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The diversity of labour market policies in Europe

Analysis and comparison of the British, Swedish and French cases

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Abstract

The aim of this study is to consider the diversity of national labour market policies in Europe during the nineties through the analysis and comparison of three representative cases, namely the United Kingdom, Sweden and France in a theoretical perspective. This diversity is shown to come from different understandings of the labour market, as from heterogeneous institutions across countries.

To deal with this issue, we first offer a detailed analysis of the theories underlying the choice of labour market policies. We then proceed with a comparison of countries' performances during the nineties. Finally, we present the estimated impact of institutions in labour market's achievements.

Our first conclusion is that the labour market policies implemented during the nineties in the United Kingdom, Sweden and France differ, since they are linked to three different theories, which are respectively the standard neo-classical theory, the new labour market theories and the institutions' theory.

Assessing the countries' achievements, we conclude on the better performance of the United Kingdom in the field of unemployment during the nineties.

Lastly, we show the difficulties in applying a common European labour market policy, since heterogeneous labour market institutions are estimated to play a big role in national labour market's performances and have to be taken into account when implementing policies.

Keywords

Labour market policies, unemployment, labour market institutions, neo-classical theory, new labour market theories, institutions' theory

Résumé

L'objectif de ce mémoire est d'étudier la diversité des politiques nationales d'emploi en Europe durant les années quatre-vingt-dix, à travers l'analyse et la comparaison, dans une perspective théorique, des trois cas représentatifs que sont le Royaume-Uni, la Suède et la France. Nous tentons de démontrer que cette diversité est issue, d'une part des différentes compréhensions du marché du travail, d'autre part de l'hétérogénéité des institutions entre ces trois pays.

Pour traiter cette question, nous proposons d'abord une analyse détaillée des théories sous-jacentes aux choix des politiques d'emploi. Puis nous procédons à une comparaison entre les performances de ces pays durant les années quatre-vingt-dix. Enfin, nous présentons l'impact estimé des institutions sur les performances des marchés du travail.

Notre première conclusion est que les politiques d'emploi mises en place durant les années quatre-vingt-dix au Royaume-Uni, en Suède et en France sont différentes parce qu'elles trouvent leur origine dans trois théories différentes, qui sont, respectivement, la théorie néo-classique standard, les nouvelles théories du marché du travail et la théorie des institutions.

A l'issue de la comparaison des réussites de ces pays, nous concluons que le Royaume-Uni est le plus performant en matière de chômage durant les années quatre-vingt-dix.

En dernier lieu, nous montrons les difficultés d'application d'une politique d'emploi commune en Europe, étant donné l'hétérogénéité des institutions du marché du travail dont le poids, dans les résultats obtenus sur chaque marché du travail, est considéré comme étant important. Ces institutions doivent donc être prises en compte lors de la mise en place des politiques.

Mots-clés

Politiques d'emploi, chômage, institutions du marché du travail, théorie néo-classique, nouvelles théories du marché du travail, théorie des institutions

Foreword

(i) Proceeding, difficulties and choices explanation

To do this study, we followed a proceeding of research, treatment of data and writing. Along this proceeding, we came up against several obstacles and had to make choices:

- Research of documents: when looking for labour economics' literature, we found easily a set of new evaluations about labour market policies, which have been done in several European countries, as proposed in the EU Guidelines. However, if the United Kingdom and Sweden have a long time tradition of policies evaluation, France's literature remains rather poor in this field. In addition, the only labour market policies' evaluations done in France come from the public authority, which seems to withhold precise information on policies effectiveness. To counter this difficulty, we found information from OECD international studies.
- Research of figures: to compare countries' performances, we needed homogeneous data, i.e. data of common characteristics, stored or calculated with the same process. For this reason, we chose to avoid national data and worked essentially on OECD standardised time series (we could have chosen Eurostat database, but OECD database is much larger).
- Data processing: the risk was obviously to store too many data, without being able to retrieve the core information needed. To avoid this risk, we decided to start researches quite early in the year and to process bit by bit in the treatment of data.
- Writing: last but not least, a final difficulty was naturally to master English, in order to be able to express ideas as clearly as in French. Several readings have been necessary. Yet, mistakes may remain.

(ii) Acknowledgements

To achieve this work, we benefited from the precious recommendations and help in research of our thesis director in France, Jacky Koehl (Lecturer in the University of Nancy II). Additionally, our thesis director in Sweden, Harald Niklasson (Professor in Växjö University) validated the structure of the thesis and provided references as well. Thesis assessor Florence Ramillon provided leading advice too, as to the proceeding to follow. Finally, ICN – Ecole de Management gave access to facilities in Nancy, while Dresdner Kleinwort Wasserstein, furnished access to databases in Paris. These have to be sincerely thanked.

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I. Introduction

A. Theme

High and persistent unemployment has been a major issue in most OECD countries since the early 1970s. The political response to unemployment has been traduced by a sensitive increase of State expenditures in favour of labour market policies from the middle of the 1970s. Thus, after a decade of Keynesian policy mix in the 1980s, various policies were developed in the 1990s to improve labour market performance on a durable basis. However, the systems applied differed sensitively among countries. Actually, since various representations of the working of labour markets are allowed, many kinds of political instruments may be involved to fight unemployment.

Labour market policies can be defined as public interventions that act directly on the labour market and aim to improve its working and to reduce disequilibrium that might appear. Because of the specific instruments used in these policies and their long-run effects, labour market policies differ from cyclical economic policies and belong thus to structural policies. However, because of the objectives aimed in these policies and the field of implementation, they differ from industrial policies and cannot be compared to them. Then, they need a specific study in line with their characteristics. Traditionally, labour market policies are divided into two categories: the active measures that act on the vacancies' deficit compared to the active population; and the passive measures that act on the effects induced by the insufficiency of the number of vacancies for the active population. In other words, active programs aim at enhancing the access of the unemployed to labour market and jobs, by improving job-related skills and the functioning of the labour market, while passive programs relate to spending on income transfers, namely unemployment benefits and early retirement pensions. In 1992, OECD countries' labour ministries accorded themselves to enhance active programs. The same principle was included in the EU Employment Guidelines¹ in 1997.

¹ see Appendix 1: EU Employment Guidelines 1997

B. Problem statement

European national labour markets, be they already inside the Euro-zone or not, are characterised by great heterogeneity in industrial relations, employment regulations, systems of replacement income and in the role of national active labour market policies. Thus, the UK stands out clearly compared to the countries of continental Europe (low level of unionisation and ‘New Deal’ policy); France is unique in the nature of its industrial relations (negotiations are highly decentralised and cooperation among social partners is weak); Sweden is close to Southern Europe in terms of regulatory constraints (redundancy, short-term contracts and working hours). Therefore, the study aims to explain the differences in the labour market policies applied in Europe from the early 1990s to the early 2000s, by focusing on the cases of three representative countries, namely the UK (characterised by a liberal system), Sweden (incentive system) and France (interventionist system).

C. Methodology used

The economic analysis provides a classification of labour market policies², according to the point of view that is adopted. Then, we can make a distinction between:

- Policies acting on supply and aiming to decrease the labour cost (flexibilisation of the labour market);
- Policies depending on demand (growth policies, incentive policies to maintain employment);
- Mixed policies (labour supply reduction or labour demand extension).

The first policies described in the Tchibozo classification can be linked to the standard neo-classical theory; the second ones to the new labour market theories; and the last ones to the institutions’ theory. Our approach is founded on the assumption that labour market policies can, to a certain extent, be read in a coherent way thanks to theoretical analyses.

To answer to the problem stated above, we will look at the three representative countries chosen from 1991 to year to date (depending to the available data) and try to show (II) how –

² G. Tchibozo (1998), *Economie du travail*, Dunod, Paris

at least in the field of labour economics – the United Kingdom’s system is close to the standard neo-classical theory (liberal system), whereas Sweden applies an incentive system (the ‘Swedish model’) formalised in the new labour market theories and finally France, with its strong interventionist culture, trusts the institutions’ theory recommendations. Then, we will focus on the labour market policies’ effectiveness in a cross-countries assessment (III). This will lead us to consider the role of institutions (IV), which may influence, directly or indirectly, countries performance, before to conclude (V).

II. The labour market policies implemented in the three countries: to what extent can they be linked to theory?

As a starting point, differences between theories³ can be summed up in the following figure:

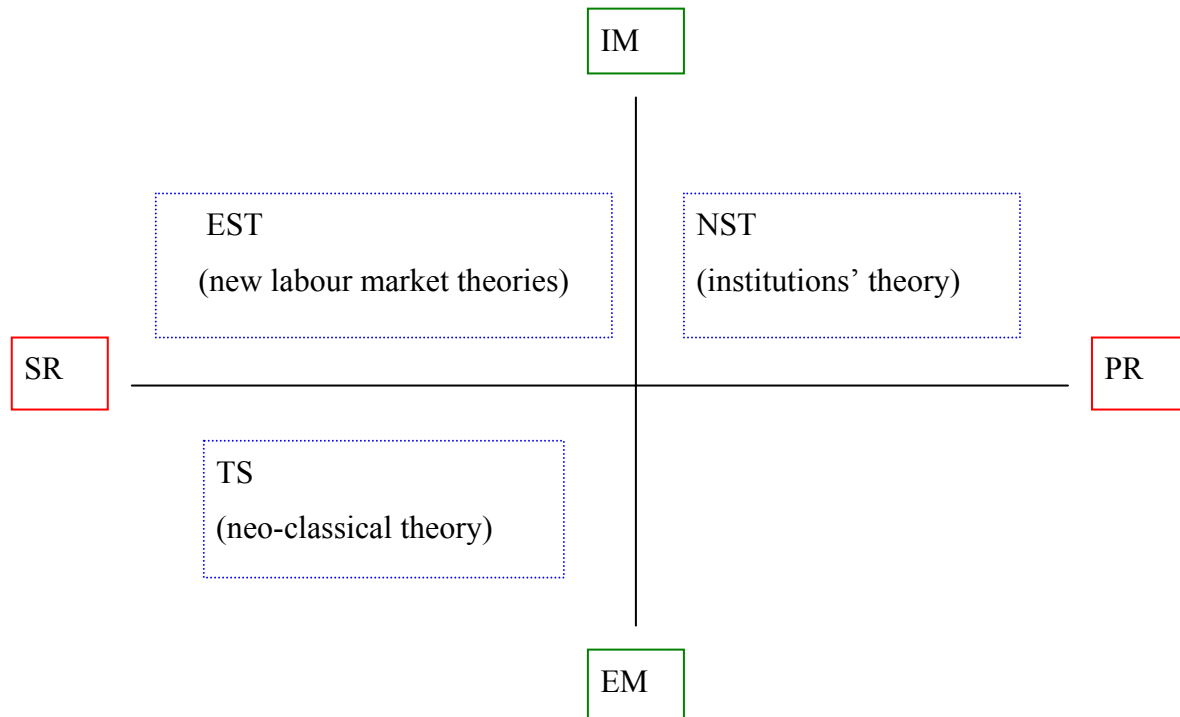


Figure 1: Specific characteristics of each studied theory

Given that the hypotheses concerning agents' rationality are:

- either **SR** = substantive rationality, i.e. agents are rational and calculators, with a total knowledge of the possibilities offered as a whole and they decide according to the maximisation program of their utility under revenue constraints
- or **PR** = procedural rationality or bounded rationality, i.e. agents are rational, but in a non-perfect universe

³ inspired by the classification operated in O. Favereau (1989), "Marchés internes, marchés externes", *Revue Economique*, mars 1989, p.273-328

The analysis' point of view may be:

- either EM = external market, i.e. the resources allocation is done thanks to price
- or IM = internal market, i.e. the resources allocation is done thanks to the rules applied in the community

Finally, theories are characterised as:

- ST = standard theory
- EST = extended standard theory
- NST = non standard theory

Then, keeping in mind these differences between economic analyses, we shall easily understand that the identified causes of unemployment determine the choice of labour market policies, according to the theory it relates to. Thus, section A will expose the identified causes of unemployment for each country and emphasise the link with unemployment theories, while section B will develop the convenient solutions to unemployment, in line with each theory.

