU-LFS q3 2005 (temp work)

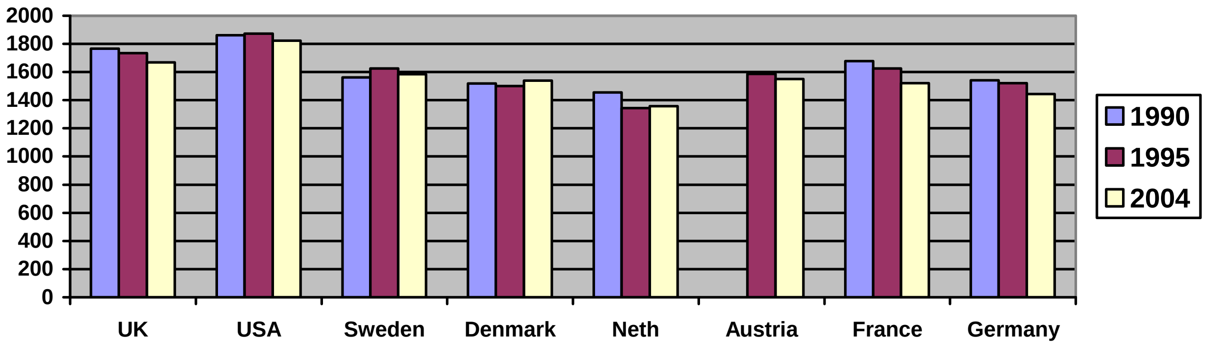
Working Time Flexibility

Some of the policy instruments to which the government is opposed would not necessarily be inconsistent with the OECD's recommendations in the *Jobs Study.* For example, the government has resisted the removal of the individual opt-out from the Working Time Directive, but the *Jobs Study's* recommendation on working time was not to oppose regulation per se, but to suggest that those regulations that inhibit diversity of working time should be relaxed or removed. It is important to recall that the WTD imposes an average rather than an absolute limit on working hours measured over a three, six or twelve month reference period. In principle therefore the Directive allows a worker to work 48 hours a week for every working week of the year, which is hardly an "inflexible arrangement", and the annualisation provisions allow for significantly longer hours occasionally as long as compensatory rest is available. The Netherlands has the widest differentiation of hours in the EU and more stringent regulation of working hours than the UK.

Sweden and Denmark have tougher working time regulations too – whether through the law or generally applicable collective agreements. It is therefore difficult to understand the government's opposition to an in principle ceiling on working time as an argument purely derived from the case for labour market flexibility.

Similarly, as Figure 9 shows, there is no apparent relationship between the number of hours worked per year on average and other aspects of labour market performance. The employment rate, unemployment and collective bargaining coverage all seem unrelated to the number of hours worked. For example, the Netherlands has the lowest number of hours worked per year per person in employment – even lower than France with its 35-hour week – but a very high employment rate and low unemployment. Working time in the UK has been on a slow downward trajectory (despite the absence of regulation) at a time of strong employment growth. While flexibility in working time may be important, an absence of effective regulation is not a necessary condition of labour market flexibility.

Figure 9: Actual hours worked (per year, per person in employment)



Source: OECD Factbook 2006

The OECD's more recent assessment of working time flexibility reinforces these conclusions and gives little support to the Chancellor's belief that the EU Working Time Directive could impose an intolerable burden on the UK economy. Indeed, the OECD describe the lessons from the experience of the last decade as follows:

- Workers and employers should be able to negotiate arrangements "in a decentralised manner within a framework of rules" set either by working time legislation or some other binding framework, which fixes some minimum standards to safeguard workers' health and safety.

- Government has a role to play in the encouragement of "family friendly" employment policies by facilitating access to childcare and parental leave.

The OECD's most recent work also draws attention to the need to widen the participation of women and older workers in the labour market. These objectives demand that rather more attention is paid to "work-life balance" policies and new approaches to the recruitment, retention and training of older workers.

So far as women workers are concerned there is a link between these policies and the tax/benefit system. Some countries tax married working women at higher effective marginal rates than other workers. The Nordic countries have made progress in eliminating this bias in the tax system over the last decade.

Improving the employment rate of older workers is seen as a necessary response to the inevitability of demographic change, with fewer prime age workers and more people beyond the "normal" retirement age. Again there may be disincentives in the tax system – for example the encouragement of early retirement which was a characteristic of some developed countries in the 1990s – and explicit age discrimination. While legislation may play a role, it is recognised that the real challenge is to change employers' practices so that they understand the contribution that older workers can make.

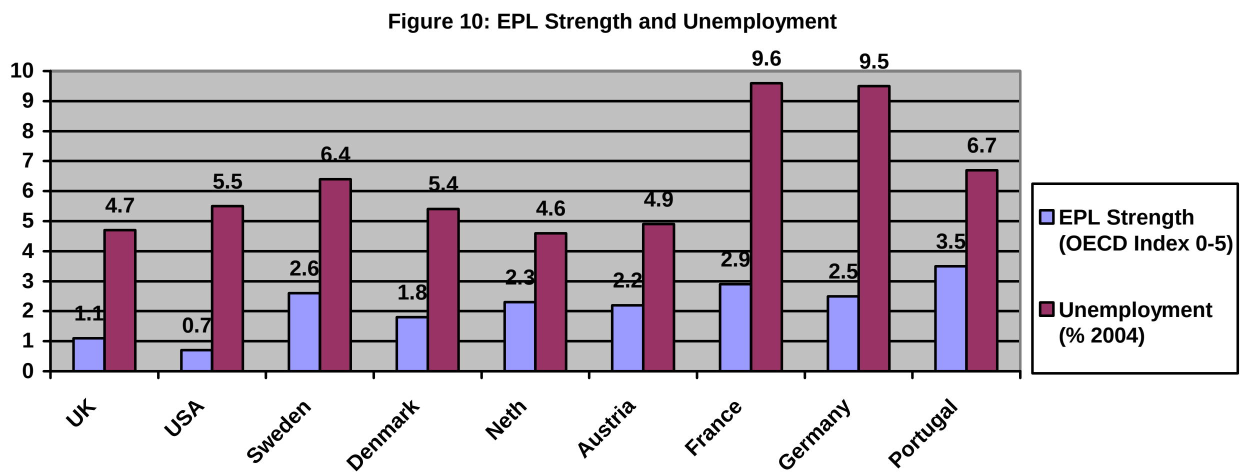
This could be read as an endorsement of the policies adopted by the UK government over the last nine years – making work pay, attempting to close the gender pay gap, extending the employment rights of working parents and promoting the employment of older workers - but it also suggests that the job is by no means complete. Furthermore, one might say that this "positive" aspect of the story seems to be disconnected from the government's wider approach to flexibility. Ministers might encounter less resistance if they made clear that an inclusive labour market with a wide differentiation of working time patterns was a central part of their narrative.

In particular, these conclusions offer an opportunity to begin to talk about working time flexibility over the course on an individual's working life. People may be quite happy working long hours in their twenties, may wish to reduce their hours when they become parents, take time off for education and training (or combine education with work) and phase their exit from the labour market as they approach (or work beyond) retirement age. Longer life expectancies and longer working lives also point in the direction of this approach, which is reinforced by the unavoidable demographic fact that we are witnessing a significant shift in the ratio of prime age workers to those over normal retirement age. Working and saving for a longer retirement are critical issues in this context and the discussion about working time is inextricably linked to the proposed new architecture of the UK pensions system.

We would argue therefore that government should present the objectives of public policy in precisely these terms so that flexibility in working time is seen to be relevant for workers of *all* ages. Focusing exclusively on the situation of working parents with young children carries some risks, if only because others may take the view that "flexibility" is only about childcare. The notion of "lifetime working hours" is a useful conceptual framework to move beyond the UK's rather arid debates about whether 48 hours is a reasonable limit on working hours or not.

Employment Protection Legislation

Employment protection legislation is much tougher in Sweden, Denmark and the Netherlands than in the UK. It is true of course that the "high unemployment" countries seem to have stronger EPL (see figure 10). Nevertheless, Portugal, with a relatively high employment rate has the strongest EPL in the EU and what, according to HMT, appears to be the lowest level of structural unemployment, although it has a greater long-term unemployment problem than Sweden, the Netherlands or Denmark (see Figure 11, below)[16].



Source: OECD Factbook 2006 (unemployment, 2004); Employment Outlook 2004 (EPL strength 2003)

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[16] *EMU and Labour Market Flexibility*, op cit, charts 3.1 and 3.6

HMT have recognised that a straightforward statement "strong employment laws bad: weak employment laws good" lacks a convincing empirical foundation.

> *Evidence suggests that the impact [of EPL on employment] is small and/or ambiguous or that there is only a general relationship which can break down when other explanatory factors are taken into account*[17]*.*

They do say of course that the effect of EPL is to prolong periods of unemployment and make wages less flexible. But while this may be true at *some* level of EPL – and it would be hard to quarrel with that conclusion – it is not clear that further modest regulation of the UK's labour market would produce these effects, particularly given the good employment records of other EU countries with higher levels of EPL.

It would be hard to find any British politician who did not publicly profess that the UK's "light touch" employment regulation is an important ingredient (perhaps the most important) in the flexibility mix. Yet, as we have seen, this is not quite HMT's view and nor is it necessarily the view of the OECD today. Nevertheless, for the avoidance of doubt it is important to understand that the OECD still maintain the view that strict EPL can have an adverse impact on innovation even if the impact on employment is "ambiguous". Essentially, the argument runs as follows: strict EPL may act as a disincentive to employers to hire new employees, but it also acts as a deterrent to firing. These effects are in balance and it is therefore quite reasonable to say that the strictness of EPL has no effect on employment over the course of the economic cycle[18]. On the other hand, it may be the case that strict EPL has the effect of reducing the employment opportunities of the most disadvantaged (in this case women and young people) by creating a powerful group of labour market insiders – which is often said to explain high unemployment in France.

The impact on innovation is said to be negative because EPL slows down labour market churn when "the adoption of new technologies and innovation…have to be accommodated through labour turnover"[19]. Conversely, EPL might have a positive effect because offering employees a higher degree of security elicits a higher level of discretionary effort. Longer job tenures may enhance human capital too – employers are more likely to invest in the training and development of workers who stay with the organisation for a prolonged period. Equally, there are valuable

[17] Ibid, para 4.52
[18] For a full account of these arguments see *Employment Protection Legislation and Labour Market Performance* in *Employment Outlook*, OECD (2004), p61
[19] Ibid, p 80

opportunities for employees to develop tacit knowledge leading to productivity gains that can be captured by the employer.

It is problematic however that the OECD's approach to EPL is primarily economic. What is missing from their analysis is any sense that employment protection laws exist to offer a degree of workplace justice that would simply not materialise in a free market. Many of the EPL provisions currently under scrutiny date from the 1960s (this is certainly true in the UK) when the restructuring of developed economies began to gather pace – particularly the shift in employment from manufacturing to services. The original intention of these EPL interventions was not to preserve the economy in aspic, but to ensure that difficult processes of change were seen as legitimate and that workers received the assistance they needed to find work elsewhere in a dynamic labour market.

This helps to explain why the Danish labour market model, known as "flexicurity", works relatively well – it cuts with the grain of the "creative destruction" that is "the fundamental impulse of the capitalist engine" [20]. A moderate level of EPL, which as we have seen is significantly higher than in the UK (Figure 10), is combined with very generous benefits, rigorous job search requirements, limited eligibility and investment in high quality ALMPs. Job tenures in Denmark are either comparable to or somewhat lower than job tenures in the UK but the perceived level of employment security is somewhat higher. Danish workers may know that change is constant (and unavoidable), but they can also be confident that the effectiveness of the system provides a high level of insurance against the worst excesses of restructuring. In this sense the Danish model is a fine example of Robert Reich's suggestion that policy makers have more options available than "save all the jobs" or "let the workers drown"[21]. "Flexicurity" offer workers both a lifeboat and the prospect that they will very soon find a secure footing on dry land. It is hardly surprising therefore that the OECD have singled out the Danish model as a praiseworthy effort to combine high levels of employment with workplace justice. The question for the UK is whether we can move in a similar direction, given our different history, culture and institutions?

Unemployment benefits and "activation policies"

Benefits for the unemployed in Sweden are around twenty-five percent of average in work income. In the Netherlands the replacement rate is around fifty percent and in Denmark just above sixty-five

[20] Schumpeter, *Capitalism, Socialism and Democracy* (1942), Unwin Edition (1987) 63
[21] Reich, *Locked in the Cabinet* (1997), p 137-139

per cent [22]. A conventional analysis suggests that these countries should have a significant unemployment problem. How then might their strong employment performance be explained? HMT are honest enough to give the answer themselves:

> *Empirical evidence suggests that the way in which the benefit system is administered is just as important as the level of financial support; most notably, the eligibility period and the eligibility requirements[23].*

This is a rather different mix of carrot and stick from that used in the UK, where benefits are low (around eighteen per cent of in work income) and benefit conditionality tight. One might reasonably say that social outcomes are better if the unemployed are protected against a catastrophic collapse in income when they lose their jobs and are also encouraged to undertake intensive job search during a limited eligibility period.