A. Identified unemployment causes

Cyclical unemployment is identified when changes in unemployment are positively related to changes in the business cycle (or in GDP). This has been the case in European unemployment until recent years. However, high and persistent unemployment in the expansion context of the mid-1990s has shown evidence of the existence of a structural component in unemployment.

1. Structural unemployment: NAIRU versus natural rate

It is worth to notice that the first model presented (natural rate of unemployment) is based on a level representation, whereas the second one is based on a variation representation (NAIRU) of the link existing between unemployment and prices.

i. Natural rate of unemployment

Friedman introduced the natural rate of unemployment. It corresponds to full employment, with a stable inflation rate (but price level is not necessarily stable). It must then be invariant. The Friedman's natural rate of unemployment is "the level that would be ground out by the Walrasian system of general equilibrium equations, provided that there is embedded in them the actual structural characteristics of the labour and commodity markets, including market imperfections, stochastic variability in demands and supplies, the costs of getting information about job vacancies and labour availability, the costs of mobility, and so on⁴." Inflation rate is determined by the growth in money supply and in nominal aggregate demand, according to Friedman. Under the assumption of the absence of monetary illusion, wages are automatically indexed to inflation. There is then a symmetric price dynamic:

- Either monetary policy produces unemployment less than the natural rate; then inflation increases without limit;
- Or monetary policy produces unemployment unnaturally high; then inflation decreases indefinitely.

Then, natural rate theory implies that there is no durable policy trade-off between unemployment and inflation (monetarist theory). However, a short-run policy trade-off remains possible, given the price level stickiness and assuming rational expectations (new labour market theories) instead of substantive ones.

ii. NAIRU: Non-Accelerating-Inflation Rate of Unemployment

The concept of the NAIRU (Non-Accelerating-Inflation Rate of Unemployment) was introduced by F. Modigliani and L. Papademos. In the NAIRU theory, firms are supposed to determine prices according to the unit labour cost anticipated, i.e. in line with their target wages, themselves subject to productivity level of employees. Given that bargaining process is based on real wages, negotiated wages must take into account the labour market's situation. Then, if price and wage anticipations are realised, unemployment rate does not accelerate inflation (neo-classical theory). Elements that are involved in the NAIRU are the same as those involved in wage and price determination process, i.e. labour productivity and

⁴ in M. Friedman (1968), "The Role of Monetary Policy", *American Economic Review*, March 1968, p. 1-17

sensitivity to the labour market's situation. Flexibility on the labour market has thus a major role to play on the ability of the economy to reach its equilibrium unemployment.

Yet, the realisation of anticipations is a strong hypothesis of the model. Indeed, assuming errors in anticipations⁵ (new labour market theories), short-term unemployment differing from the NAIRU becomes possible, through inertia or stickiness of prices.

Finally, the NAIRU might be considered in a partial-equilibrium model. According to Tobin's interpretation, "the NAIRU is the unemployment rate at which the inflation-increasing effects of the excess-demand markets just balances the inflation-decreasing impacts of the excess-supply markets⁶." Thus, the NAIRU does not assume Walrasian equilibrium; instead it assumes an economy in which at any time most markets are characterised by excess demand (preponderance of job vacancies over unemployment if applied to labour markets) or excess supply (preponderance of unemployment over job vacancies) at prevailing prices. Therefore, the NAIRU may vary from time to time as the relationships between unemployment, vacancies and wage changes vary, and as the dispersion of excess demands and supplies across markets changes.

2. Frictional or cyclical unemployment

Frictional unemployment is short-term unemployment. Indeed, assuming a Walrasian framework, unemployment appears when real wages increase. This creates excess in labour supply as well as in goods demand. But since the competition is perfect, real wages are rapidly adjusted and the economy tends to its general equilibrium level. The only kind of unemployment remaining is then "voluntary" unemployment, i.e. job seekers that refuse to work at the market price. As we will see later, the job search theory formalised frictional unemployment by relaxing the perfect information hypothesis of the standard neo-classical theory.

⁵ R. Layard, S. Nickell, R. Jackman (1991), *Unemployment: Macroeconomic Performance and the Labour Market*, Oxford University Press

⁶ in J. Tobin (1998), *Supply Constraints on Employment and Output: NAIRU versus natural rate*, Cowles Foundation Paper 1150, Rome, p. 8

Cyclical unemployment may occur when an external shock appears in the economy (e.g. shock in oil prices in the 1970s). However, contra-cyclical policies are able to invert the trend if the economy is not (imperfection of markets). Thus, cyclical unemployment follows economic fluctuations. It is then short or medium-term unemployment. Assuming a hysteresis effect of unemployment (if agents make their expectations according to the past events), cyclical unemployment may persist and become structural (new labour market theories).

3. Identified unemployment in each of the three countries

As we have seen, various causes of unemployment are theoretically possible. We now have to identify the characteristics of British, Swedish and French unemployment to link them to theory.

i. United Kingdom unemployment

In the UK, there has been a steady upward drift of unemployment since 1960, with a very large increase post 1979. The UK has experienced sharp boom-bust cycles. There were deep recessions in the early 1980s and early 1990s and a fast boom in the mid-late 1980s as in the late 1990s. Until the 1990s, the trough of each recession was associated with higher unemployment than the previous downturn. Thus, if a key feature of the UK unemployment is its sensitivity to the business cycle, a structural component might also be embedded in British unemployment.

In the early 1990s, UK unemployment was relatively high (around 10% in 1993) by OECD standards (around 7.5%), due to the deep recession of 1991-1993 (see figure 2 below). However, in 1994, the sharp decrease in UK unemployment rate led it relatively low by Sweden unemployment (which used to be considered as an example for other European countries). Expansion of the late 1990s has pushed the number of unemployed below that of the previous cycle. This might be explained by the greater flexibility of the UK labour market, compared to other European countries and over time. Then, the NAIRU theory seems to be adequate. Indeed, the British government involved structural reforms of the labour market during the 1990s, whose objectives were to enhance market flexibility (following the neo-classical interpretation of the NAIRU).

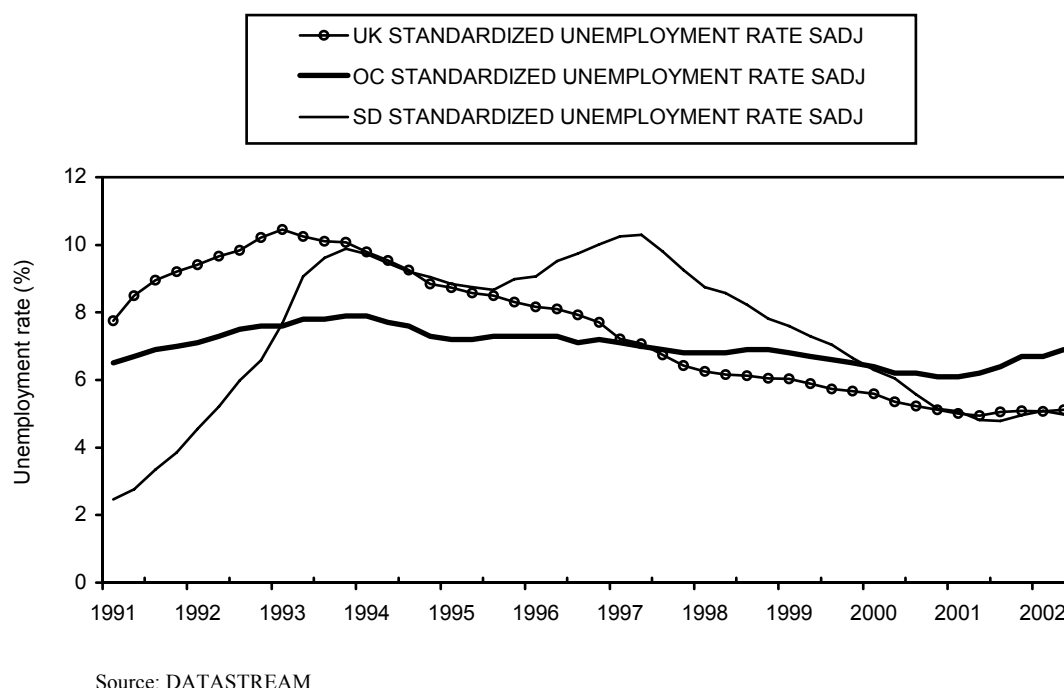


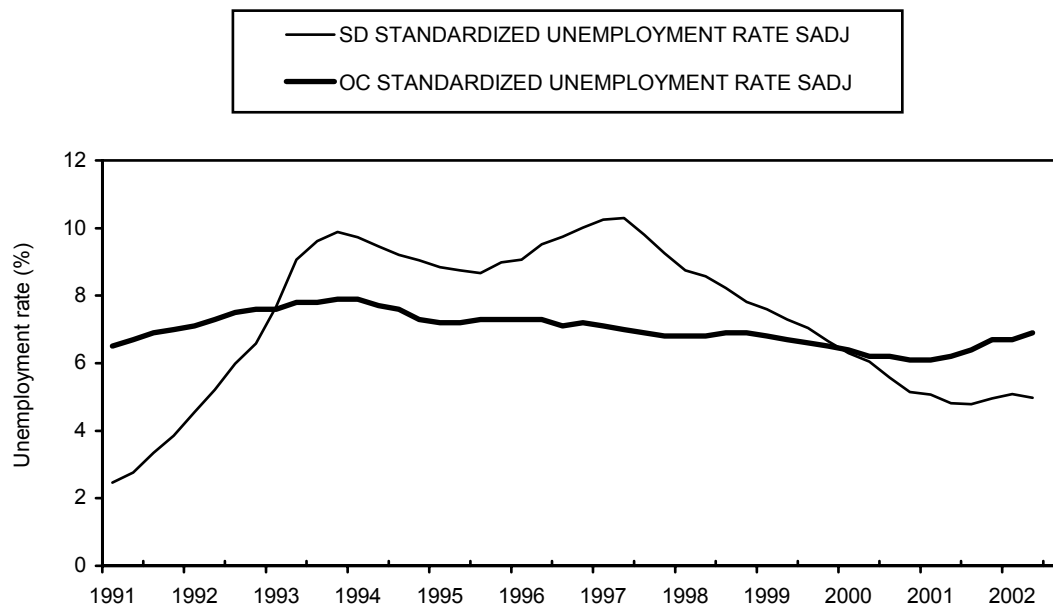
Figure 2: UK standardised unemployment since 1991

ii. Sweden unemployment

Until the 1990s, Sweden unemployment was far lower than European standards. However, the sudden and deep recession of the early 1990s raised sensitively Swedish unemployment (more than quadrupling between 1991 and 1993, from 2% to 9%). Then, Sweden entered an expansion cycle without reducing significantly its unemployment. A peak was reached in 1997 (see figure 3).

Structural parameters or hysteresis effects could have affected the apparent cyclical unemployment of the country. This could be explained by real wages rigidity to the drop when faced to recession. The high incentive component of Swedish policies and institutions leads to seek a global interpretation of the micro-economical functioning of the labour market, since the Walrasian framework and the classical analysis are no more possible (institutions' design do not respond to neo-classical hypotheses). Then, an explanation of Swedish

unemployment is given by the new labour market theories, through, among other things, the analysis of the Beveridge curve that describes the matching process on the labour market⁷.



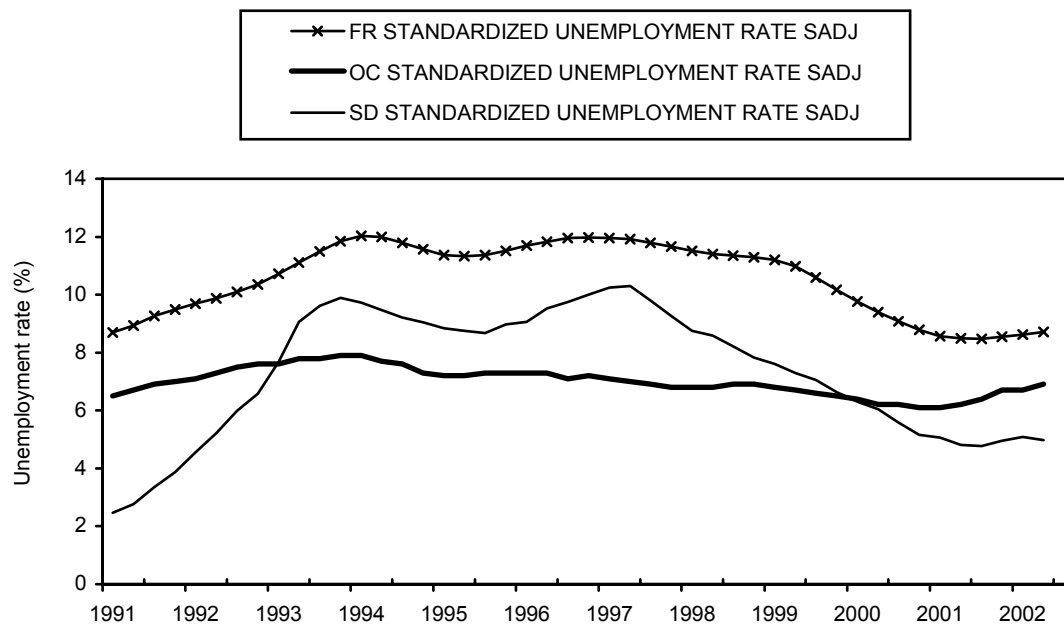
Source: DATASTREAM

Figure 3: Sweden standardised unemployment since 1991

iii. France unemployment

Since 1991, France has to face a deterioration of its labour market situation. Indeed, unemployment is increasing steadily from that time, except in the late 1990s where the strong growth in all European economies induced a natural reduction in unemployment (see figure 4). However, during the entire period, French unemployment (11% in average) is above European and OECD standards (7% for OECD average). Further, French long-term unemployment (more than 12 consecutive months), as well as low-skilled unemployment, is high and persistent. This shows the specificity of the French unemployment. It cannot, therefore, be identified as a frictional unemployment.

⁷ The Beveridge curve analysis will be treated in detail below.



Source: DATASTREAM

Figure 4: France standardised unemployment since 1991

Following Nobel Prize M. Allais, five factors of unemployment can be identified in France: the numerous rigidities of the labour market (existence of a minimum wage, important social charges); the Maastricht criteria that constraint France to maintain a strong currency and to reduce budgetary deficit during the 1990s; the geographical position and historical events that boosted immigration in France; a technological component (productivity gains result first in a reduction of labour demand, before that new investments increase labour demand) and a cyclical component. The major factors identified by M. Allais to characterise French unemployment are the two first ones, i.e. market rigidities and lack of competitiveness of the country. French unemployment is then structural. Given the weight of institutions in the wage determination, the analysis must be done through institutions' theory.

Then, the analysis of unemployment determinants leads us to study three kinds of policy frameworks, hence various solutions to the unemployment problem: the one provided by standard neo-classical theory for the United Kingdom, the one introduced by new labour market theories for Sweden and the one given by institutions' theory for France.

B. Convenient solutions

The diagnostic of unemployment determines the objectives and the means that must be assigned to the labour market policy. Since the different diagnostics exposed above led to various theories, the convenient solutions to reduce unemployment are also numerous. We will first analyse the link existing between the standard neo-classical theory and the British labour market policies. Then, the implications of the new labour market theories to Sweden policies will be studied. Finally, the institutions theory will be shown to fit with the French labour market policies.

1. Standard neo-classical theory and the British ‘New Deal’

The analysis of the British unemployment insists on the rigidities of the labour market. Hence, structural reforms have been implemented since 1979 and the Thatcher government. The objective is obviously to promote a competitive working of the labour market, through more flexible labour laws (e.g. lowering of trade unions power⁸, decentralisation of wage bargaining, diminution of employment protection), incentive policies (e.g. encouragement of part-time, temporary and independent jobs, reduction of unemployment benefits) and the implementation of programmes aiming to increase the adjustment process between labour demand and supply (e.g. lowering of minimum wages⁹, implementation of various training programmes). Then, the global level of employment is able to fit rapidly the cyclical variations of activity.

The neo-classical theory considers the labour market as a ‘producer services’ market. In this respect, adjustments between labour supply and demand towards equilibrium are made through labour cost (or wage) flexibility.

Two fundamental hypotheses underlie the model (the validity of those will be discussed later):

- First, anticipations of the economic agents are perfect. This means that firms in the one hand, and individuals, which offer their labour force, in the other hand, have a

⁸ *Trade Union Reform and Employment Rights* implemented in 1990

⁹ The *Trade Union Reform and Employment Rights Bill* dissolved the remaining Wage Councils in 1993, but a quite low minimum wage was restored by the New Deal, launched in 1998.

perfect knowledge of the economic variables that enter in their choices. This is the case for the wage rate and the general price level.

- Second, prices are perfectly flexible, and firms do not face outlet constraints on the goods market.

In this framework, labour demand is the sum of the expressed firms demand.

i. Enterprise's labour demand equation

Considered solely and placed in a competitive environment (price taker), the firm has the following labour demand equation:

- The labour demand is a decreasing function of the labour cost (wage);
- The factor prices being constant, the labour demand is an increasing function of the product price.

Then, the labour demand is a decreasing function of the real wage rate. Thus, the aggregate function of labour demand is considered as decreasing, regarding the real wage rate (see figure 5).

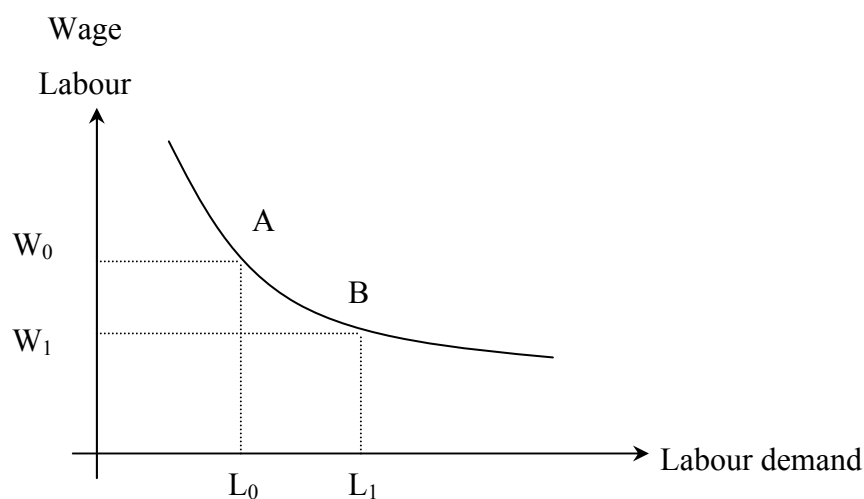


Figure 5: Labour demand of the firm

Moreover, difficulties encountered in aggregating labour demand functions, when the market is away from equilibrium, allow assuming that all the firms are similar. A representative firm is then the basis of the argument.

ii. Workers' labour supply equation

Because of an arbitrage operated by agents between labour and leisure, the labour supply is not necessarily a growing function of the real wage rate. Indeed, if we assume an increase in the real wage rate, then two opposite effects occur (figure 6).