The Danish model is also relevant to any consideration of ALMPs and unemployment benefits. In theory, a country that offers generous benefits ought to experience a higher level of unemployment than a country with a more parsimonious regime – applying Richard Layard's dictum that "if you pay people to do nothing then that is precisely what they will do". Indeed, the *Jobs Study* suggested that governments ought to consider limiting benefit durations, imposing conditions on entitlements and fixing benefit levels so that the "reservation wages" of the unemployed were consistent with labour market conditions[24]. However, the critical issue here now appears to be the relationship between the level of benefits and the effectiveness of a country's "activation programme" to get the unemployed back into the labour market[25] - hence HMT's observation that is the administration of the system rather than the level of benefits that matters. In other words, high benefits, when combined with job search requirements, limited durations and active labour market assistance seem to support good employment performance. They also help to ensure that the trauma of unemployment is reduced – losing one's job is bad enough but compounding the problem with a dramatic drop in income can only have an adverse impact on physical and mental health.

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[22] *EMU and Labour Market Flexibility*, op cit, para 4.18 and chart 4.3. The UK replacement rate is around 18% of in-work income
[23] Ibid, para 4.19
[24] In other words, the unemployed should set their sights low and be willing to accept low paying jobs.
[25] See *Labour Market Programmes and Activation Strategies: Evaluating the Impacts* in *Employment Outlook*, OECD (2005)

Functional Flexibility

There is one final element in HMT's analysis that deserves comment. A long discussion of the importance of functional flexibility concludes that the UK has become more flexible on this dimension since 1997 because skill levels have risen. Unfortunately, this is to extrapolate too far from the undoubted improvements that have taken place on the supply side. In particular, as an accumulating body of evidence shows, levels of functional flexibility in the UK are significantly lower than in other major EU countries[26]. UK enterprises apply innovative practices later, experience more difficulties in doing so and report worse results. Toby Wall has suggested that this means that many organisations in the UK are "over controlled and under managed"[27]. Ewart Keep has been blunter, suggesting that if British businesses had access to a workforce as well qualified as their competitors in Germany or Denmark they simply would not know how to utilise these skills to best advantage[28]. Indeed, there is some evidence to show that the supply of skills has improved so that it is now running ahead of employer demand. Francis Green has expressed the argument very well:

> *On the face of it more skilled jobs might be regarded as of higher quality – more challenging and more satisfying. Nevertheless, more highly educated people do not always express greater levels of job satisfaction. One reason for this is that the jobs do not come up to their expectations. While the jobs are more skilled than in an earlier era, the workers that fill them have qualifications whose levels have risen somewhat faster. Workers who are "over qualified" for the jobs that they do express lower levels of jobs satisfaction.*[29]

There is some evidence to suggest that HMT are more aware of this problem today than they were in 2003. For example, *Productivity in the UK 6*, published to accompany the 2006 Budget, makes clear the importance of good management and notes that most of the ICT usage productivity gap between the UK and the USA can be explained by the quality of management[30]. Nevertheless, much of the policy focus remains on improving the supply of skills. This is self-evidently important, but one might observe that the evidence suggests a need for more attention to be paid to management skills – particularly people management skills. We should also note that the UK

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[26] See for example the CBI's study of labour market flexibility published in 2002, the research carried out by the ESRC centres SKOPE and COI and the findings of the 1998 Workplace Employment Relations Survey.
[27] Wall, *A Digest of Studies of Process Innovation* (2001)
[28] Keep, *Creating a Knowledge Drive Economy – Definitions Challenges and Opportunities,* SKOPE (2000)
[29] Green, *The Demands of Work* in Dickens et al (ed) *The Labour Market Under New Labour*
[30] HMT*, Productivity in the UK 6* (2006), p 57-60

appears to have more "managers" as a percentage of the working population than most other developed countries (official statistics suggest that one in seven employees in the UK is a "manager"), which reinforces the argument that there is too much low quality supervision and too little high quality management in many UK businesses.

How do we know how much unemployment is "structural"?

A central objective of all the policies discussed so far is to reduce the level of "structural" unemployment – the level below which unemployment cannot fall before inflation becomes a problem. This assumes two things, both of which are highly contested amongst economists. First, that there is a clear trade-off between inflation and unemployment (the so-called Phillips curve). Second, that the level of "structural" unemployment can be defined with some precision.

This is not the place to address the first issue in detail, except to note that some economists have found it increasingly difficult to make sense of the supposed inflation/unemployment trade-off – the Phillips curve failed to explain the experience of the 1970s and policy makers became rather more circumspect about the suggestion that they could fine tune the economy to achieve a particular level of unemployment and inflation. Expressed simply, relationships that were supposed to be straightforward and linear (if employment goes up inflationary pressure will increase, if unemployment rises then inflation will fall) proved to be true in general but very complex in practice. In particular, the precise calibration of the unemployment/inflation relationship (at what particular level of unemployment will inflation rise?) has proved hard to pin down[31].

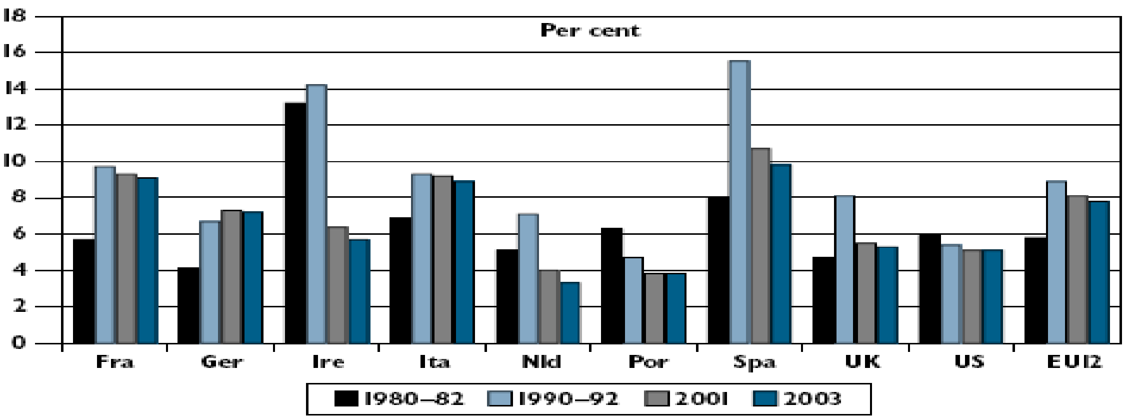
Turning to the second issue, there are apparent anomalies in HMT's assessment of the level of structural unemployment in the UK, suggesting that it is equally difficult to define *that* concept with any precision. The principal tool of analysis here is the NAIRU (the non-accelerating inflation rate of unemployment), which means the level of unemployment consistent with a stable level of inflation so that if unemployment falls further then inflation will start to rise and, in theory at least, accelerate. Whether the NAIRU makes any analytical sense – does inflation really *accelerate* once unemployment falls below a certain level? – remains a controversial question. For these purposes it is sufficient to say that estimates of the NAIRU appear to move significantly over rather short periods of time. The OECD have estimated for example that the NAIRU in the Netherlands was seven per cent in 1990-92, four per cent in 2001 and three and a half per cent in 2003. In the UK

[31] Ormerod, *The Death of Economics* (1994), Ch 6 *Unemployment and Inflation*

the NAIRU was eight per cent in 1990-92, almost six per cent in 2001 and under five per cent in 2003 (see Figure 11)[32].

The real surprise here though is that the NAIRU in the UK was said to be lower in 1980-82 than it is today (around four and a half per cent). But surely that was a time of mass unemployment when the UK's labour market was far more "inflexible" than it is today? Unions were stronger, benefits relatively higher, employment patterns less diverse. Another finding of particular interest is that the NAIRU was significantly lower in France and Germany at that time than it is today – even though those labour markets are now more "flexible" than in the past. Witness for example the significant reforms to the German bargaining system over the last five years, all of which meet the *Jobs Study's* requirements, through the introduction of "opening clauses" in collective agreements and greater scope for flexibility at enterprise level.

Figure 11: Estimates of Structural Unemployment 1980-2003



Source: OECD, Economic Outlook 2002

It is important to understand that the NAIRU remains a highly contested analytical tool. Critics say that structural unemployment cannot be "observed" and can only be estimated *ex post* with a high degree of uncertainty. Perhaps most seriously, the NAIRU is derived from estimated econometric relationships that explain inflation developments imperfectly and can be subject to large margins of error. This is not the place to engage in a detailed assessment of competing methodologies, but suffice to say that econometricians do not themselves agree about the robustness of their findings. Choices made in specifying the equations – which use rather different premises to explain inflation – can produce very different results. A particular concern is that the estimated level of the NAIRU can be highly influenced by the most recently observed level of unemployment – which may help to

[32] *Disparities in Regional Labour Markets*, in OECD Employment Outlook (2002)

explain the wide fluctuations reported in Figure 11. In other words, the NAIRU is always pretty close to the actual level of unemployment (and the actual level of unemployment changes dramatically over the economic cycle), which is of little usefulness in identifying "structural" weaknesses in the economy.

But if all this is right (and it almost certainly is) a dispassionate observer might find it hard to understand how an analytical model of this kind can act as an effective guide to monetary policy. How, when they are making judgments about interest rates, can the Monetary Policy Committee of the Bank of England be certain where the NAIRU has settled at any particular time? Nor is it clear in this context how the OECD's assessment of the structural level of unemployment is related to the implementation of the *Jobs Study* recommendations. Divergent levels of unemployment appear not to be associated in any significant way with the "flexibility" or "inflexibility" of the labour market – Portugal with amongst the strongest EPL in the OECD has a very low level of structural unemployment[33].

Other assessments of the *Jobs Study* approach

We would do well to remember that the *Jobs Study* analysis remains controversial and that many reputable commentators continue to suggest that "OECD style flexibility" is by no means a necessary condition for economic success. On the other hand, we need to recall too that many of these critical assessments predate the *Jobs Study* review and have not therefore enjoyed the benefit of the OECD's most recent account of labour market flexibility.

An excellent critique can be found in a very careful piece of analysis by John Schmitt and Jonathan Wadsworth. They sought to evaluate whether a higher level of flexibility explains superior UK and US employment performance over the 1990s and to test what they saw as the "central prediction" of the OECD's model[34].

> *[T]hat greater labour market flexibility should be associated with lower unemployment and higher employment of traditionally marginalised workers, including the less skilled, particularly young workers and those with lower levels of formal education.*

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[33] As we shall see, some commentators attribute this result to the fact that the practical enforcement of Portugal's strong EPL rarely benefits employees.
[34] Schmitt and Wadsworth, *Is the OECD Jobs Strategy Behind US and British Employment and Unemployment Success in the 1990s?*, in Howell (ed.) *Fighting Unemployment: The Limits of Free Market Orthodoxy* (2005)

The theoretical reason for this is clear. Flexible labour markets ought to lower the relative costs of hiring less skilled workers, pricing them back into jobs. Of course, the corollary is that if these effects cannot be detected then "flexibility" is not delivering the predicted results and other explanations – principally macro-economic – should be sought for the UK and US superior jobs record.

Schmitt and Wadsworth report the following findings:

- *Youth*: Youth unemployment in both the UK and the US is solidly in the middle of the OECD range. More interventionist countries (eg. the Netherlands, Austria, Denmark) have lower youth unemployment rates. A similar picture emerges when relative unemployment rates and employment to population ratios are examined.

- *The less educated*: Again the UK and the US sit in the middle of the OECD distribution of unemployment amongst the less educated. Seven countries had better performance than the US and all had less flexible labour markets. Similar findings apply to employment rates. The least educated workers were better off in Germany, Sweden, Switzerland, Japan and Portugal than they were in the USA. The UK had the fifth worst relative employment rate when the gap between the employment rate of the least educated and most educated was measured. If anything the data suggest that flexibility may be associated with *worse* not better outcomes for these workers.

- *Regional unemployment*: A flexible labour market ought to equalise unemployment rates between regions simply because in a flexible labour market economies should be better positioned to adjust to regional economic shocks and should therefore have more uniform unemployment rates across national regions. While there are methodological difficulties here (no general definition of what constitutes a region) neither the US or UK seem to have a narrower distribution of regional unemployment than other countries[35].

- *Long term unemployed:* There is some support for the flexibility thesis here because the USA has the second lowest level of long-term unemployment and the UK is in the middle of the ranking. A number of OECD economies do better than the UK including Austria,

[35] Ibid, p 175-176

Denmark, Norway and Sweden and, as we have seen, their labour markets are much less "flexible".

Schmitt and Wadsworth then undertake a direct comparison between the UK, France and Germany to respond to the criticism that these small countries are atypical. Across the full range of measures referred to above they suggest that the most striking finding is that the UK's performance is not that different from France and Germany:

> *Greater OECD style flexibility in the UK….does not appear to have produced better relative outcomes for marginalised workers there than France and Germany achieved with their apparently more rigid labour markets.*

They conclude as follows:

> *As the data for the United States and the United Kingdom show, OECD style flexibility is not a sufficient condition for improving the circumstances facing less-skilled workers. As the data for many of the other countries – especially Austria, Denmark, the Netherlands and Sweden – show, OECD style flexibility is not a necessary condition either.*

In another carefully calibrated assessment, Allard and Lindert offer an altogether more orthodox perspective, suggesting that high levels of unemployment compensation help to prolong unemployment, that EPL has a negative employment impact and that ALMPs have only a limited effect on the job prospects of the unemployed unless they are combined with other policies[36]. To complicate matters further they also suggest that it is not the strictness of EPL that matters as much as the rigour of enforcement. Spain and Portugal offer a natural experiment to test the hypothesis. Both have similar levels of EPL, but Spain experienced persistently high unemployment in the 1980s and 90s (sometimes over 20 per cent) whereas Portugal has had low unemployment since the mid-1980s.