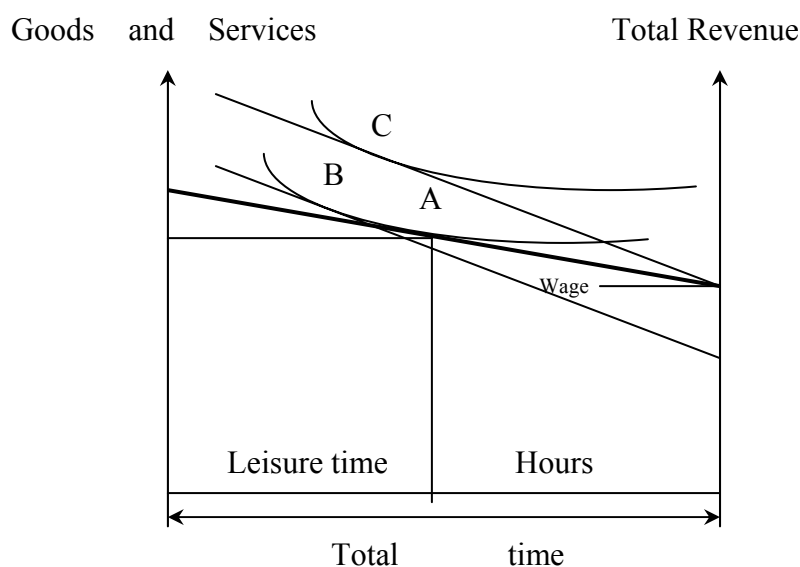


Figure 6: Substitution and revenue effects

On the one hand, hours worked (labour supply) rises, relatively to leisure time (leisure demand), because of the rising cost of leisure induced by the increase of real wage rate (substitution effect: from A to B); but on the other hand, leisure time (leisure demand) rises – considering leisure as a normal good – relatively to hours worked (labour supply), because of the increase of revenue induced by the raised real wage rate (revenue effect: from B to C). Then, the substitution effect must be superior to the revenue effect to permit a growing function (as shown in our figure).

iii. Market equilibrium

As shown in figure 7, the labour market equilibrium (E) is at the intersection between labour demand (L^d) and labour supply (L^s). However, at that point, the entire active population is not

(necessarily) employed. Indeed, frictional unemployment ($L_e L_3$) might occur. It corresponds to voluntary unemployment, since prices are perfectly flexible and environment perfectly competitive.

Nonetheless, neo-classical economists are aware of the possibility of a disequilibrium unemployment due to excess supply on the labour market. Indeed, an increase in the real wage rate (W_e to W_1) leads to a disequilibrium point (A), the labour supply of workers being constraint by the labour demand of the firms. It induces a total unemployment ($L_1 L_4$) that can be divided into frictional unemployment (equilibrium unemployment $L_2 L_4$) and disequilibrium unemployment ($L_1 L_2$) implied by the market failure (excess supply).

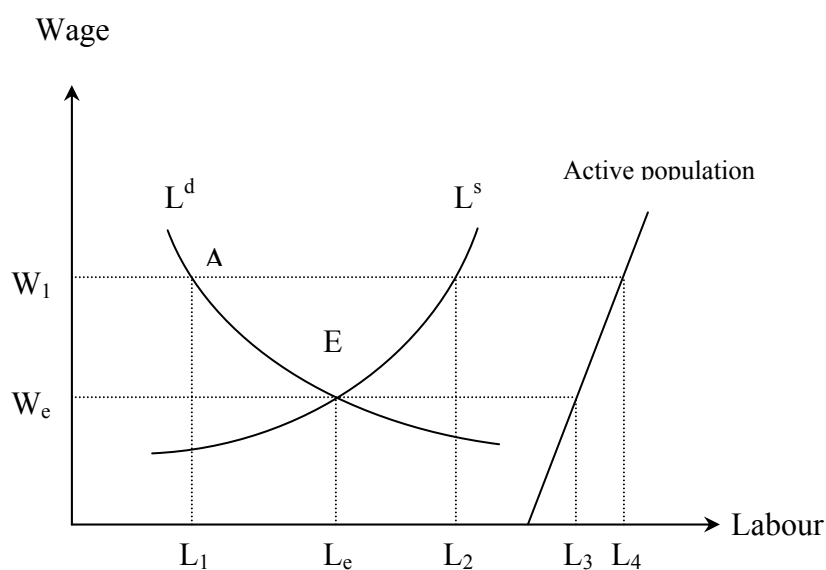


Figure 7: Labour Market Equilibrium

iv. Job search theory

Assuming that available information on the labour market (i.e. real wage rate, job vacancies, non-salaries advantages...) is not perfect, but that insiders know the statistical distribution of wages proposed on the labour market, the job search theory proposes a formalisation of the frictional unemployment. In the theory, firms are not supposed to seek for recruitment. Further, there is no informational asymmetry between the firms and the job seekers (concerning the characteristics and productivity of the job seekers).

The general framework of the theory must then take into account the following hypotheses:

- Individuals maximise the mathematical expectancy of their revenue (wage revenue as well as unemployment benefit revenue) during their entire life cycle¹⁰;
- An employment proposition is a random event, to which we can associate a real wage with a known probability;
- The job starts at the beginning of the period that follows the employment proposition;
- During their seeking, individuals welcome 1 employment proposition at each period, and the seeking has a direct cost;
- At each seeking period, individuals earn an unemployment benefit;
- Individuals have an infinite temporal horizon and no preference for the present (these are secondary hypotheses, which help to simplify the presentation of the theory without lowering its main findings).

Henceforth, individuals fix their reservation (or acceptance) wage (i.e. the wage that equalises both the expectancy of the additional gain perceived if the seeking is prolonged, and the additional cost of this seeking). The determinants of the reservation wage are then the amount of unemployment benefits, the expected wages distribution and the intensity of individual preference for present. These determinants influence the reservation wage through the following mechanisms:

- An increase in unemployment benefits, *ceteris paribus*, raises the reservation wage level. Indeed, the relative seeking cost is reduced, and the optimal seeking length is raised. However, unemployment benefits are limited in time, which raises the net cost of the seeking from a period to another;
- An increase in the expected wages distribution (following an additional professional formation, for instance) boosts the reservation wage level;
- An increase in the individual preference for present has for consequence to reduce the reservation wage as well as the optimal length of the seeking.

Since the job seeking and the employment process take time, the matching of labour demand and supply is not immediate, which leads to incompressible frictional unemployment. This unemployment deals with people that seek for a first job or people that just quit their job. It

¹⁰ Taking the entire life cycle into account points out the weight of human capital's improvement or depreciation in the matching process, since skills' enhancement is considered as an investment and wage as a return on investment. Furthermore, the importance of a substitution effect between labour and leisure in a recession period, when wages are lowered, is enforced by this time variable.

corresponds to the equilibrium unemployment rate that is reached when workers are not victim of a monetary illusion (i.e. labour supply is determined according to real wages) but do not have a perfect knowledge of the employment possibilities proposed (the standard hypothesis of a perfect diffusion of information on the market is relaxed).

As a conclusion, the job search theory has the major advantage to introduce a basement to the frictional unemployment. Indeed, it makes possible to assume that a job seeker can have a rational interest in refusing an employment proposition and extending his seeking duration (if the real wage is inferior to the reservation wage). An important thing to notice is the exclusion of the Walrasian agent on the labour market. Information is then random, and the adjustment process has a relatively long duration. However, it remains within the neo-classical framework, since the competitive hypotheses (apart from the one concerning information's diffusion) are all maintained.

Finally, the job search theory is a justification of the labour market policies that aim at reducing the duration of the job seeking and at enhancing the diffusion of information in the labour market. Indeed, these measures lower the cost and length of the seeking, then the reservation wage for job seeker, and finally reduce frictional unemployment.

v. Recommendations concerning labour market policies

Assuming that labour market is at its equilibrium level, the neo-classical theory attributes unemployment to frictions in the labour market, due to the length and procedures of job seeking and placement. In this respect, the labour market policy must implement means to reduce the length and procedures of job seeking and placement (i.e. by improving the quality of public placement services and the quality of the information on the vacancies). Given that information is a collective service and induces external effects, its diffusion's enhancement must be done by the State.

However, the possibility of a market failure is evoked by the theory (e.g. an increase in the real wage rate away from its equilibrium level, might be due to market rigidities). Then, the role of the economic policy will depend on the nature of unemployment: if unemployment is due to excess supply, the policy must aim at improving price flexibility to permit a decrease in the real wage rate, whereas if unemployment is essentially frictional, then a decrease in the

real wage has for consequence the decrease of the employment level (the labour demand being, in that case, constraint by the labour supply).

Since the nature of unemployment is difficult to assess, the neo-classical theory insists on the arbitrator role that must be kept by the State. Indeed, according to the theory, the labour market can move towards perfect concurrence and the State must only induce this move. Labour market policies aim then at controlling the respect of the competitive rules. Obstacles to these rules (i.e. imperfections like a lack of flexibility in the wage determination) must be reduced. In this respect, any trade union or employers' association must be fought, i.e. either deleted or decentralised.

vi. The British labour market reforms: the 'New Deal'

After the implementation of the JSA (Job Seekers' Allowance) in 1996 that already tightened the unemployment benefit eligibility, the New Deal was created in 1997 and implemented in 1998. The UK New Deal is characterised by a supply-side political conception. The labour demand stimulating measures have been reduced in order to permit necessary adjustments to reach the labour market equilibrium.

The New Deal is a mandatory active labour market program affecting, above all, young people claiming unemployment benefit for at least 6 months in the UK. The program offers a combination of treatments, particularly job assistance for 4 months and a time-limited wage subsidy paid to employers. Furthermore, the low real wages for the low skilled and the relatively low growth in these wages over the past decade focussed policy attention on "in-work" benefits and wage subsidies for the low skilled. Training programs have hence been developed in order to meet the qualifications demand of the firms (*Welfare to work* programme towards youth and long-run job seekers). The aim is then to make work more attractive for those who consider current labour market opportunities to be insufficient work incentives.

Moreover, a *Workfare* concept has become apparent. Indeed, the unemployment benefit system is now under eligibility condition: job seekers receive replacement revenues only if they participate to reinsertion programs. This strategy of constraint aims to avoid the hysteresis effect of cyclical shocks on unemployment, i.e. the persistency of unemployment

after the recovery, due to the depreciation of the human capital, the discouraging effect of remaining unemployed after a long period and the “unemployment trap” created by a too generous unemployment benefit system. The program is time-limited in order to attenuate the negative disincentives for human capital accumulation. The limit of the *Workfare* strategy is however the appearance of the so called *working poor trap*, i.e. people who are obliged to accept a job that is not well-paid, due to market flexibility. This liberal characteristic of the British labour market cannot be found in the Swedish labour market, especially as regard to the flexibility of prices.

2. New labour market theories and the ‘Swedish model’

Indeed, empirical observations of the Swedish labour market show that the real wage rate is relatively low sensitive to the production’s fluctuations and is rigid to the drop when faced to a recession period. Actually, during the last decades, wages have been marked by strong inertia in Sweden (changes in the rate of unemployment did not have a statistically significant impact on the evolution of wages¹¹). If the labour supply function does not have a high elasticity relative to the real wage rate, the labour market cannot be considered as a Walrasian market. Consequently, an adjustment towards the equilibrium of the labour market cannot be automatically done. Therefore, the new labour market theories provide elements to analyse the Swedish labour market.

The new labour market theories have been developed in the early 1970s. They aim at giving microeconomic basement to the rigidity (or low flexibility) of the real wage, relative to economic cycles. The new arguments introduced in these theories help then to explain the persistency of unemployment in developed economies. The identified causes of unemployment are then various, as well as the induced labour market policies.

The models are underlain by the hypothesis of a substantial rationality, but in an imperfectly competitive economy; then, errors in anticipations are possible.

¹¹ R. Layard, S. Nickell and R. Jackman (1991), *op. cit.*

i. Efficiency wage theory

The employees' salary constitutes a cost for the employer, but also a gain. Indeed, higher salaries lead to healthier workers and increased productivity. This relationship is formalised in the efficiency wage theory. The efficiency wage's origin has four possibilities, described below.

First, the wage-productivity relationship. Productivity being function of the efforts sustained by the workers, we assume that the quantity (and quality) of the effort is positively correlated with the salary. The incentive effect of efficiency wage is bigger when the initial level of wage is low and tends to decrease when the initial wage is high. Introducing the hypothesis that the situation of the labour market has an effect on the intensity of the effort sustained by employees (because of the fear of unemployment), the link between wages and unemployment is indirectly shown. Indeed, high unemployment induces bigger efforts, then higher productivity for the same wage level. The efficiency wage is thus expected to change, according to the labour market evolution.

Second, the adverse selection process. Imperfect knowledge of productive capacities of job seekers by the employers introduces a risk of mistake in the employment process. In order to avoid bad selection, the employer can increase the wage offer, as an incentive to reveal information. Indeed, job seekers who accept a lower wage than the one proposed are supposed to be the less productive.

Third, the moral hazard issue. In order to avoid moral hazard issue (opportunist behaviours), the employer must effectuate a control of each employee (or can proceed by survey). The threat to get fired constitutes here the incentive element. The efficiency wage takes into account the utility given by the unemployment situation (positively correlated), the cost of efforts (positively correlated) and the possibility to control efforts (negatively correlated). This process may generate involuntary unemployment, since the insiders' total utility is superior to the outsiders' utility that claim thus for inferior salaries and are then supposed to be less productive.

Finally, salaries' equity models. This model developed by G. Akerlof helps to understand the utility of additional hours worked for the firms (incentive effect of a prime) and for the

employees (the earned wage is superior to the referential wage). Since the insiders' productivity is raised relative to the outsiders' one, involuntary unemployment is induced by the existence of additional hours worked.

ii. Wage and employment negotiation models

A Nash program, where the employer association seeks its profit's maximisation and the trade union seeks its utility's maximisation, can be used to define the bargaining process. Indeed, employment on the one hand, and wage on the other hand, increase in line with the risk aversion for the former, and with the higher negotiation power of the trade unions for the latter, since trade unions use their power both to avoid unemployment and to raise wages. The asymmetry in powers induces an inefficient equilibrium, and a lower flexibility in wages. Moreover, the job seekers are away from the trade unions. They remain then outsiders for a longer period of time.

iii. Insiders/outside theory

This theory was developed from the middle of the 1980s. The main idea is that the existence of recruitment costs, formation costs and firing costs lead the firm to have bigger interest in employing insiders rather than outsiders. Moreover, cooperation between insiders and hostility towards outsiders lead to the same result: the outsiders are excluded to the labour market, as long as insiders' labour supply is superior to labour demand.

iv. Matching process and Beveridge relationship

The equilibrium unemployment results from the differences between job seekers' characteristics and qualifications asked by employers. There is a unique unemployment rate for a given firing rate and an exogenous labour market tension. This relation between the unemployment rate and the vacancies rate is known as the Beveridge curve. The effectiveness of the matching process can then be evaluated.

The Beveridge curve provides information on the qualified labour's deficit as well as on the structural change of the labour market. An increasing high number of vacancies associated

with low unemployment level can be a signal of qualified labour's scarcity and of labour market's tension. If it is associated with persistent high unemployment level, then it can be an indicator of the existence of a gap between available skills and the qualifications needed on the labour market.

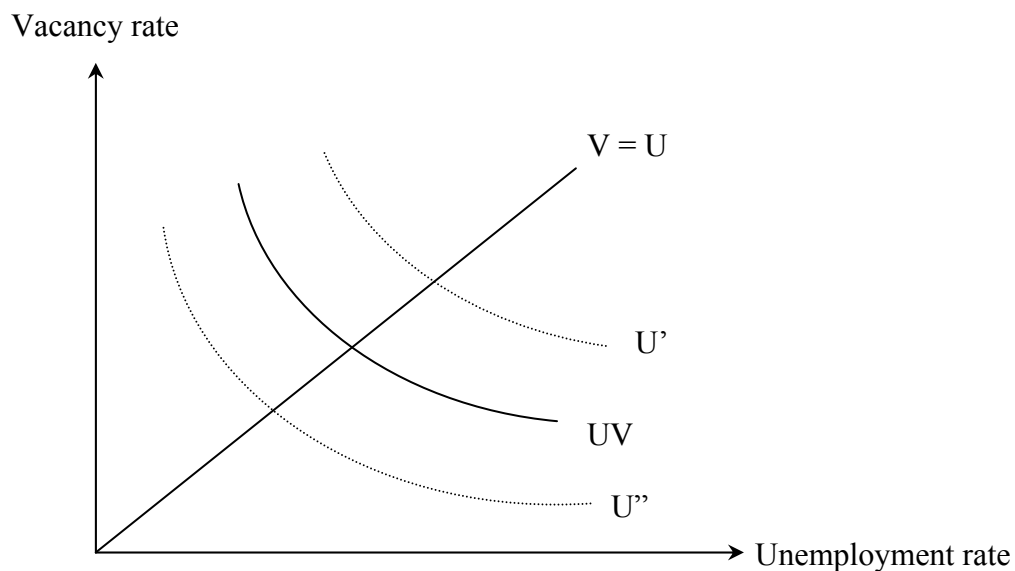


Figure 8: Beveridge curve in theory

In the figure above, the Beveridge function is represented by the curve UV. Points above the $V = U$ line are full employment by Beveridge criterion. A bend of the curve towards the right (UV to $U'V'$) is a sign of a worse adjustment between labour demand and supply: unemployment and vacancies rise together, due to structural changes on the labour market (provided by unfavourable evolution of relative prices that drop jobs' profitability for firms, for instance). By contrast, shift to curve $U''V''$ represents a better matching on the labour market. This might occur when whether unemployed and/or firms increase their seeking intensity, or information's diffusion is improved on the market.

v. Unemployment determinants in a matching model

On the one hand, the labour demand function implies in this model that the vacancies rate is, when the labour market reaches its equilibrium, independent from the unemployment rate.

Indeed, assuming that the productivity is equal to the labour cost (wage + recruitment cost), and that the firm considers real wage rate and interest rate as exogenous, the employer chooses the capital stock level consequently, in a residual way. On the other hand, the labour supply function implies that employees influence unemployment through wage determination.

Finally, the equilibrium unemployment is function of the interest rate (exogenous), the number of vacancies relative to the number of job seekers, the real wage and the capital stock. Then, a negative aggregated shock on demand or supply leads to opposite variations of unemployment rate and vacancies rate. On the contrary, when the shock concerns the Beveridge relationship (unemployment vs. vacancies), the unemployment rate and the vacancies rate evolve in the same direction. This is the case when whether the matching process is affected by the acceleration of the restructuring of the economy (firing level), or the effectiveness of the matching process is affected by changes in the replacement rate. Then, structural changes have a longer impact than aggregated shocks on the unemployment level.

vi. Solutions proposed to reduce unemployment

The non-perfectly competitive aspect of the labour market is recognised in the new labour market theories. However, the labour market policy does not aim to transform the labour market into a more competitive one. Indeed, the specificity of the labour market makes it impossible.

Nonetheless, the public authority has the mean to reduce unemployment through different actions. First, as in the neo-classical theory, the public authority must play its role of arbitrator, i.e. it has to control the respect of the labour market's rules. Then – and this point represents not only a difference, but also an opposition with the neo-classical theory – the public authority has an incentive role to play to counteract labour market's failures.

In this respect, the unemployment benefit system is considered as an efficient element of policy used to improve the unemployed job seeking. In addition, it can contribute to an increase mobility of workers between firms. However, the disincentive effect of a too generous subsidiary (the amount as well as the duration must be taken into account) is a problem underlined by the theory. The evaluation of the impact of the benefit system is then important and can also be developed, in order to measure the superior limit of the aid.

Further, the new labour market theories point out that wages are not determined in a perfectly competitive framework. The NAIRU theory helps to understand the role of the wage determination in this context. Indeed, it has been shown that the wage determination is correlated to the labour market situation and to the labour productivity evolution. The more these links are important, the more the equilibrium unemployment is low. Then, the collective negotiation (wage bargaining) has an important role. At which level is it the more efficient? The preferred level is at an extremity: either it is totally decentralised (the firm level), or it is entirely centralised (at the larger level of the economy). In the first case, the negotiation has a direct effect on the firm labour demand; in the second case, it has consequences on the general price level. In both cases, the equilibrium unemployment is affected, directly or indirectly. The branch level is considered to be inefficient, since trade unions only anticipate the effects on the branch price level and labour demand. The global effect is an overwhelmed wage level that affects negatively the labour market situation.

Since taxes play an important role on the wage determination, the new labour market theories propose a drop in the tax wedges, the impact on the unemployment level occurring through wages.

Finally, the theories' diagnostic of the unemployment causes underlines the gap existing between the job seekers' characteristics and the qualification required by the firm. This gap results from a lack of efficiency in the education system, but also of the hysteresis effect of unemployment. Then, it must be offset by the public authority's intervention. This implies the implementation of job training and training subsidiaries to facilitate the re-qualification of job seekers. Since the improvement in the formation has (positive) externalities on the environment, the charge must be taken by the State.

vii. The Swedish labour market policy: the 'Swedish model'

Low unemployment rates traditionally enjoyed by Sweden have often been attributed to the country's extensive system of active labour market programmes, which have thus often been regarded as a model for other countries to emulate.

However, in the beginning of the 1990s, there is a dramatic change in the labour market situation in Sweden, whose economy is brought to its deepest economic slump in more than

50 years. Indeed, unemployment reaches unpublished levels, more than quadrupling between 1990 and 1993, and this despite a further expansion in the offer of labour market programmes (over 3% of GNP on such measures).

The core of the ‘Swedish model’ is an institutional environment where unemployed individuals can potentially choose among a wide array of options, each one aimed at improving their labour market opportunities in different ways (direct incentives to move back into employment or other incentives aiming to improve individual productivity and skills). Then, in Sweden, nobody is left untreated by the unemployment system.