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[36] Allard and Lindert, *Reconciling Unemployment and Growth in the OECD*, in Lindert, *Growing Public: Social Spending and Economic Growth Since the Eighteenth Century*, Vol 2 (2004)

> *The contrast resulted from a large, but hard-to-measure, difference in legal enforcement. In lawsuits filed in the wake of employer dismissals, the laid off workers tend to win their cases in Spain, but not in Portugal*[37].

However, there are two aspects of their analysis that offer a slightly different approach to the OECD's original story. First, it is argued that

> *While it lasts, corporatist wage bargaining seems to preserve jobs and reduce unemployment.*[38]

Although it is also recognised that these arrangements are unstable, depending as they do on the:

> *complex diplomacy between business and labour and also on the ability of each encompassing national organisation to control the behaviour of its own members.*[39]

Nevertheless, this is a useful corrective to the view that corporatism has nothing to offer and should be consigned to the dustbin of history. It is also consistent with the view that "social partnership" of this kind can help to legitimise difficult decisions. That corporatism can be sustained for a prolonged period, contrary to Allard and Lindert's suggestion, is illustrated by the Irish experience, where a series of agreements concluded since the mid-1980s has helped to secure stable and (largely) non-inflationary growth. The OECD make a useful point in their analysis of the "governability" of collective bargaining arrangements – in other words, the extent to which trade unions and employers associations can enforce agreements on the rank and file, which helps to explain why corporatism can overcome the difficulties identified by Allard and Lindert[40]. Not surprisingly the Nordic countries score highly on this dimension, but countries with a much lower level of "governability", like the Netherlands and Ireland have concluded successful national agreements on wages and other aspects of labour market policy, suggesting that no matter what the formal institutional arrangements may be, social norms and the quest for consensus can play an important reinforcing role.

Second, Allard and Lindert explore why, despite the supposed negative impact of high benefits on employment, countries with very different approaches have achieved similar levels of GDP growth.

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[37] Ibid, p 114
[38] Ibid, p 116
[39] Ibid
[40] Employment Outlook 2004, op cit p 152

They explain this finding by noting that high benefits leave the more productive at work (thus raising the average level of labour productivity) and remove from the labour force a set of workers that tend to be less productive even when they are at work. Indeed, the marginal product of the "removed" workers may tend to be close to zero, not because they produce nothing, but because they may produce "negative effects on others at work":

> *The presence of the marginal workers in the workplace may force others to take time away from other tasks to help them, monitor them, discipline them and prepare to get rid of them. Their presence in the workplace may lower the implicit standards expected of other workers. Such effects may make the true marginal product of those workers – their effect on the collective productivity of whole work units – very close to zero.*[41]

This may seem like a harsh judgment, but it is the correlate of HMT's suggestion that as labour market participation rises one might expect the rate of productivity growth to fall, simply because these "new" workers will take some time to achieve their full potential[42].

We might also pay close attention to Allard and Lindert's conclusion that conscious policy choices have influenced the trajectory of unemployment in the USA, the UK and the larger countries of Western Europe:

> *The Anglo-American strategy since the late 1970s has been to push people into low-wage employment. The Continental strategy has been to push them out of it, protecting wages while holding people temporarily in the unemployment bin…[T]he Anglo-American message to many workers, especially women and young adults, has been delivered in the form of high job turnovers, low minimum wages, "workfare" reforms and tax credits for the lowest levels of earnings…The Continental alternative has divided those same groups into those getting better bottom salaries and those still waiting.*[43]

Of course, as we have seen, the choice is not as stark as Allard and Lindert suggest. Furthermore, the Nordic experience suggests that high benefits do not exacerbate the unemployment problem

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[41] Allard and Lindert, op cit p 118
[42] *Productivity in the UK 6,* op cit, Ch 2, Measuring Productivity Performance, para 2.24 et seq
[43] Allard and Lindert, op cit, p 121

as long as they are associated with effective job search and activation strategies. There is no "European" unemployment problem, even though some large countries in Western Europe have high rates of unemployment. Equally, the message in the Nordic countries to women and young people hardly fits Allard and Lindert's characterisation of the "Continental" strategy. It does seem possible to reconcile high levels of employment with an effective welfare state and decent work for those at the bottom of the income distribution. Indeed, elsewhere Lindert has been rather optimistic about the future of the Swedish welfare state, suggesting that high levels of taxation have had no adverse impact on growth and that there is no reason why, with appropriate macro-economic policies, the model should not be sustained for the foreseeable future[44].

An obvious point to make about the Schmitt and Wadsworth analysis is that the OECD now take the view that the flexibility story is about more than deregulation or hire and fire. Indeed, some of the countries that Schmitt and Wadsworth identified as being *outside* the (1994) neo-liberal paradigm are now seen as exemplars of a rather different model of flexibility, which is firmly *within* the confines of the (revised 2006) paradigm. Whether one views this as a recantation by the OECD or as a modification of the existing analytical framework in the light of new evidence is a rather unimportant discussion. What matters is that a wider range of policy options have been identified, all of which are relevant in determining how full employment might be secured and sustained.

Redefining Flexibility?

Is it possible, based on all the above, to develop a somewhat stylised account of the government's approach to labour market flexibility? How does this match up against the OECD's model? What might be said about the empirical evidence to support this approach? The table below seeks to identify those policies that the government supports and those to which they are opposed.

[44] Lindert, *On the well-known demise of the Swedish welfare state,* in *Growing Public*, op cit (Vol1) (2004), p 264

Table 1: Defining Labour Market Flexibility

The Government Favours	The Government Opposes
Relative, real and nominal wage flexibility.	Any labour market institutions that inhibit wage flexibility
Functional flexibility	Regulations that might encourage employers to focus on functional flexibility
Active labour market programmes	Higher benefits for the unemployed
Tight benefit conditions and job search obligations	
A diversity of employment patterns and working time	Any further regulation of working time
	The regulation of agency work at EU level
A labour law framework to protect the most vulnerable against exploitation	More stringent EPL, including restrictions on firing
A national minimum wage fixed flexibly with lower rates for younger workers	A minimum wage fixed formulaically with application of the full rate at the age of 18
Weak trade unions and a decentralised and uncoordinated collective bargaining system	Stronger trade unions and a more centralised and coordinated bargaining system

Some might argue that this is a rather unfair characterisation – particularly given the changes to trade union law since 1997. Nevertheless, HMT's analysis seems to be based on the premise that weak unions are an advantage for the UK – whatever the Chancellor may profess to believe about the importance of organised labour.

Our next step must be to try and synthesise all the evidence reviewed so far and set a benchmark for evaluating the effectiveness of labour market policy in the UK, the USA and Europe. The following conclusions are offered somewhat tentatively, but they do seem to be supported by a growing body of research, from the OECD and elsewhere:

- Wage flexibility does make a difference to the ability of an economy to withstand an economic shock without seeing a significant and sustained rise in unemployment.

Flexibility can either be secured through the free market (which is associated with rising inequality) or through co-ordinated collective bargaining and a social pact (which is associated with more equity in distribution). Corporatism works – although only under certain conditions, and a real effort is required to make these arrangements sustainable.

- Employment protection legislation has no clear negative effect on employment. Some countries have combined "moderately strict" EPL with good employment performance – even though at some level EPL *may* have an adverse impact on employment, the enforcement arrangements and who wins in the judicial processes (employers or employees?) are important factors to weigh in the balance.

- Skills matter – they are an essential element in "functional flexibility" – and this includes management skills.

- Unemployment benefit levels can have an adverse effect on unemployment but one must look at the policy package as a whole. High benefit levels are entirely consistent with high employment when combined with appropriate "activation strategies".

- Product market regulation and competition policy are both of great importance. Countries with strong employment performance, whether "Anglo-Saxon" or "Nordic", have relatively lightly regulated product markets and a strong competition regime. The UK has the least restrictive product market regime in the OECD (see Figure 4).

- Strong employment performance is not necessarily associated with low taxes and a minimal state. The Nordic social democracies have performed just as well as the UK and the USA – and have achieved more equitable social outcomes.

The elements of policy dealing with macro-stability, innovation and entrepreneurship are now matters of consensus, although there may be differences of interpretation. However, what must be remembered throughout this discussion is that "structural" policies are worthless unless macro-policy is oriented to strong and sustainable growth over the course of the economic cycle. In other words, there is little value in worrying about labour market flexibility if the economy is plunging into recession and government, by following a pro-cyclical policy, prevents the normal operation of the “automatic stabilisers”[45]. Maintaining the level of effective demand – or at least running a moderately expansionary fiscal policy when the economy is slowing down – remains an essential ingredient in the policy mix. Keynes may be dead but Keynesianism is very much alive.

This then brings us to our next question. What are the implications of the analysis for labour markets across Europe? The financial pages of British newspapers are packed with commentary suggesting that “Europe” is sclerotic and needs a healthy dose of Anglo-Saxon style structural reform. But what precisely does this mean? What changes should be made at the level of the EU and what should be left to national governments. More controversially, do France and Germany have no alternative but to become more like the USA (or the UK)?

[45] The increases in public spending associated with an increase in the number of those receiving unemployment benefits and other social transfers.

4 What does this mean for "Europe"? The Lisbon Agenda, Structural Reform and Unemployment

This discussion about the need for flexibility is not simply an obsession of the right-wing British newspapers. It has been at the top of the EU's agenda since the Lisbon summit in June 2000 when the Council committed the EU to an ambitious programme of structural reform. At the same time some of the larger member states (particularly France and Germany) have been working through their own national debates about how to reduce their unacceptably high rates of unemployment. These two narratives are often confused in the minds of the UK's commentariat and an assumption is made that the UK has broadly got policy right whereas "Europe" has got policy wrong. This impression is compounded by the tendency of government ministers to speak as if "Europe" is on its knees economically and, to paraphrase Chris Patten, that there are millions of French and Germans standing on street corners, waiting expectantly for the British Red Cross food parcels to arrive.

To muddy the waters further, British eurosceptics (and sometimes government ministers) often argue that our prized "flexibility" is threatened by ill-considered interventions by Brussels bureaucrats who know little or nothing about economic dynamism and entrepreneurship.

It is important to be clear therefore about the nature of the challenge facing "Europe" and the different (but sometimes related) problems that may be confronted by individual member states. This section deals first with the Lisbon process, before commenting on the specific problems faced by France and Germany.

What is "Lisbon" all about?

The principal objective of the Lisbon process was set out clearly in the Presidency conclusions:

> *To become the most dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion.*[46]

[46] Presidency Conclusions, Lisbon European Council, March 2000

At first glance this looks somewhat distant from the preoccupations of the *Jobs Strategy*, and in one sense this is unsurprising. In 2000 parties of the centre-left dominated the majority of governments in the EU and it would have been odd for them to adopt a radical agenda focused on weakening employment protection legislation and placing the efficiency of markets above social objectives. Lisbon represented a real effort to reconcile the demands of economic efficiency, in particular the requirement for improved productivity, alongside more traditional centre-left objectives like social cohesion and the pursuit of full employment. Indeed, Lisbon – which also incorporated the European Employment Strategy launched in 1997 – was welcomed by many on the centre-left as an opportunity to put employment and the quality of work at the heart of the EU’s agenda. In particular the adoption of clear employment-rate targets put full employment back at the centre of the European project.

The recommendations for member states flowing from the adoption of this broad objective will also look familiar to anybody conversant with the OECD’s analysis: increase investment in research and innovation; raise skill levels across the EU; promote entrepreneurship; complete the internal market, especially in networked services and financial services; co-ordinate macro-economic policies to create a stable environment and promote growth; modernise social protection; promote social inclusion; and, last but by no means least, create more and better jobs.

It is striking that the more controversial elements of the *Jobs Study* model are absent from the Lisbon conclusions. There is nothing about wage flexibility, little about working time, nothing about collective bargaining institutions and nothing about employment protection legislation. Of course, a sceptic might say that this is entirely predictable. After all, the EU has no competence in any of these areas except working time, and only there to the extent that working hours are a health and safety issue. On the other hand, the Council often makes statements about issues where national action is required to support Community initiatives. If member states really believed that these other elements in the policy mix demanded attention then they would have said something about them.

However, there is a broader question about some of the underlying assumptions in the Lisbon conclusions that need to be teased out before the discussion can progress. For example, there is an apparent concern with ‘Europe’s’ poor productivity performance, which continues to appear in

Commission documents and in the deliberations of the Council[47]. Essentially, the concern here is that the EU has to match the US in measured labour productivity if member states are to remain prosperous in the future.

There is some intellectual confusion here, not least because, on the measure of GDP per hour worked, France, Germany and some of the smaller member states in the EU 15 already have productivity levels equivalent to or better than the USA.

Figure 12: Output per hour 1995-2004 (UK=100)

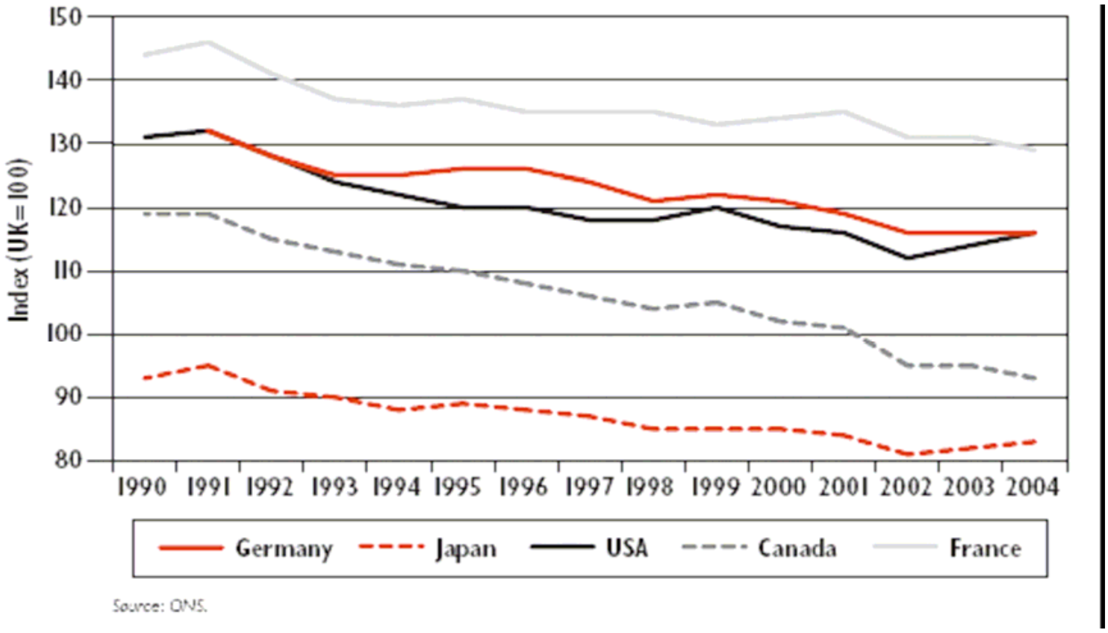


Figure 12 shows that UK productivity has improved over the last decade and a half and also demonstrates the extent of the productivity advantage enjoyed by France and Germany on this measure. The gap has been narrowing between the US and Germany, but France retains an advantage of more than ten percentage points.

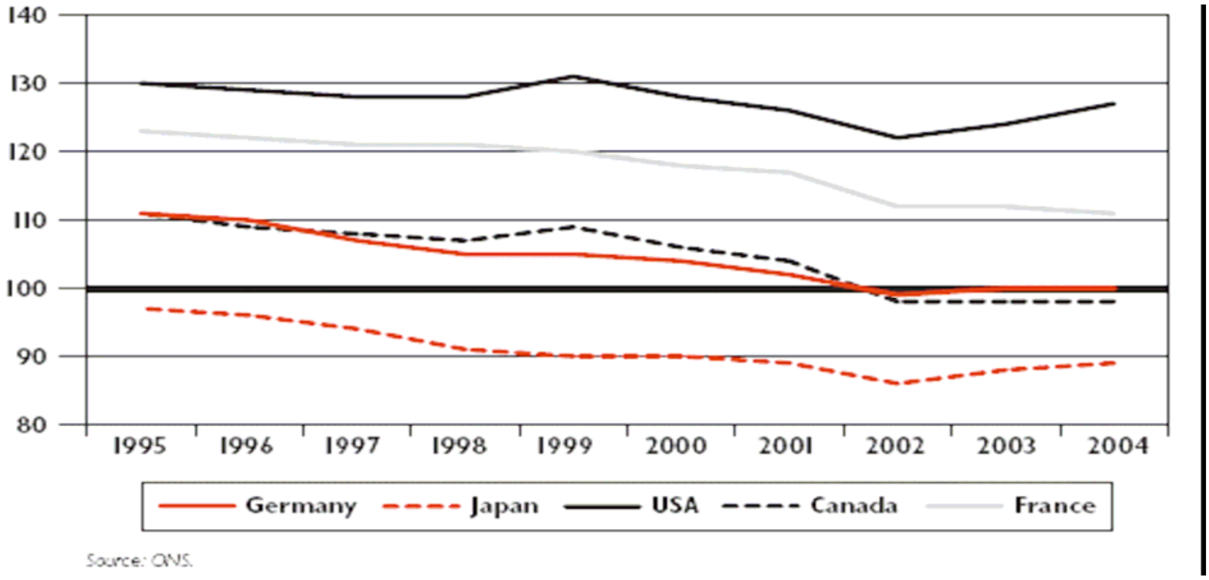
Even on the measure of GDP per head (which makes no allowance for differences in hours worked) the productivity differences look less stark than they first appear (see Figure 13). For example, a comparison between France and the USA (in 1999) shows that the difference in GDP can be accounted for by two factors – 21% higher output per person employed and 15% higher employment per head of population. And the difference in output per person is derived from the

[47] See for example the Commission's Mid-Term Review of Lisbon, *Working Together for Growth and Jobs: A new start for the Lisbon strategy*, COM (2005) 24 and the Commission staff working document in support of the mid-term review SEC (2005) 160

fact that US employees work longer hours. In other words it really *is* all about working time. The French are *choosing* to work fewer hours than their American counterparts. Some of this is a conscious choice, French workers take lunch breaks, holidays and work fewer hours per week, and some of it is involuntary – no doubt the unemployed would like to work more than they do. But the conclusion is irresistible:

> *Overall **all** of the prosperity difference between the US and France is explained by a difference in **total** hours worked per head of population, and none by measured efficiency per hour worked*. [48]

Figure 13: Output per worker 1995-2004 (UK=100)



If the French chose to work as many hours as the Americans – and increased their employment rate – then they would be significantly richer. This does not mean of course that measures to improve productivity across the EU are irrelevant – quite the contrary in fact. And for the ten new member states increasing productivity is essential if the prosperity gap with the EU 15 is to be closed.

Furthermore, a degree of scepticism has also been expressed about the likely impact of the measures designed to complete the single market in utilities and financial services:

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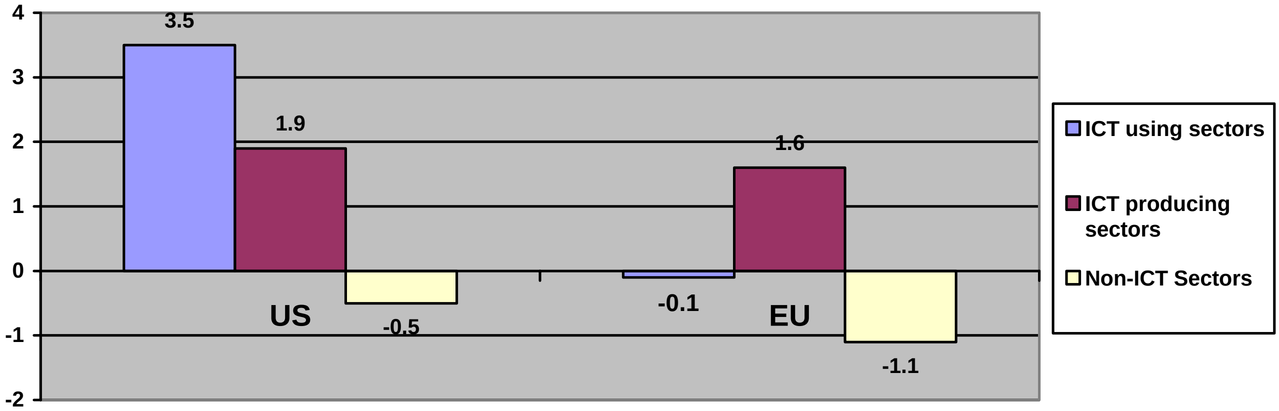
[48] Turner, *What's Wrong With Europe's Economy?*, LSE Queen's Prize Lecture (2003) 3, available at: http://cep.lse.ac.uk/queens/Adair_Turner_transcript.pdf

> *[T]he product market liberalisation on which much of the attention is focused, is useful, worth pursuing, but unlikely to make more than a marginal difference to the gap in productivity level between the US and Europe*.[49]

While all of this relates to differences in the productivity level, it does not necessarily account for differences in productivity growth. It is often said that the US has seen more rapid growth because it has a more flexible economy of precisely the kind that the Lisbon process is trying to create across the EU.

This has been a particular advantage, so runs the conventional wisdom, in the ICT sector, which accounts for much of the surge in productivity growth in the USA. Yet even here all is not as it seems. Recent studies suggest that the ICT-producing sectors are almost equally productive in both Europe and the US. The real difference lies in ICT-using sectors, and here the US advantage can be found in wholesale, retail and financial services. Indeed, ICT producing sectors have made either made a larger contribution to productivity growth in the EU than in the USA or have contributed almost as much (see Figure 14).[50]

Figure 14: Changes in annual growth rates in output per hour 1990-95 to 1995-2001 (%)



Source: O'Mahoney and van Ark (2003)

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[49] Ibid, 7

[50] van Ark et al, *ICT and productivity in Europe and the United States: Where do the differences come from?*, CESifo Economic Studies, Vol. 49, 3/2003, pp. 295-318. See also O'Mahoney and van Ark, *EU Productivity and Competitiveness: An Industry Perspective*, European Commission (2003)

The reasons for this remain controversial. For some commentators it is because service markets in a number of EU countries are less flexible than in the US, shop-opening hours are more restrictive for example, emphasising the importance of product market regulation[51]. Whereas others have suggested that spatial factors account for most of the difference – the USA is a much larger country with a widely dispersed population, so you can have larger stores, with wider aisles, larger trucks delivering 'just-in-time', with deliveries guaranteed because there is less congestion – and hence more effective use of ICT to manage logistics[52].

A third explanation is that US managers are simply better at maximising the efficiencies consequent on the more intensive application of ICT – and the biggest returns to ICT investment are found in precisely those sectors (wholesale and retail) that account for the US productivity miracle[53]. This does not necessarily mean that European firms should adopt US business practices, not least because of the regulatory and cultural differences. Indeed, one might say that European business practices served the continent well during the post-war period of "catch-up" and may do so again as these new technologies become universal in their application.

What broader conclusions might we draw from this analysis? It would be easy to say that Lisbon was the wrong answer – structural reform - to the wrong question – how does the EU 'catch up' with the USA? No doubt in one sense this is true. But there are some more profound questions at stake here. The Lisbon Strategy, as framed in 2000, was essentially an effort by member states to adapt the economy of the EU to a world of more open trade, an accelerating pace of technologically driven change and more intense competition, principally between businesses in developed countries. In other words, the intention was to develop a policy mix that enables the EU to manage 'creative destruction' so that the adverse social consequences are minimised. Far from being a new response to a new phenomenon, the Lisbon process was a deliberate reaction to the accelerating pace of change in the world's mature capitalist economies. It is based on the premise that markets are no respecters of persons or human rights and that difficult processes of structural change cannot be left to themselves. One might reasonably say that Lisbon was deliberately designed to accelerate the process of 'creative destruction' across the EU, but the important point here is that this will take place in an overarching policy framework that emphasises quality employment and social cohesion.

[51] Van Ark et al, op cit
[52] Turner, op cit
[53] See Bloom et al, *It Ain't What You Do, It's the Way that You do IT: Testing explanations of productivity growth using US affiliates,* ONS (2005)

In an important sense this is not new either. The initial impulse for European social policy in the 1970s was driven far less by the desire to create a 'European social space' and far more by the desire to introduce measures to smooth the path of restructuring that would flow as a natural consequence of the integration of markets – hence the directives on business transfers and collective redundancies, supplemented more recently by the European and domestic level information and consultation obligations. One might also say that the same principles provided the philosophical justification for the social action programme adopted by the Delors Commission, often seen as the high water mark of European social policy, as a complement to the completion of the single market.

That Lisbon is more than just a recitation of the orthodox neo-liberal mantra can be found in the two reports produced for the European Commission by expert groups led by Wim Kok. The first report concerned the employment objectives of the process and made a series of recommendations focused on improving the adaptability of workers and enterprises, increasing the employment rate, investing in skills and improving the delivery of the objectives through better governance – a recommendation that was affirmed in the second Kok report and has now been adopted by the Commission.

Perhaps the most positive interpretation is that the report represents an attempt to rethink the notion of labour market flexibility so that it is less about reducing workers rights or weakening the collective bargaining system, and more about creating a workforce with an appetite for change and the capabilities to adapt to a more difficult world, where the notion that a worker can be employed doing much the same job for the whole of their working life really is a thing of the past. Certainly, the examples given in the report of successful member states – Sweden, Finland, Denmark, the Netherlands – are some distance away from the conventional notion of an Anglo-Saxon, deregulated, hire-and-fire economy, and of course these are precisely the countries that the OECD now identifies as having developed a successful alternative to the orthodox neo-liberal model. It makes perfect sense to say that Wim Kok's approach was to develop a model of "flexicurity" at European level, which could inform the national labour market policies of member states.

Simply put, the Kok1 model of a flexible labour market might be said to have the following elements:

- The goal is clear: a much higher level of labour force participation.
- This demands that EU member states ensure that all workers have the skills they need to adapt to changing economic circumstances.

- Yes, there needs to be more flexibility, but security is important too if sustainable change is to be secured and both processes and outcomes seen as legitimate.
- There should be a diverse pattern of contracts and working patterns available on the labour market, giving workers the opportunity to balance work and caring responsibilities and employers access to the labour they need when they need it.
- The labour market itself should be more diverse, with more women in employment across the EU and a higher level of participation from older workers. This is essential if the demographic challenge is to be met.
- There is a need to reduce non-wage labour costs principally by reforming employers' social security contributions so that taxes on labour are reduced.
- ALMPs are essential in promoting employability and social inclusion.

This is a model of flexibility which draws upon the experience of successful member states and retains a commitment to the values of the "European social model" - solidarity, consensus, strong welfare states. It offers a conceptual framework for thinking through these issues in the future which is generally consistent with the conclusions we reached at the end of section 4. A cynic might say that it is simply the 1994 *Jobs Study* without the harsh neo-liberal edge, but the fact that most of the countries praised in the report are Northern European social democracies suggests that such criticism is misconceived.