The Swedish labour market policy has two components¹². A passive one: it is a benefit system that supports individuals while unemployed (unemployment compensations: cash labour market assistance – KAS and unemployment insurance – UI); and an active one: various incentive labour market programmes (maximum duration of 6 months) offered in order to improve the opportunities of unemployed workers (labour market retraining, public sector employment, job introduction projects, programmes targeted at specific groups, etc) by facilitating job search, augmenting human capital with formal teaching, providing job experience, improving working habits, or offering a cheap way for employers to screen productivity.

Furthermore, the active and passive components of the labour market policy are closely intertwined until the 2000 reform¹³: unemployed workers who participate in a programme for five months effectively renew their eligibility to generous unemployment compensation. Hence, “while programmes may offer the possibility of enhancing the human capital of participants *in principle*, programmes *as a fact* serve as a vehicle to renew unemployment benefits, and could thus reinforce the work disincentive associated with the unemployment

¹² From B. Sianesi (2002), *Differential Effects of Swedish Active Labour Market Programmes for Unemployed Adults during the 1990s*, IFAU Working Paper 2002:5, Office for Labour Market Policy Evaluation, Uppsala

¹³ Indeed, the 2000 reform abolished the possibility to renew benefit eligibility by participating in an active programme, in order to reduce the negative interaction existing between active and passive programmes, and introduced an ‘activity guarantee’ giving some full-time activity to job seekers, in order to limit the human capital depreciation implied by long-run unemployment. We notice however that our study deals mainly with the 1990s, that is to say before the 2000 reform.

insurance system.”¹⁴ The cycling phenomenon is shown to be quite important. This can be explained by the low salary earned by work, compared to the unemployment compensation revenue perceived without working.

3. Institutions’ theory and the French ‘PARE’

French labour market has a strong specificity that lies on the traditional intervention of State in employment relationships. Moreover, trade unions have an important bargaining power and labour conventions constitute a rigid framework for the labour community. During the 1990s, the cyclical component of unemployment becomes less and less visible in France. This leads to suppose a sharp increase in structural unemployment. Indeed, the specificity of French industrial relations underlines the importance of labour institutions in the matching process. Thus, the analysis of the French labour market cannot be done in a Walrasian framework, or in a rational expectancy framework, which lets the question of institutions untreated. An alternative analysis goes through institutions’ theory.

The study of the collective actions, their institutional framework and the out-market transactions (inside the firms) has been initiated by J.R. Commons. The analysis of the various forms of organisations and labour relationships was then developed. In institutions’ theories, labour is considered as a group phenomenon and associated with the concept of the bounded rationality of individuals. Indeed, the rationality is considered as bounded, since there is a non-measurable uncertainty element in information and a high degree of complexity in the decision-process. In this respect, decisions are taken after a process of errors. However, there are some decisions, which are repetitive and lie on rules and mechanisms determined by institutions. Because economic laws are founded on the scarcity concept, then rules and institutions are needed to control human behaviours and avoid violence and injustice. The control is collective and is composed on the one hand by informal institutions (as social habits and customs), which are independent from the public power, and on the other hand by formal institutions (as State, family, trade unions...) that benefit from the public authority’s protection. Each institution has got working rules and can deliver sanctions if the rules are not respected.

¹⁴ B. Sianesi (2001), *An evaluation of the active labour market programmes in Sweden*, IFAU, Working paper 2001:5, Office of Labour Market Policy Evaluation, Uppsala

i. General framework of the theory

The collective control of human behaviour needed to avoid violence and injustice assumes a new economic framework for analysis.

First, it must take into account the working rules of institutions that give the limits to everyone's prerogatives, free individuals initiatives and, at the same time, limit the actions of the whole members of the community. The property right, for instance, gives the possibility to an individual to use and own a good and, at the same time, it excludes other members of the community to use and own it.

Second, it is worth to keep in mind that institutional forms are numerous and economic activities are not only constraint by economical play rules, but also by morale and justice.

Third, in the collective conflicts' solving that brings institutions into play, the role of an external arbitrator is very important. Obviously, its role is to avoid the transfer of conflicts into violence, whose effects are negative for the community as a whole.

In this respect, the transactions' process in the economy must also be defined. According to J.R. Commons, a transaction results in the alienation and the acquisition by individuals of the rights attached to the property and the liberty created by the community. Three kinds of transactions can then be distinguished:

- The one that are done through negotiation (i.e. bargaining trades);
- The one that are conclude through managerial decisions (e.g. an authority relationship in a firm);
- And the one that are implied by rationing (i.e. taxes).

Labour is a particular domain, where bargaining trades occupy only a small place. Indeed, the labour relationship is determined by an uncertainty context that makes managerial decisions necessary. Moreover, labour is collective inside firms and inter-individual cooperation is also necessary. Labour institutions are then needed to solve potential conflicts, and to control cooperation and coordination between workers.

Finally, in institutions' theory, there is an important duality between the market and the firm. O. Favereau¹⁵, describes it as following:

¹⁵ O. Favereau (1989), *op. cit.*

- The market is a way to allocate resources and to co-ordinate activities by the mean of prices, which do not exclude rules but limit them to a secondary role;
- In a reversal way, the organisation is a mean to allocate resources and to co-ordinate activities by the help of rules, which do not exclude prices but limit them to a secondary role.

ii. Internal labour market's characteristics

The neo-institutional economist O.E. Williamson studied the labour relationship inside the firms from 1975¹⁶. His argument is underlain by the bounded rationality of individuals. The internal labour market is opposed to the external market studied by the neo-classical theory. According to O.E. Williamson, the latter is structureless, whereas the former is structured inside the firm by various institutional constraints. Access of the internal market is limited to 'ports of entry' that generally correspond to employment positions in the lower level of the organisation's hierarchy. By opposition, jobs in the middle or in the peak of the hierarchy welcome people of certain seniority, by the mean of internal promotion. In addition, training for workstations on the internal market of the firm implies qualifications' acquisitions, which are specific to the firm. Job training constitutes then a cost that has to be supported by the firm as an investment. An uncontrolled turnover is thus a loss for the firm, since the trained worker quits before providing to the firm a return on investment. An internal bonus added to the external wage level is then necessary to avoid turnover (this argument has been restudied by the neo-classical efficiency wage theory).

The labour relationship is also justified by the existing indivisibility of the physical capital, which allows increasing scale return when the use of capital is collective. Further, the indivisible aspect of information makes it profitable to join resources needed to reach it. In addition, the internal market is preferred to peer groups since opportunist behaviour becomes more difficult under an authority relationship. Finally, the specificity of the work induces lower transaction costs in the labour relationship than in the external market. Specific tasks are met in the following circumstances:

- When particular (non-standardised) equipment is used and its working knowledge needs experience (learning by doing);

¹⁶ in D. Redor (1999), *Economie du travail et de l'emploi*, Montchrestien, Paris

- When specific process are invented by insiders;
- If informal teams are constituted by mutual adaptation between individuals;
- If there are information's channels that are specific to the firm.

These implementations must be confronted to the uncertainty element of the economic environment, and the firm needs to take into account the bounded rationality that can lead to opportunist behaviours. Then, the theory insists on the role of job training to help the firm to have an advantage upon the external market, by decreasing transaction costs. The question of the effectiveness and dynamism of the internal market is then open.

iii. Effectiveness of the internal markets' structures

An important point concerning the internal market's relationship is the superiority of the collective interest upon the individual interest, in order to avoid opportunist behaviours. The authority's owners seek to reach determined objectives:

- Bargaining costs must be minimised;
- The internal structure of wages is rationalised according to tasks' characteristics, which are translated in the organisation's hierarchy (centralised negotiation inside the firm, but decentralised negotiation inside the economy as a whole);
- An effectiveness cooperation must be encouraged, i.e. a positive behaviour of workers as a whole towards labour, which includes initiatives' taking and capacities to face unforeseen incidents.

iv. Weight of internal promotions and hierarchic structure

Internal promotions help the organisation to reach its three main objectives. Indeed, it lowers bargaining costs, since the employee is already inside the market. In this respect, internal promotion is included in the rationalisation of wages' process. Finally, it leads to more cooperation inside the structure, through an incentive process that links the collective interests to the employee's interest.

If the internal promotion is well applied, ports of entry are then limited to jobs at the lowest level of the hierarchy. Moreover, internal promotion helps the firm to select its employees, through the observation of candidates'. Finally, the competition introduced inside the firm by

the possibility of internal promotion increases productivity and constitutes an incentive to reveal information. Uncertainty is then substantially reduced.

To conclude, the theory implies a pyramidal structure in order to improve the authority's power, completed by horizontal relationships in order to encourage cooperation, communication, and motivation's control.

v. Ways to reduce unemployment

The institutions' theory enlarges the field of labour market policies. Indeed, incentive systems aim to correct the market's failures and to weight on individual decisions dealing with the labour market. But a real action on institutions is needed to transform the labour relationships in their basement. Then, the public authority's intervention must be directly applied on the labour market, through legislation and formal rules. Nonetheless, and because there are important informal rules that act on the labour relationships, trade unions and employers' association also have to negotiate without the public authority's intervention. Finally, the impact on the unemployment will be function of the cohesion degree existing between individuals' groups and of the workability of institutions (rules as well as habits).

vi. The French labour market policy: the 'PARE'

The French labour market policy is characterised by the State intervention in labour conventions. Then, active programmes constitute an important part of the business. Since 1993, France has implemented a policy aiming to increase the content of low-skilled employment in the GDP, essentially through a sensitive decrease in social charges concerning low wages. Moreover, active labour market programmes have been applied (according to the EU agreement) to help long-term unemployed to re-insert the labour market and enhance youth people insertion. These measures belong to the 'PARE' (Aid Programme for Employment Return), which was created in 1997 and insists on:

- Skill enhancement through professional training, in order to improve the labour market matching process;
- Early retirement financing to reduce active population and facilitate internal promotion;

- Reduction of labour costs to improve employment of specific target groups, mainly through employers taxes lowering for low-skilled unemployed, long-term unemployed and youth population;
- Creation of public jobs aiming at promoting professional insertion and increasing the employment content of GDP.

As regarding passive measures, they used to be important in the French policy, which has traditionally a strong social component. Thus, in 1993, labour market measures represented 3% of GDP, the two-third being devoted to the unemployment benefit system¹⁷. Yet, though still well extensive, it tends to diminish in comparison to active labour market policies. Lastly, the implementation of the working hours' reduction at the end of the decade intended to share employment between employees and unemployed, then to reduce unemployment. This measure – and its complex and rigid implementation – is part of the French specificity in the European environment.

Before to go further and to tackle the effectiveness of policies, it appears necessary to re-set the main findings of the former analysis.

First, we have seen that theories are underlain by strong hypotheses as substantive rationality for the neo-classical theory, rational expectations for the new labour market theories and a bounded rationality for institutions' theory.

Further, the neo-classical theory assumes the flexibility of labour markets, which are considered as any other market. Whereas the two other theories studied assume price and wage stickiness in the labour market.

The standard neo-classical theory concludes on the existence of frictional unemployment, its persistency coming from market failures that have to be tackled to restore flexibility. As for the new labour market theories, rational expectations and market rigidities result in structural unemployment, which must be fought through incentive labour market policies. Lastly, the institutions' theory adopts holism instead of individualism methodology and focuses on the

¹⁷ As we will talk about interactions between active and passive labour market policies thereafter, it is worth to notice that unemployment benefit in France is an entirely passive measure, since eligibility to is not conditioned by programmes participation (whereas it is in the UK and in Sweden).

rules provided by organisations. Then, the State intervention in negotiation is recommended to improve the labour market functioning.

Thus, policies appear to be linked to theories. The next step will be to assess whether a policy performs better than another through an empirical study of labour markets' situation.

III. Assessment of labour market policies effectiveness

In this part of the study, we will assess labour market policies effectiveness through macroeconomic considerations and present the main lessons issued by microeconomic evaluations (A). Side effects of policies will be shown through a wage-setting and employment analysis, before to conclude with a comeback on the hypotheses of each model (B).

A. Countries performances and successes of labour market policies

In this section, we first assess countries performances through the analysis of macroeconomic observations. Then, we operate a breakdown of labour market policies and present the results of the microeconomic evaluation's literature.

1. Macroeconomic cross countries performances

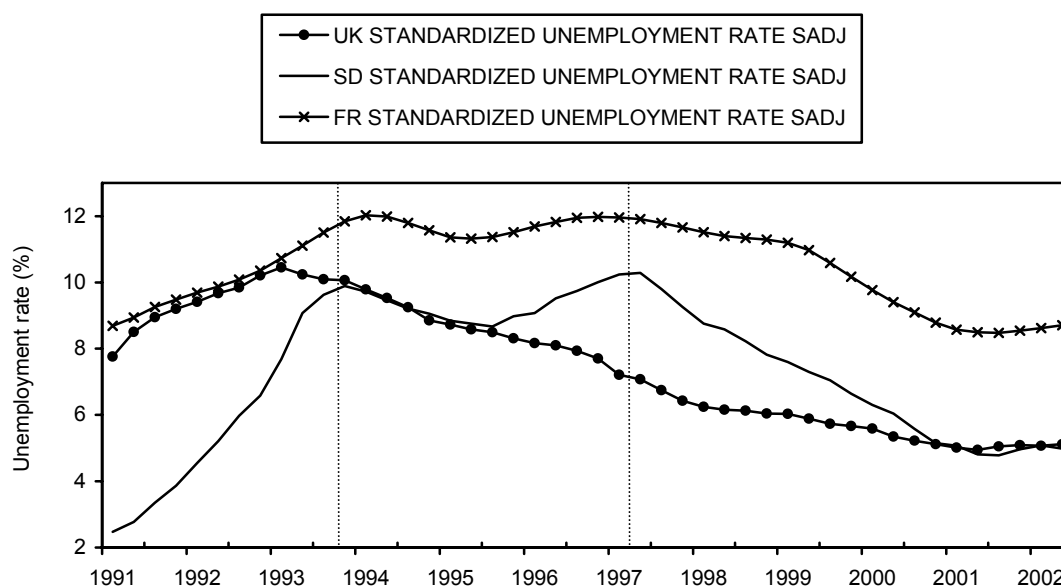
Several variables must be taken into account to assess labour market policies performance. First, the observed unemployment rates (level and growth pace) will be studied across countries; then estimations of the structural unemployment will be analysed; lastly the labour force and employment growths will be compared within countries.

i. Observed unemployment rates

Looking at the quarterly evolution of unemployment rates across the three countries, we notice a general upward trend from the early 1990s (figure 9). This can be imputed to the sudden and global recession, which occurred in 1993 in Europe in a context of global geopolitical instability¹⁸. In a reversal way, a general downward occurred in 1997 after the

¹⁸ Indeed, the beginning of the 1990s have been marked by several shocks throughout industrialised countries: in 1991, war in Iraq induced an oil shock, while the US entered into recession and Europe integrated the economically instable Eastern Germany. See Appendix 2: Gross Domestic Products during the 1990s.

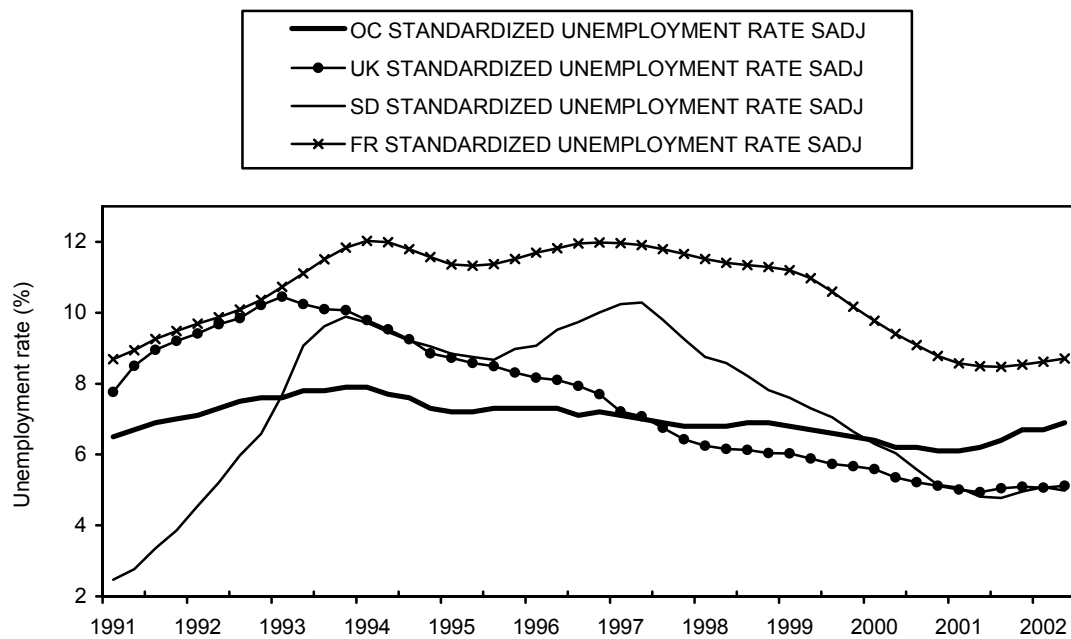
short slowdown of the mid-1990s, marking thus the starting point of the virtuous growth cycle of the late 1990s.



Source: DATASTREAM

Figure 9: Unemployment evolution in the three countries

If we compare the three countries unemployment rates to OECD relatively steady unemployment average, however, significant cross countries differences can be highlighted (figure 10). In fact, Sweden displays unemployment rates that are consistently lower than the OECD average before 1993 and after 2000. In between, Sweden unemployment rate follows a similar trend to the one in France, besides its higher volatility and lower level. The case of the UK is clearly aside from the rest since 1993. The steady decrease of UK unemployment rate allows the country to perform better than OECD average from the second semester of 1997.



Source: DATASTREAM

Figure 10: Unemployment rates in the three countries vs. OECD average

Moreover, the analysis of the percentage change of unemployment rates provides evidence of cross sectional countries differences (see figures 11 and 12). Indeed, Sweden supports high volatile unemployment, especially in recession times, whereas France has steady ups and downs in unemployment rate, which seems to vary in a tube (+ to - 5% amplitude of change). As for the UK, the sharp amplitude of its change in unemployment rate in the first part of the 1990s does not last. Indeed, UK unemployment rate is on a relatively steady downward trend since 1993.