This then brings us to the second Kok report, *Facing the Challenge*, which was intended to give new impetus to the whole Lisbon process and influence the Commission's thinking in advance of their mid-term review (completed in early 2005). Recalling our earlier observation that macro and structural policies must be mutually reinforcing, a central question here must be whether the second Kok group recognised these important inter-dependencies? Did *Facing the Challenge* really face the challenge?

One might reasonably say that expectations were high and always likely to be disappointed. It was wrong to believe that Kok could produce a miracle cure for the high and persistent unemployment, yet some seemed to hope that the publication of the report would mark a point of departure for a new approach to policy. The terms of reference for the second Kok group were essentially structural, to: *'identify measures which together form a consistent strategy for the European economies to achieve the Lisbon objectives and targets'*[54]. They were therefore compelled to focus

[54] Kok et al, *Facing the Challenge: The Lisbon strategy for growth and employment* (2004) 5

on the themes identified in 2000: the knowledge society; the internal market; the business climate; the labour market; and, environmental sustainability.

References to the macro policy agenda are limited but they *are* there in the report, and that in itself is important. To have omitted all reference to the demand side would have been to acquiesce in the view that macro policy makes no difference, that all problems are structural and that member states have no responsibility beyond the funding of education and training institutions and the provision of a minimal welfare safety net.

According to Will Hutton, *rapporteur* of the second Kok Group, the policy challenge for the high-unemployment countries in the EU is whether they can find ways to use their housing markets to create more confident consumers. In other words, will people be willing to borrow on the back of rising property values – will they be willing to withdraw equity from their houses?[55] To adopt this policy would demand some pretty radical changes in housing tenure and a big change in the consumption patterns in France, Germany and Italy. Nevertheless, there is *something* to be said for this view and it should not simply be dismissed as an Anglo-Saxon eccentricity.

And what of the main recommendations of *Facing the Challenge*? How might they be assessed? To begin with, it ought to be uncontroversial that the number of Lisbon targets should be reduced and that a renewed political focus and commitment should be forthcoming from member states. Equally, the proposals for an action plan to promote innovation, an internal market scoreboard, deadlines for the implementation of single market legislation, measures to reduce the barriers to setting up a business and the full implementation of the Kok 1 recommendations all appear uncontroversial. The generally progressive tendency of the report can be found in the recommendations around lifelong learning, active ageing (more labour market opportunities for older workers) and the use of environmental policy as a source of innovation and comparative advantage. Equally, the proposals for 'naming, shaming and faming' member states are all designed to give the process teeth and improve the level of transparency around national implementation programmes.

Some might say that this assessment of *Facing the Challenge* is too sanguine, and it is certainly the case that, whatever the intentions of the High Level group, the Commission's mid-term review, which explicitly draws on the group's report, has nudged the Lisbon agenda several degrees in the

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[55] See Hutton, *France and Italy Need to Spend, Spend, Spend*, The Observer 29 May 2005

direction of a centre-right course. In particular, the review focuses on the impact of regulation, seems to make no effective linkage between structural and macro policies and contains no reference to the importance of the Lisbon employment targets. Equally, critics have pointed to the Commission's observation that, *greater adaptability should contribute to ensuring that wage labour costs do not exceed productivity over the course of the cycle and reflect the labour market situation*[56], as an indication that concerns about wage flexibility and the role of the collective bargaining system are now firmly back on the Commission's agenda. On the other hand, the Commission's focus on the environment, research and development and innovation must be right. Critics need to be clear about where they believe the Commission is wrong – and why. Most importantly, it is essential for those concerned about the Lisbon process to have a persuasive account of what an alternative agenda might contain.

At the time of writing there is real doubt about the likely trajectory of structural reform in the EU. The French and Dutch 'no' votes on the constitutional treaty cannot be ignored and must reflect some popular dissatisfaction with the orientation of economic policy. More precisely perhaps, both the French and Dutch 'no' reflect a concern that further integration in Europe will encourage 'creative destruction' and reduce the effectiveness of social safety nets. Put crudely, the fear is that the benefits of structural change will accrue to the better off, large corporations and investment bankers. Workers believe that they are being left to drown and, in the absence of a better alternative are arguing that policy makers *should* 'save all the existing jobs'.

These concerns may be based on a fundamental misunderstanding of the Lisbon process, but that process has its ambiguities, as we have seen, and in any case the concerns are real, and policy makers ignore them at their peril. In practical terms it would be wrong to consign the whole process of structural reform to the dustbin of history. But policy makers need to be much clearer in emphasising the twin objectives of economic dynamism *and* social justice, flexible labour markets *and* security for workers. A failure to reframe the argument in these terms will compound the errors that led to the 'no' votes and put at risk the future of the European project. Indeed, it might be said that a clear articulation of the "flexicurity" argument remains the best hope for keeping the European project moving forward. It is certainly the most persuasive argument available to those of us who believe that more market integration is the route to higher prosperity but find it hard to explain these long-term benefits when there can be unavoidable short-term costs.

[56] *Working Together for Growth and Jobs*, op cit, 28

So what about unemployment?

So much then for the process of "structural reform" at European level. But, as we have seen there is a strong sense that these policies, however important they may be, are inadequate to the task of solving French and German unemployment in particular. To a large extent this must be right, if only because France and Germany face national challenges that require national solutions. As Adair Turner has pointed out:

> *Labour market problems arise from complex combinations of multiple different factors – the level of minimum wages, the ease of hire and fire, the ease of part-time working, the nature of wage-fixing processes and the generosity and, crucially, the conditionality of unemployment benefit*[57]*.*

However, our analysis so far is suggestive of a policy agenda that falls outside the standard story that reducing unemployment demands a straightforward weakening of protections for workers and a determined assault on the system of collective bargaining. The Nordic countries are a successful counter-example, but even the UK's experience points in a rather different direction. Our National Minimum Wage (NMW), introduced in 1999, has been gradually climbing up the OECD's index of toughness with no adverse impact on employment and other aspects of the labour market have been re-regulated too, again with no detectable effect on unemployment. It is clear therefore that regulation and collective bargaining are not in themselves the causes of high unemployment. The critical issue is the *nature* of regulation and the *operation* of the system of collective bargaining.

Our conclusion therefore is that both France and Germany would be ill-served by policies that involve the dismantling of institutions that have proved their effectiveness over a prolonged period. Equally, given our assessment of the success of the Nordic countries (with their high taxes and high social transfers) there is little to support the argument that a wholesale dismantling of welfare states is required to restore French and German "competitiveness". We should also recall the first recommendation of the Jobs Study in 1994 – that developed countries should aim for macro-economic stability, with expansionary fiscal policy in bad times and fiscal consolidation in good times. France and Germany may have some "structural" problems, but their problems are not exclusively "structural".

[57] Turner, *What's wrong with Europe's economy?* (2003)

For example, contrary to the conventional wisdom, Turner locates the German problem in the monetary and fiscal policy of the eurozone and the level of the deutschmark-euro exchange rate at the time the single currency was created[58].

Ronald Schettkat reaches a similar conclusion but notes that the problems Germany faces today are the result of monetary and fiscal policy mistakes over a prolonged period, combined with a wage formation policy that made things significantly worse[59]. Reunification was presented as a "win-win" with no costs for West Germans and enormous benefits for East Germans. Huge West-East fiscal transfers were required at a time when the German government was committed to keeping taxes unchanged. Nevertheless, something had to be done to ease the pressure on budget deficits so social security contributions were increased which then put further upward pressure on wages and labour costs. The Bundesbank took a rather dim view of the fiscal policy stance and tightened monetary policy to restrain inflation. At the same time unions and employers agreed to raise East German wages to West German levels – and, during the post unification boom, wages rose substantially in West Germany.

> *[T]he three major macro-economic policies (monetary, fiscal and wage policies) were inconsistent, with labour costs allowed to rise in the context of tight monetary policy (constraining demand) and loose fiscal policy (raising public deficits). The result has been disappointing employment growth.*[60]

This is a rather surprising conclusion simply because Germany is often described as the paradigmatic "co-ordinated market economy", where an interlocking network of mutually reinforcing institutions have generated sustained economic success[61]. To the contrary, what we have witnessed over the last fifteen years is a huge failure of co-ordination.

Of course, the French economy was not subjected to anything like the shock of re-unification, but there is still a legacy of macro policy errors – particularly the failure to undertake the kind of fiscal consolidation that we have witnessed under Gordon Brown's stewardship of the economy in the

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[58] Ibid
[59] Schettkat, *Is labour market regulation at the root of European unemployment? The case of Germany and the Netherlands* in Howell (ed) *Fighting Unemployment*, op cit
[60] Ibid, pp 277-278
[61] Hall and Soskice (ed), *Varieties of Capitalism: The Institutional Foundations of Comparative Advantage* (2001)

UK. Public deficits continued to rise even when the economy was growing strongly, thus reducing the room for manoeuvre when the economy slowed.

It is relatively easy to diagnose what has gone wrong in the past and much more difficult to prescribe what should be done in the future. Nevertheless, what should be clear from the foregoing analysis is that action is needed at both macro and structural levels to get the French and German economies moving again.   There is a strong argument that the monetary and fiscal frameworks in the eurozone need reform – if only because they have a pro-cyclical bias and impose too much of a fiscal straitjacket on economies in trouble. For example, the ECB's pursuit of price stability may have the effect of killing the green shoots of recovery when they first emerge. A better approach would be to adopt the model of symmetrical inflation targeting used by the Bank of England – perhaps with an inflation target set by ecofin (just as the UK's target is set by the Chancellor) to secure a degree of political accountability. Similarly, the Stability and Growth Pact could be revised in line with the UK's fiscal rules; the "golden rule" that the state will only borrow to invest over the course of the economic cycle, and the "sustainable debt" rule that requires debt to be held at a prudent level – effectively no more than 40% of GDP- over the course of the cycle.

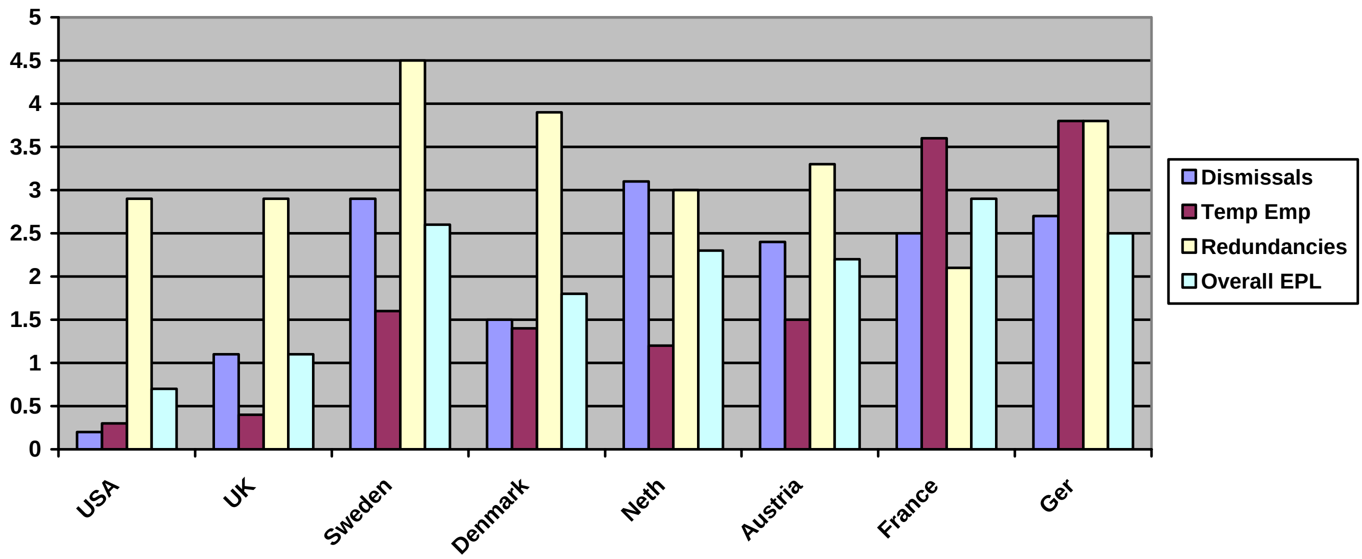
It would be wrong to believe that macro policy at European level can offer a complete solution. As we have noted, it has been argued that countries ought to look at how they can increase the level of domestic demand– which brings us back to Will Hutton's argument that the structure of the housing market and rising asset prices are important sources of liquidity in the economy.

However, it would be equally wrong to believe that there is nothing wrong with the French and German labour markets. This is not just a matter of unemployment, but also the overall level of labour market participation (the employment rate) which, as we have seen, explains much of the "productivity gap" with the USA. Increasing the employment rate (with the consequent increase in tax receipts) is important if countries in Europe are to meet the challenge of an ageing population (and higher pensions costs). To that extent *all* countries should consider whether their regulatory regimes are employment enhancing or not.

What can be said with some confidence, however, is that the approaches of the French and German governments have been partial and insufficiently radical. This is not to argue for a comprehensive assault on labour market institutions, but to suggest that a co-ordinated approach is needed if these countries are to develop a suitably adapted version of the "flexicurity" model. In other words action is needed in all those areas identified by Adair Turner: minimum wages, EPL, the range of working time arrangements on offer, the process of wage formation, unemployment insurance and ALMPs. A programme of reform would look at the level and coverage of minimum wages (paying particular attention to youth), the encouragement of more diversity in working patterns (whilst ensuring that all employees have the same fundamental rights, just as they do in the UK), some *limited relaxation* rather than a thoroughgoing repeal of EPL provisions (perhaps to the overall levels of the "low unemployment" countries), the role of collective bargaining (considering how the system can promote non-inflationary wage growth alongside improved productivity) and whether the unemployment benefits system can be combined with effective ALMPs to create a comprehensive "activation strategy".

Nevertheless, some care has to be taken, not least because the "rigidity" of labour market regulation is a complex matter. While EPL *generally* may be more stringent in France and Germany, this disguises significant differences in the extent to which dismissals and forms of employment are regulated (see Figure 15)

Figure 15: The Overall Strictness of Labour Market Regulation (OECD index 0-5)



Source: OECD Employment Outlook 2004

What emerges here is the absence of any clear pattern. France and Germany regulate temporary employment more than the other countries but are not exceptional in their regulation of collective dismissals (redundancies) – the elements taken into account in assessing the rigour of regulation include: the definition of collective dismissals (ie when the regulations are triggered), notice requirements, the number of days involved and "other costs" to employers. Denmark and Sweden have strongest regulation on this measure, whereas France has the *least rigid* regulation of collective dismissals on the OECD’s measure of “overall strictness” – it is the regulation of individual dismissals and temporary work that gives France such a high score (2.9) on the OECD’s index.

A further conclusion therefore is that policy makers in both Germany and France need to develop a better understanding of the relationships between different labour market institutions and their impact on employment. To focus exclusively on the extent of labour market regulation is a mistake and a package of nothing more than labour law reform will almost certainly fail. On the other hand a programme that includes the reform of collective bargaining arrangements, minimum wages, the tax and benefits system, ALMPs *and* a modest redesign of labour market regulation is much more likely to be effective.

Recent initiatives in both France and Germany may have been too piecemeal to have the desired effect, at the same time as they have angered those who may believe that their labour market position is to be made more insecure. This is not a recipe for success, as events in both countries have proved.

For example, the French government has sought to address the youth unemployment problem by introducing a “first employment contract” (*contrat premiere embauche or CPE*), which would make firing easier in the first two years of employment. We might note that the Thatcher government in the UK made a similar effort to deregulate the youth labour market by removing young workers from the protections of the wages councils in 1986. Equally, for most of the period of Conservative government all British workers were covered by something like the CPE because the qualifying period for unfair dismissal protection was fixed at two years. In neither case did these policies produce a positive employment response. Indeed, the UK labour market has been re-regulated on both dimensions since 1997 – specific youth minimum wages have been introduced for 18-22 year olds (1999) and 16-17 year olds (2004) and the qualifying period for unfair dismissal has been reduced to one year. Employment growth has been robust despite these changes – suggesting that deregulation on these dimensions is not a necessary condition for the reduction of unemployment.

An obvious difference between the UK and France is that the adult rate of the NMW only applies from the age of 22, whereas the full amount of the SMIC applies from the age of 18. Most reputable studies suggest that while sensibly fixed minimum wages have no impact (or perhaps even a positive impact) on the employment prospects of prime age workers (those between the ages of 24 and 65) there can be an adverse impact for those aged 18-24[62]. This is why the UK's Low Pay Commission has been so careful in handling youth minimum wages, but it also suggests that the French minimum wage as currently configured *could* be exacerbating the youth unemployment problem. Indeed, there is stronger evidence for this conclusion than for the argument that increasing the qualifying periods for employment protection would be employment enhancing. On the other hand, only the bravest French politician would suggest that what France needs is a lower "youth minimum wage".

The labour market reforms introduced by the Red-Green coalition in Germany (the Hartz reforms) were principally focused on benefit levels, durations and job search requirements rather than an integrated approach to the achievement of flexicurity. Both the CPE and Harz encountered serious resistance and there is no guarantee that a more comprehensive programme would be better received. On the other hand, it would be possible for governments to be clear about the areas where reform is *not* required. For example, there is nothing to support the case for a *wholesale dismantling* of labour law, progressive taxation or generous welfare states – even though reform may be required[63].

Equally, there is no evidence that some ill-defined phenomenon like "globalisation" requires a "race to the bottom". It makes much more sense to have a sophisticated account of what is wrong in the "high unemployment" countries and avoid making general statements (supported by nothing more than prejudice) that the European social model is finished and that we simply cannot afford high levels of welfare spending if we want to meet the "challenge of India and China". As Adair Turner has suggested, this case, which has become "a mainstay of journalistic commentary and of business lobby group belief" is "at very least greatly overstated"[64].

Where then does this leave the case made by the CBI and the UK government that "labour market flexibility" is one of the jewels in our economic crown. Could the UK have a slightly *less* flexible labour market *and* continue to generate strong employment growth? Is there an optimal level of EPL that would guarantee a higher level of workplace justice *and* full employment? It is to these issues that we now turn.

[62] See for example *The National Minimum Wage: Protecting Young Workers*, LPC (2004)
[63] See Lindert, op cit and Turner, op cit.
[64] Turner, op cit

5 Towards an Anglo-Social Model?

Flexibility today

We have seen that the flexibility story is rather more complicated than the standard account suggests and that when government ministers, employers representatives or media commentators discuss these issues they are often talking about myths rather than realities. A more charitable way of expressing the same thought is that many subtleties are lost in the presentation of the argument. Indeed, the supposed threat to flexibility is used to rule out any discussion of labour market measures that either government or employers find unpalatable – for whatever reason. As a result our public conversation is impoverished, our political debates ritualistic and the exchanges between the social partners unrewarding – with employers complaining about red tape and unions demanding more rigorous forms of labour market regulation.

Much of this is unhelpful obfuscation and nonsense – on all sides. A few facts may help us to clear this miasmic haze and allow us to view the situation in a clear light.

First, the UK remains a lightly regulated economy. According to the OECD levels of product market regulation are the lowest in the developed world (Figure 4) and the labour market is almost the least regulated – only the USA is lower in the index (Figure 10). So much then for the argument that British business is drowning in a torrent of red tape.

Second, despite this very clear finding, it is also important to understand that the UK's labour market is *more* regulated than was the case in 1997. One of the central arguments used by the Conservative Party during that year's election campaign was that a Labour government would introduce job-destroying regulations and would allow the trade unions to determine major questions of national policy. Neither argument has proved to be true.

It is undeniable however, that "flexibility" under Labour is very different from the "flexibility" that prevailed in the 1979-97 period. Many of the labour market reforms introduced by Mrs Thatcher have been undone – and new rights for employees have been introduced – with no adverse effect on unemployment.

For example:

- The UK now has a national minimum wage, which is rising steadily up the OECD's "toughness" league table.
- Qualifying periods for unfair dismissal have been reduced and compensation increased
- Comprehensive working time legislation has been introduced (albeit with an opt-out from the 48 hour week) guaranteeing rest periods and paid holidays.
- Maternity and paternity leave entitlements have been extended. Workers with caring responsibilities have the right to request reduced hours of work.
- Trade unions have the right to be recognised for collective bargaining if they can demonstrate an appropriate level of membership support.
- Workers have the right to elect representatives who must be consulted by the employer about significant change in the workplace.
- Part-time workers have the same employment rights as full-time workers.

This is a very different labour market model from that which the government inherited in 1997. However, we might also usefully direct our attention to those areas where the change of government did *not* lead to a change of policy. Most of the laws regulating the activities of trade unions – and prohibiting certain kinds of strike action – remain on the statute book. Similarly, the government took no action to revive the provisions that allowed for the extension of collective agreements to employers who did not recognise a trade union. Perhaps most importantly, the government resisted the reintroduction of the Fair Wages Resolution (rescinded by the Thatcher government in 1983), which required all those doing business with public bodies to pay the union negotiated rate. Contrary to the position of previous Labour governments, the Blair administration has deliberately eschewed a clear commitment to the promotion of collective bargaining as the fairest and most effective route to safeguard workplace justice. Indeed, the government has resisted suggestions that ACAS's statutory objectives might be revised to include the explicit promotion of collective bargaining – a formulation that was removed in the 1980s by the Conservative government.

One might say that this is unsurprising. After all, trade union membership has largely collapsed in the private sector (to less than one in five employees) and there is little purpose in reviving provisions that can only work effectively when most employers observe collective agreements. Even so, it is striking that the regulation of trade unions is the principal part of the Thatcher settlement that the government has left intact.

The Dark Side of Flexibility

So far most of our discussion has looked at the positive impact of different forms of flexibility on employment. But it is important to understand that, in the UK at least, flexibility can have a dark side too. Earnings inequality has increased over the last twenty years and the trend has yet to be reversed. In part this owes much to the exponential growth in incomes at the very top of the distribution. As I have argued elsewhere, this is a damaging phenomenon that is bad for social cohesion, life expectancy and health[65].

Growing inequality has been matched by a decline in social mobility. More than anything else a child's life chances are determined by their parents' occupations, the neighbourhood they live in an the school they attend. The opportunity to transcend the disadvantages of background has significantly reduced in the last twenty years[66]. Indeed, recent research suggests that those born in the early 1970s who experienced poverty in childhood are significantly more likely than the previous generation to experience poverty throughout their lives[67].

In part this can be explained by the changing dynamics of the labour market. Average job quality has almost certainly increased in the last two decades – the UK has more highly skilled and well-paid "good jobs" than was the case in the past. But we also have more "bad jobs" too, defined as low skill, low pay and low productivity occupations, as well as fewer "middling" jobs that offer decent pay and employment security. In other words, the labour market now has the shape of an hourglass with more good jobs *and* more bad jobs, but more good jobs *than* bad jobs (Figure 16). A worker at the bottom of the hourglass will find that the ladder of opportunity to a higher paid occupation has some rungs missing – hence the decline in mobility. This is not simply a matter of sectoral shifts in employment (from manufacturing to services for example). The hour glass phenomenon can be found within sectors – more people doing routine jobs in supermarkets alongside more people doing high pay, high skill jobs managing complex logistics systems.

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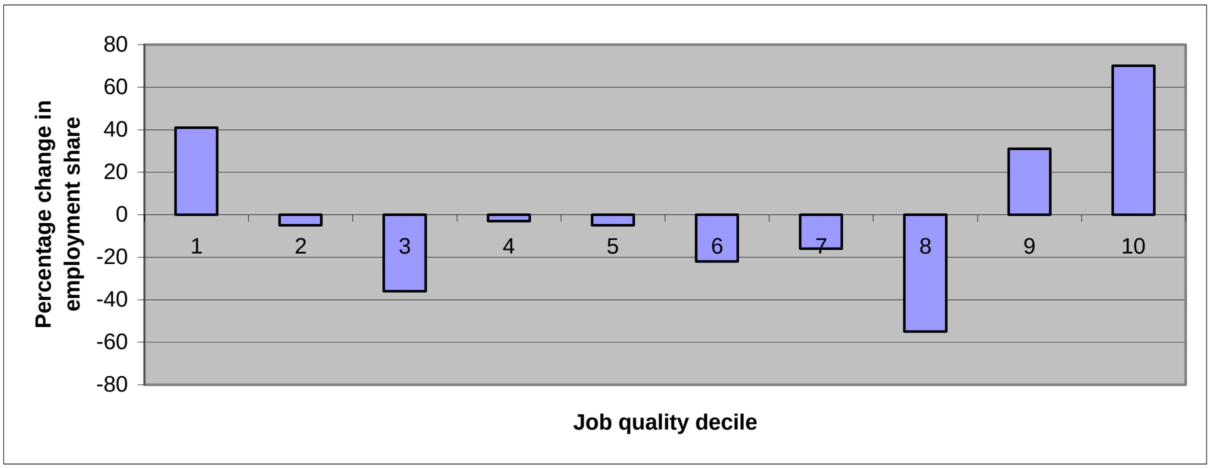
[65] Coats and Max, *Healthy Work: Productive Workplaces* (2005)
[66] Fabian Society, *Narrowing the Gap* (2006)
[67] Blanden and Gibbons, *The Persistence of Poverty Across Generations*, JRF (2006)

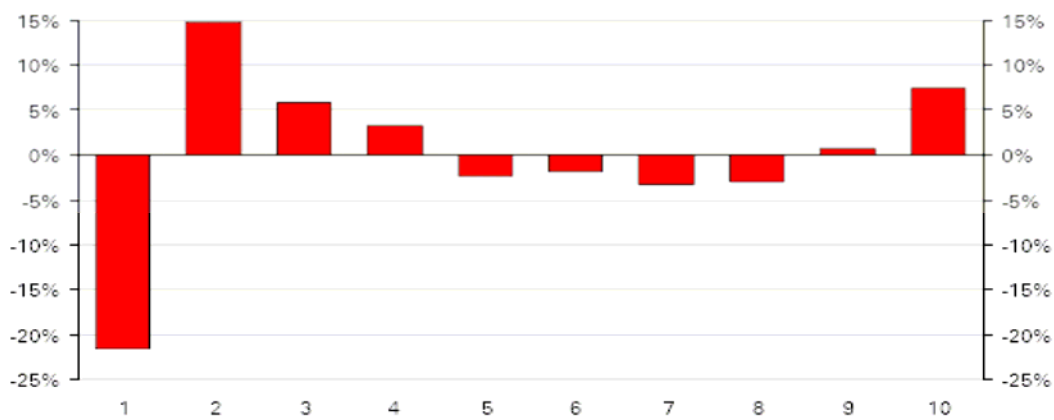
Figure 16: The "Hour Glass" Labour Market: Job Change by Income Decile 1979-99



Source: Goos and Manning, *McJobs and MacJobs* in Dickens et al (ed) *The Labour Under New Labour* (2003)

It has been suggested that there is little evidence for this trend continuing over the last seven years and that the most significant shift has been the fall in the proportion of jobs in the lowest decile (Figure 17)

Figure 17: Percentage change in employment share by 1998 income decile*



Source: DTI analysis of Annual Survey of Hours and Earnings, National Statistics. All employees, United Kingdom. * Total percentage change in the employment share of each income deciles between 1998 and 2005, by gross hourly earnings.

Of course this is true, but it may simply show that policy works and the government's efforts to improve the quality of work at the bottom of the labour market have borne fruit. For example, one might expect a rising NMW to encourage employers to create slightly better jobs, if only to demonstrate that they are not minimum wage employers. Nevertheless, it would be wrong to jump to the conclusion that labour market polarisation has come to an end and the essential hourglass dynamic still seems to be present here. Indeed, the best projections of labour market change suggest that the phenomenon is set to continue for the foreseeable future[68].

It is striking too that most of the employment growth has taken place in the second, third and fourth deciles. Self-evidently these are not "rotten" jobs, but they are not necessarily "high quality" jobs either. While public policy may be focused on the need to create a "dynamic knowledge economy", the real economy seems to be creating lots of rather routine or "mediocre" jobs – as long as one believes of course that pay is determined by productivity and skills. This points to another source of weakness in the UK labour market – improving skills supply but stagnant skills demand, which is causing the rise in job dissatisfaction identified by Francis Green.

While a simple polarisation story may distort the complexity of labour market change, we would be unwise to conclude that the UK has solved the hourglass problem. Furthermore, the DTI's analysis is based on seven years' experience, whereas Goos and Manning look at a twenty-year period. We need a much better sense of whether there has been a real break in the trend before we can be confident that the UK is en route to the creation of a more inclusive and egalitarian labour market.

What we must also recognise is that the growth in inequality can be detected in many developed countries, even those with a strong tradition of egalitarianism. For example, pre-tax household income inequality increased by 25% in Sweden over the course of the 1980s to the middle 1990s (albeit with a much narrower initial distribution than in the UK) although post-tax inequality increased by only 1% - proving the effectiveness of the Swedish welfare state[69].

We could conclude that the structural changes sweeping across the economies of the developed world are having a big impact on the distribution of incomes – only France and the Netherlands bucked the trend towards growing inequality over this period[70]. Growing inequality is not therefore an exclusively British problem, although during the 1980s the speed of polarisation was greater in the UK and the US. Most importantly perhaps, we need to understand that rising pre-tax income inequality is not necessarily a *consequence* of labour market flexibility – other forces may be at work here.

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[68] SSDA, *Working Futures* (2004)
[69] See Esping-Anderson, *Inequality of Incomes and Opportunities* in Giddens and Diamond (ed) *The New Egalitarianism* (2005)
[70] Ibid

We might also note that the government has adopted some clear objectives aimed at addressing the problem. The most well known of course is the commitment to end child poverty, where a modest degree of success can be reported – although the level of child poverty in the UK remains above the average for the EU15. Equally, the government has tried to improve the incomes of the working poor through the combined effect of the NMW and the tax credits system, although the best assessment suggests that income inequality overall has been left unchanged since 1997 despite this high level of policy activism[71].

We are then left with two questions. What do we do about the rich? And what do we do about the poor? This is not the place to examine the case for a more progressive tax system, except to note that other countries have managed to keep inequality at much lower levels with no adverse impact on economic growth or employment[72]. Much of the rhetoric about the incentive effects of low taxation has a poor empirical foundation. Of course, to some extent the progressiveness of the tax system is determined by social and political choices. It may simply be the case that the Nordic countries are more comfortable with an extensive welfare state, reflecting their preference for collective consumption over individual consumption. Yet even if this is true the point of principle still stands: it is possible, if people will vote for it, to combine economic dynamism and social justice.

Is there anything more that might be done about the position of the poor? Or, to phrase the question slightly differently, can we make the welfare state work harder? One possibility would be to encourage people to claim the means tested benefits to which they are entitled. But an equally workable strategy would be to try and improve the wages of those at the bottom of the earnings distribution, thereby reducing reliance on the state to top-up low wages.

This approach starts from the premise that while the NMW may place an effective floor under wages, it is not necessarily the best instrument or the only instrument available to eliminate low pay – since minimum wage workers are by definition low paid. The government has, to a degree accepted the logic of this position through their manifesto commitment to "sector forums", bringing together the social partners in sectors where low pay and low skills are most concentrated "to

[71] Dixon and Paxton, *The State of the Nation: An Audit of Social Injustice in the UK*, in Pearce and Paxton (ed), *Social Justice – Building a Fairer Britain* (2005)
[72] See Lindert, op cit, Esping-Anderson, op cit

discuss strategies for raising productivity, health and safety standards, as well as employee pay, skills and pensions"[73].

This is an admirable proposal that tries to address low pay by increasing productivity, in the self-evident belief that the fundamental principles of economics are true and that rising productivity is associated with rising wages. It is disappointing that the most recent statement from the DTI seems to be diluting this commitment, decoupling sector forums from low pay and simply talking about "skills, health and safety and local enforcement networks"[74]. This looks like a missed opportunity to devise an instrument that tackles low pay beyond the limitations of the NMW. No doubt the DTI are concerned about the willingness or ability of the social partners to engage in dialogue of this kind – the description of the policy so far suggests that either employers or trade unions have an effective veto on whether any progress is made. One possible solution is to ask the Low Pay Commission to identify the sectors where forums are most needed and make recommendations about the process that could be used to bring the parties to the table.

A new social model?

It has been suggested that the net effect of the government's labour market reforms has been to move the UK towards a new social model – the "Anglo-social" model – that is an idiosyncratic hybrid of the liberal and social democratic welfare state models[75]. Just how credible is this case? Can it be equally well described as a step towards a distinctively Anglo-Saxon conception of "flexicurity"? Mike Dixon and Nick Pearce certainly think so:

> *While Britain is currently closer to a liberal model than a social democratic one, the next decade presents a genuine opportunity to develop its best features and move towards what could be thought of as a new "Anglo-social" welfare model, incorporating and reconciling economic performance and flexibility with equality and workplace justice[76].*

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[73] Labour Party Policy Forum Document, *Section 3:Full Employment and Working In Modern Britain* (2004), otherwise known as "The Warwick Agreement"
[74] DTI, *Success at Work: Protecting vulnerable workers, supporting good employers* (2006)
[75] Dixon and Pearce, *Social Justice in a Changing World: The Emerging Anglo-Social Model*, in Pearce and Paxton (ed) op cit
[76] Ibid, pp 80-81

A useful starting point is to delineate those elements of policy that constitute the supposed "new" model since this gives us a basis for a dispassionate evaluation of the scale of the change. We might therefore characterise the labour market elements of the model as follows:

- A high employment rate – with the government setting the ambitious target of reaching an 80% employment rate by 2010 – and high levels of female participation in the labour market.
- Growing employment in low pay, low productivity jobs alongside growth in high pay, high productivity jobs.
- Well-developed ALMPs (the various "New Deals") to get the unemployed and excluded back into the labour market.
- A tax and benefits system that builds on the foundation of the NMW to "make work pay" – essentially by subsidising low wage employment through tax credits.
- A commitment to raise the skill levels of the workforce – exemplified by the commitment that the state will cover the costs of all training towards level two qualifications.
- A growing body of rights for working parents and widening entitlements to request flexible working, leading to a wider differentiation of working patterns.

So far the model has proved that it is effective in creating lots of jobs – but concerns remain about both the quality of many of these jobs and the likely impact on earnings inequality. Dixon and Pearce identify the following challenges facing the Anglo-social model in the immediate future:

- Growing income and wealth inequality
- Women's increased participation in the labour force and the implications of the pursuit of gender equality for the provision of care
- Stalled or declining social mobility
- Marked local and regional inequality
- Rising cost pressures in the public sector
- The management of relatively high levels of migration and migrant participation in the labour market.

It is not possible to deal adequately with all of these issues here and little will be said about the public sector or migration – both of which demand separate treatment. We might also note that there are other concerns too, not least the problem of employment insecurity (one in six British workers say they are uncertain about the future of their jobs) and declining job satisfaction[77].

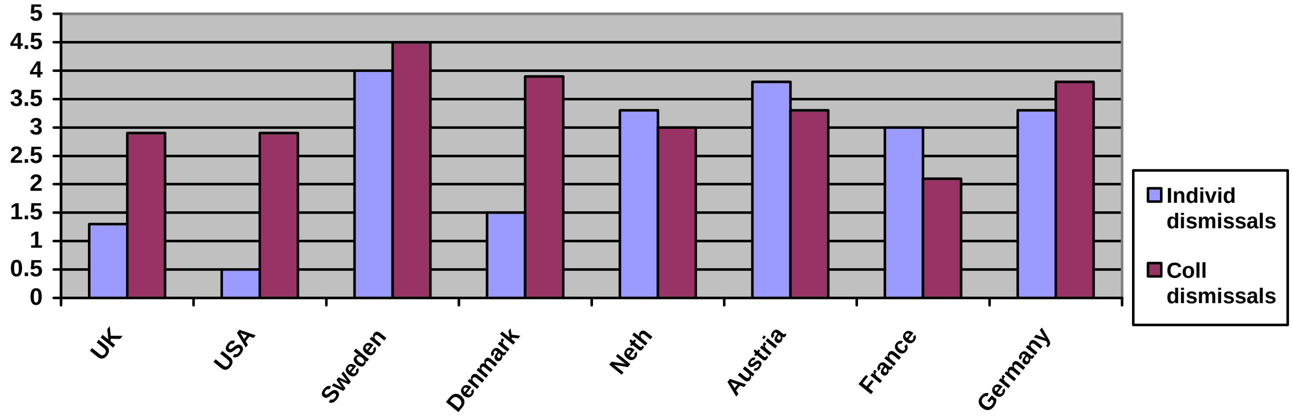
How then might we go about solving these problems? An obvious answer, generally advanced by the trade unions, is that the UK needs a more rigorous framework of employment protection legislation to entrench the workplace justice that the market cannot provide. Equally, the government seems to believe that the social mobility question can be addressed principally through skills development. In their view education and training are routes out of poverty and offer the most disadvantaged access to the life chances that are taken for granted by the more privileged. How might we assess these arguments? Are either of them genuinely compelling and are there other policy instruments that might be used to combine "flexibility" and "justice"?

Better employment protection?

We know from the OECD's work that countries with more stringent levels of EPL than the UK have enjoyed similar levels of employment performance – although with the exception of Portugal, these countries have generally lower levels of EPL than either France or Germany. Trade unions often demand "the same laws in the UK that protect workers in the rest of Europe" although beyond this rhetorical statement it is not entirely clear what new rights the unions believe should be introduced. As we have seen (Figure 15) the position is not quite so simple and straightforward. It may be much easier to dismiss *individuals* in the UK than in many other EU member states (see Figure 18 below) but the evidence suggests that the UK is not suffering from *exceptionally* weak provisions dealing with large scale redundancies – which is the apparent source of the union complaint – although, as we suggest below, there is a case for some modest strengthening of these provisions.

[77] See Coats and Max, op cit. p 29 et seq

Figure 18: Difficulty of individual dismissal/overall strength of collective dismissal regulation 2003 (OECD Index 0-5)



Source: OECD Employment Outlook 2004

It is also worth noting that trade unions in Britain now have more rights than ever before to be informed and consulted about structural change. These rights are certainly more extensive than anything that applied in the pre-1979 period. Indeed, it was only in 1975 that unions first gained statutory rights to be consulted about redundancies. The huge expansion of information and consultation rights since 1997 is a result of three interlocking EU directives – the European Works Councils (EWCs) directive, the Information and Consultation (I&C) Directive and the Collective Redundancies directive (on which the UK's 1975 legislation was based). The EWCs directive provides for regular exchanges of information between employers and employee representatives in European scale multi-nationals. The I&C directive demands information and consultation on the likely development of employment in the business, including any job losses. The Collective Redundancies directive demands information and consultation *with a view to reaching an agreement* between employers and employee representatives on steps that might be taken to:

- Avoid the redundancies
- Minimise the numbers affected and
- Mitigate the consequences for those who lose their jobs.

These are extensive rights and it is difficult to see what more might be done. Admittedly, there may be problems in ensuring that employers comply with these obligations and there are questions about the effectiveness of the penalties and sanctions. But the argument of principle remains: the rights themselves are clear and coherent and it is only at the point of practical application that the rights become problematic.

The recent announcement by Peugeot-Citroen of their intention to close the Ryton plant near Coventry is a case in point. Proper application of the three EU directives demands the following:

- Some discussion in the EWC about the broad strategic plans of the company at European level – including an exchange about model ranges and the basis for decisions about investment and the location of production.
- Using the I&C directive, some discussion between unions and employer in the UK about long-term employment prospects at the Ryton plant, including any threats to jobs and the “anticipatory” measures that might be taken by the employer. It has been clear for some time that Ryton is producing an ageing model with a limited life span and that continued production will depend on major investment decisions. Unions could have made use of these rights to open a discussion before any decisions were taken.
- At the point when the company began to “contemplate” redundancies, a process of information and consultation *with a view to reaching an agreement* should have been initiated in line with the Redundancies directive.

A creative use of these instruments should therefore ensure that unions are not surprised by “sudden” announcements. Similarly, a process of open and sustained dialogue should equip unions with the wherewithal to defend the interests of their members by arguing for the preservation of as many jobs as possible. What these obligations cannot do of course is reverse the logic of markets and compel an employer to take a decision that makes little business sense. As we have noted already, these I&C arrangements are designed to facilitate and legitimise structural change rather than act as an impediment to “creative destruction” and much of British business seems to be struggling with a “legitimation crisis”. Most importantly perhaps there is strong evidence to show that employees are less likely to trust their employers than was once the case[78]. This is expressed as a lack of confidence in both senior management at board level and operational managers. Eliminating this trust deficit demands rather more sensitive handling of difficult change processes than many British employers have managed in the recent past. In this sense at least we have much to learn from experience elsewhere in the EU.

It probably is right to say that the UK’s legislation on these matters is less prescriptive than that which prevails elsewhere in the EU15 – exactly when consultation is supposed to take place may

[78] See *The Workers’ Index*, MORI and TWF (2005)

be identified with some precision for example, although the redundancies directive simply requires consultation when redundancies are "contemplated". A recent decision of the European court of justice makes clear that:

> [*T]he obligations to consult and to notify arise prior to any decision by the employer to terminate contracts of employment*[79].

There is a strong case for some clarifying the implications of the consultation obligations as they apply in the UK. The DTI are consulting on the issue, but the substance of their proposals concern the requirement to notify the Secretary of State that redundancies are to take place and some minor changes to the drafting of guidance so that employers understand that consultation processes should be complete before redundancy notices are issued[80]. Of course, these are helpful proposals, but they do miss the point somewhat that consultation ought to take place *before the employer has made any final decisions* and not just before redundancy notices are issued. There is a huge difference between I&C on a *fait accompli* and a genuine exchange of views about possible options. The spirit and the letter of the EU directive and ECJ decisions are self-evidently more concerned with the later than the former.

We might conclude therefore that the DTI's guidance should be more precise about the point when consultation should begin. In the absence of a much higher level of clarity, trade unions and employees will continue to believe that some employers are simply "going through the motions". A modest tightening up of this kind would give a very clear signal that the government places a high value on genuine "options based" consultation where a range of approaches can be discussed. Dismissals for unavoidable "economic reasons" could be achieved through processes that were widely accepted as legitimate without any significant loss of "flexibility".

Indeed, we might go further and say that some useful changes might be made to other aspects of the UK's regime of redundancy handling. For example, some consideration might be given to the alignment of the redundancy and unfair dismissal rights by introducing a one-year qualifying period.

It would also be possible to revisit the limit on a week's pay (the basis for calculating a statutory redundancy payment) so that it is more closely aligned with average earnings. Indeed, the DTI

[79] See the judgment of the ECJ in *Junk v Kuhnel*, Case C-188/03 [2005], para 37
[80] See *Collective Redundancies: Employers' Duty to Notify the Secretary of State* (2006)

have already recognised that the current weekly limit of £290 is lower in real terms than when redundancy payments were first introduced in 1965. This observation is matched by a commitment to increase the limit over the course of the current parliament. Furthermore, it is suggested that the DTI may take powers for a "one off increase in the limit", which will be taken forward as part of the comprehensive spending review. These are important proposals and should be welcomed[81].

Some consideration might be given to the imposition of more stringent penalties on those employers who breach the information and consultation obligations. At present the maximum penalty for non-compliance with the I&C regulations is £75,000 and a failure to comply with the redundancy consultation obligations attracts a penalty of a maximum of 90 days pay multiplied by the numbers of employees affected. There is a serious question whether these penalties are real deterrents, especially for large organisations that are more than able to absorb the costs. Alternatively, one might say that small and medium sized enterprises could be disproportionately penalised. The case for a review of these arrangements is compelling.

It has also been argued that the qualifying period could be reduced further – perhaps to six months – or abandoned completely. Certainly, there is a case for considering this argument, although it might be observed that most employers operate probationary periods of at least six months that are sometimes extended to one year. If there is abuse of the current arrangements it does not appear to be widespread and, other things being equal, if changes are going to be made here the focus should be on the redundancy qualifying period and compensation levels rather than a wider programme of reform.

This brings us to the suggestion that in general it is cheaper to dismiss British workers than workers elsewhere in the EU15. Some support for this argument can be drawn from the rather low levels of statutory redundancy pay, but in unionised workplaces at least, agreements will be in place that offer much higher levels of compensation. An additional factor to be weighed in the balance is that employers elsewhere may be required to bear some of the costs of retraining and job search following the conclusion of a "social plan" with the union. But the same may be the case in unionised workplaces in the UK where the employer agrees to fund job search and outplacement facilities.

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[81] See *Protecting vulnerable workers, supporting good employers*, op cit p. 44

The Ryton experience could reinforce the views of some observers that unions always try to buck the logic of capitalism and “save all the existing jobs”. Yet in one sense it is difficult to see what else trade unions can or should do. After all, what do union members pay their subscriptions for if not some insurance against adversity? Equally, it is entirely appropriate that unions should challenge decisions that they believe are unsupported by compelling business logic.

There is a strong argument too that the supposed “inflexibility” of lengthy consultation can be an advantage for employers, creating incentives to consider alternatives to redundancies so that skilled workers are retained by the business; sometimes “labour hoarding” can be a good thing, ensuring that an organisation has the wherewithal to respond to an economic upturn because it has retained the skills and tacit knowledge of experienced employees.

On the other hand, unions may be raising expectations that they cannot meet if they suggest that the government is wholly to blame for job losses because EPL is too weak – which absolves the employer from a significant proportion of the blame. Focusing attention entirely on the law may represent a failure of leadership, if only because it creates the impression that all job losses are unnecessary and can be avoided completely if the government has the political will to act.

Whatever one thinks of the specifics of the Ryton case, an exclusive focus on labour law reform can only be a false prospectus. Expressed in the bluntest language, an organisation is not going to survive if it is offering goods and services that people do not want to buy. It would be absurd to deny that capitalism can be brutal, but it remains the best route to growth and prosperity. The question for our purposes is: how can we regulate this process? How are the “animal spirits” of markets are to be domesticated? Dixon and Pearce refer to the twin objectives of “flexibility” and “justice” and it is entirely reasonable to suggest that this is precisely the purpose of well crafted I&C legislation. Competitive markets have to be encouraged so that the capitalist goose continues to lay golden eggs, but employees must be confident that they will be treated with respect too.

Skills, Knowledge, Productivity and Social Mobility

A modest improvement to EPL could therefore have a significant impact on workplace justice. But improving social mobility is a rather more complex problem. Part of the solution must lie in skills policy, allowing those at the bottom of the labour market to maximise their potential. Even so, a comprehensive approach demands a range of interventions that start before child is born, continue through early years provision and are reinforced during the years of formal education.

Similarly, measures to get the socially excluded back into the labour market (the disabled and lone parents for example) are likely to improve the life chances of children in poor households. This raises in turn some difficult questions about access to affordable childcare and the importance of flexibility in working time. Improving social mobility depends on a comprehensive programme for the achievement of social justice, which is a rather wider canvas than our narrow concern here with labour market flexibility[82].

We also need to recognise that many people will never change their relative social position. Sometimes this may be a matter of luck, sometimes a matter of geography (there are no "good jobs" available in the locality) and sometimes a matter of natural endowments. Our objective then must not just be to secure a higher degree of social mobility but to guarantee that the experience of work for those at the bottom of the earnings distribution is better than unremittingly awful, hence the importance of the sector forums and measures to improve productivity.

This is related to a final consideration that improvements in the supply side are not, in themselves sufficient to create more good jobs. We have already seen that qualification levels are rising faster than the capacity of employers to fully utilise these skills. This means that government must begin to look inside the "black box" of the firm and develop a range of business support interventions that encourage the identification, dissemination and application of best practice. The DTI, building on the principles articulated in *Protecting Vulnerable Workers, Supporting Good Employers*, has to play the lead role here in developing government policy.

Trade Unions and Collective Bargaining

Reference has been made throughout this paper to the OECD's assessment of the impact of different forms of collective bargaining on employment performance. Evidence from the UK suggests that trade unions continue to have a powerful "sword of justice" effect in the workplace – unionised workplaces have fewer low paid workers, narrower pay differentials, a better record on gender equality (including equal pay), better treatment for disabled workers or workers from ethnic minorities and fewer workplace accidents[83]. An obvious question therefore is whether the UK could achieve a better balance of "flexibility and "justice" if trade unions were stronger?

There are two observations to be made here. The first is that if unions compress differentials too far there may be adverse consequences for the incentives to acquire higher skills with higher

[82] See *Narrowing the Gap*, op cit
[83] Metcalf et al, *Unions and the Sword of Justice*, National Institute Economic Review (2001)

skilled workers expressing discontent about the reduced incentives available to them. At the same time, a conventional analysis suggests that unemployment might rise amongst lower skilled groups because their wages had been raised above their marginal product. Lindert points out that Sweden had a compressed wage distribution like this at the end of the 1970s and that while the first and second effects could be detected, there was, at that time, no increase in unemployment amongst the lower skilled [84]. Even so, this does suggest that a degree of caution is required and that the relentless pursuit of an egalitarian wages policy may have some undesirable side effects.

Second, the evidence is reasonably persuasive that a higher degree of collective bargaining co-ordination is needed in those countries where unions have a significant impact on wage formation to ensure that the macroeconomic consequences of wage agreements are factored into the negotiating process. Of course, we should recall that the OECD are rather timorous in offering conclusions about the importance of co-ordination and point out that the relationships between collective bargaining and other labour market institutions are not well understood. Nevertheless, we might be slightly less hesitant than the cautious OECD analysts, even if we cannot produce an equation to prove a causal link, and point out that the "flexicurity" model is apparently associated with strong unions, co-ordinated bargaining and a high degree of wage responsibility. In other words unions understand, whether implicitly or explicitly that they have an obligation (shared with employers) to ensure that wage increases are non-inflationary.

This discussion could prove to be of merely academic interest in the UK if trade unions continue to wither on the vine. On the other hand, if trade unions begin to grow and exercise more influence over wage formation it will be difficult to avoid some difficult (and historically familiar) questions about the design of the collective bargaining system. Many commentators have noted that British trade unions have always struggled to become Northern European "social partners", which helps to explain the hostility of employers (and government if one refers to HMT analysis in 2003) to a resurgence of trade unionism[85]. In principle though the conclusion is clear: the UK could have stronger unions, a higher level of workplace justice and a high level of labour market flexibility. Whether the government believes it is worth taking the risk of encouraging higher union membership and the wider coverage of collective bargaining is, on past experience, not entirely an open question.

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[84] Lindert, *On the well-known demise of the Swedish welfare state*, op cit, p 276
[85] Marquand, *Decline of the Public* (2004)

Improving the situation of the unemployed?

A growing role for ALMPs is a consistent feature of the emerging Anglo-Social model, with the New Deals expanding from help for the young unemployed to older workers, single parents and the disabled. The government's proposed reforms to Incapacity Benefit must be seen as part of a comprehensive "activation strategy" that draws on the success of such programmes in the Nordic countries. However, funding for ALMPs, although it has grown apace since 1997, is still modest when compared with expenditure elsewhere. A really effective "activation strategy" could demand greater investment in the future.

Raising the question of benefit levels is always difficult and invariably contentious. However, we know that benefit levels in the UK are low and could be significantly higher without any loss of labour market flexibility – assuming of course that appropriate "activation" policies are in operation. Inevitably there will be an increased cost to the Exchequer, although one might also anticipate savings elsewhere – for example in health spending. If the unemployed manage to avoid a catastrophic collapse in income they are likely to enjoy better physical and mental health, will be better able to reap all the benefits of the active labour market support provided by JobCentre Plus and might therefore return to work more rapidly How much benefits should be increased and when they should be increased is a question beyond the scope of this paper. We can be confident however that in the right context higher benefits will not necessarily reduce incentives to work.

Conclusion

If there is an Anglo-social model emerging then it remains work in progress. Dixon and Pearce are right to say that the UK still looks more like a liberal than a social democratic welfare state, but also right to say that the UK is not *simply* a liberal welfare state. At present policy is in a state of flux. The government seems content that it has gone as far as it needs to in re-regulating the labour market, and sometimes gives the impression that it has gone too far[86]. It is certain that the NMW will be a permanent feature of the landscape while this government remains in power, that tax credits will continue to supplement the earnings of the in-work poor, that ALMPs will be enhanced and that the commitment to eliminate child poverty will be reinforced.

What we cannot be certain about, however, is whether the government will take any further action to improve the conditions of work of those at the bottom of the labour market. Equally, it seems unlikely, other things being equal, that the government will change its stance on the promotion of

[86] See for example the Chancellor's comment quoted on p 16

collective bargaining as an instrument for the achievement of workplace justice. On the other hand, we know that stronger trade unions are, under the right conditions, entirely compatible with the OECD's revised understanding of a flexible labour market. Similarly, we know that somewhat stronger EPL would not necessarily have a damaging impact on employment in the UK and that benefit levels could be increased if they were combined with a comprehensive "activation" strategy. The principal question therefore is whether the UK labour market will develop in a social democratic direction or remain largely rooted within the liberal paradigm. The jury is out and the verdict uncertain. It is not too optimistic to hope, however, that the lessons from other successful economies might be adapted to the UK's conditions. There is still a genuine opportunity to secure a better balance between performance, flexibility, equality and social justice.

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