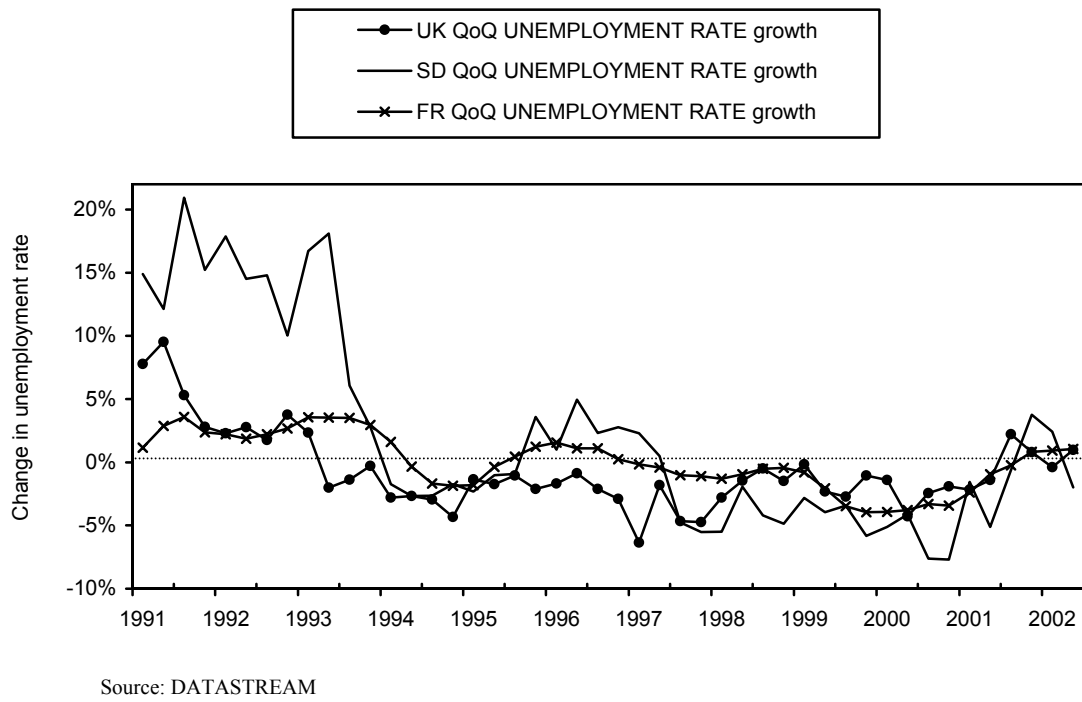


Figure 11: Percentage change of unemployment rates in the three countries

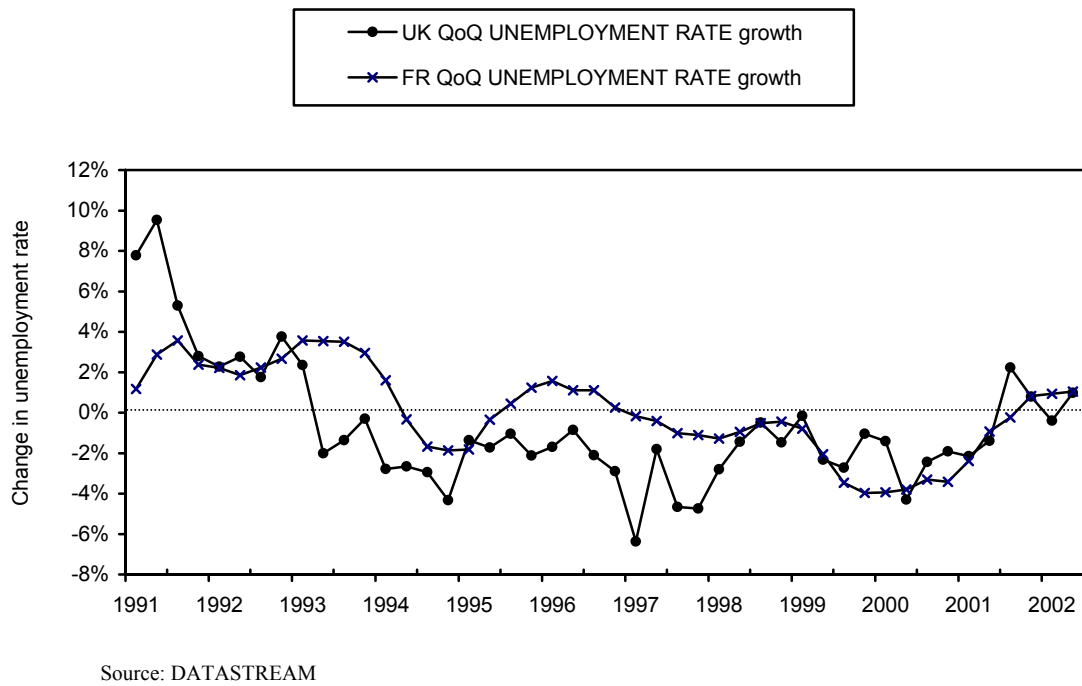


Figure 12: Percentage change of unemployment rates in UK and France

Linking these evolutions to the labour market policies applied in each country, we notice the better performance of the UK structural reforms aiming at improving the labour market flexibility in the first part of the 1990s. Relatively to those reforms, the UK New Deal, with its set of active labour market policies, appears to be less efficient, although effective.

Unlike the UK, Sweden does not enjoy good performances of its unemployment rate, relatively to the traditional active labour market policies applied in the country. Hence, the structural reform of 2000 – aiming to reduce the disincentive effect of interaction existing between active and passive programmes – seems to be justified. As a consequence, Sweden displays, from that time, rates of unemployment, which are consistently lower than the OECD average.

As for France, such a high unemployment rate for one of the leader countries in Europe leads to assume a strong structural component within unemployment. Henceforth, the decrease of unemployment starting in 1997 might be imputed to favourable fluctuations of economic activity. The remaining high rate of unemployment at the end of the decade (above OECD average by a long way) does not provide evidence of the effectiveness of the ‘French model’ regarding labour market policies.

ii. Estimated structural unemployment (NAWRU)

Close to the NAIRU, the NAWRU is the Non-Accelerating-of-Wages-Rate-of-Unemployment. The OECD Secretariat estimates it. It is a short-run indicator that measures the unemployment rate that, in a given year and in line with the effective evolution of the former unemployment, might be associated to a constant growth of wages. The NAWRU can then be defined as a structural unemployment rate for a short-run period.

According to the OECD Secretariat¹⁹, in the timeframe 1990-1997, structural unemployment doubled in Sweden (from 3.2% to 6.7%) and increased in France (from 9.3% to 10.2%), while it decreased in the UK (from 8.5% to 7.2%). This is in line with the observed unemployment rate’s evolution described above.

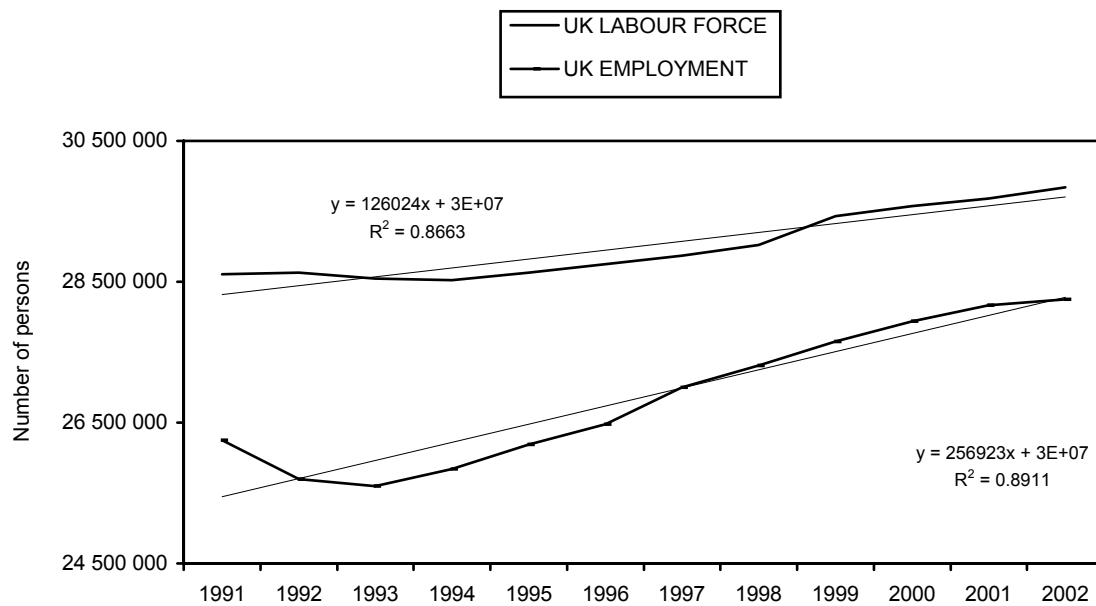
¹⁹ OECD (1998), *La stratégie de l’OCDE pour l’emploi: rapport sur l’état d’avancement de la mise en oeuvre des recommandations par pays*, Département des Affaires Economiques, Document de travail No 196

Hence, Sweden has the lowest structural unemployment rate, but its evolution is the worst one. All things considered, the UK labour market is the one that evolves in the better way, providing a steady decrease in its global unemployment rate and a sensitive decrease in its structural unemployment rate. Moreover, UK unemployment rate seems to be out of touch with cyclical fluctuations economic activity, which enhances the effectiveness of the labour market reforms implemented. Finally, as highlighted just above, France has the worst labour market situation, providing a high unemployment rate with a strong structural component.

iii. Labour force and employment

The labour force is divided into employment and unemployment. When additional persons enter the labour market, they become either unemployed or employed. It is then worth to look at labour force evolution, in order to determine whether demographic factors could have introduced a bias on countries performances. Indeed, a decrease in the unemployment rate can be induced by additional persons entering the labour market (increase in the labour force) and finding a job (increase in the employment), the number of unemployed yet remaining unchanged (and the labour market policy being of low effectiveness). Then, we shall compare the slopes of employment (in level) and labour force trends in each of the three countries. We assume that labour force and employment follow a linear growth since 1991. As the period 1991-1993 shows a sharp decrease in the Swedish labour force (even sharper in employment), we start the regression in 1993 for Sweden.

Thus, in the UK (figure 13), the linear regression is well fitting ($R^2= 0.86$ for the labour force and 0.89 for the employment). Employment increases at a faster pace than labour force (the slope of employment trend is twice the slope of labour force trend). This emphasises the effectiveness of the British labour market policies.

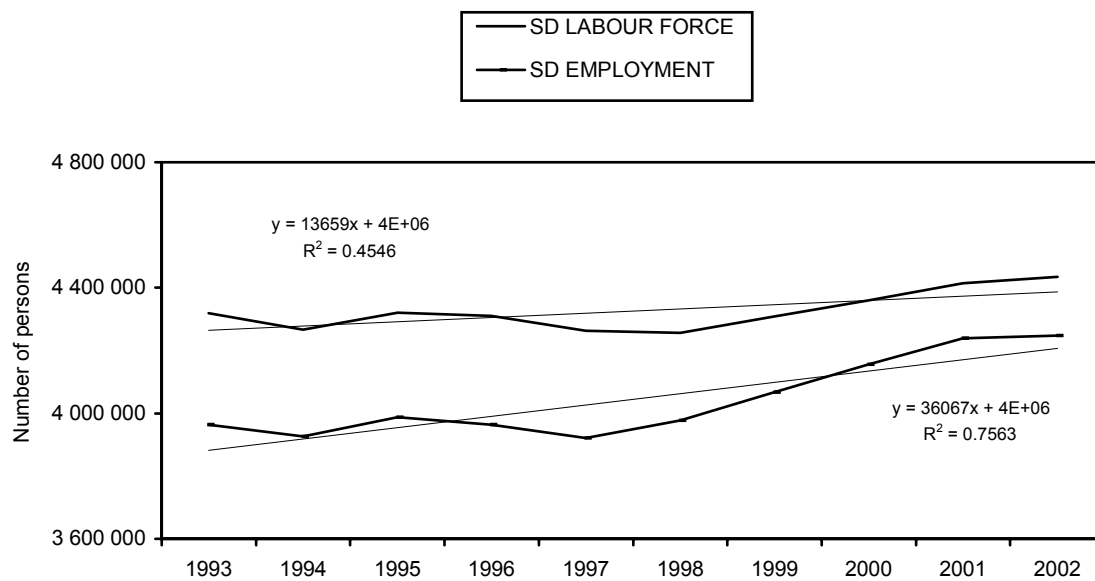


Source: DATASTREAM

Figure 13: Employment versus labour force in the United Kingdom

In Sweden (figure 14 below), the linear regression fits much better for employment ($R^2= 0.75$) than for labour force (low $R^2= 0.45$). However, figures are similar and the correlation is apparent. The results must yet be taken carefully. They show a very fast pace of employment growth, compared to the one of labour force (slopes ratio = 2.64). However, it is not in line with our previous assessment. This should mean a good effectiveness of labour market policies in Sweden. Indeed, the structural unemployment rate is relatively reduced. Actually, the high levels of unemployment rates in Sweden (from 1993 to 2000) are in line with sharp decreases in the labour force and in employment during the early and mid-1990s recessions. Disincentives effects induced by labour market policies are then assumed to be the origin of the fact²⁰.

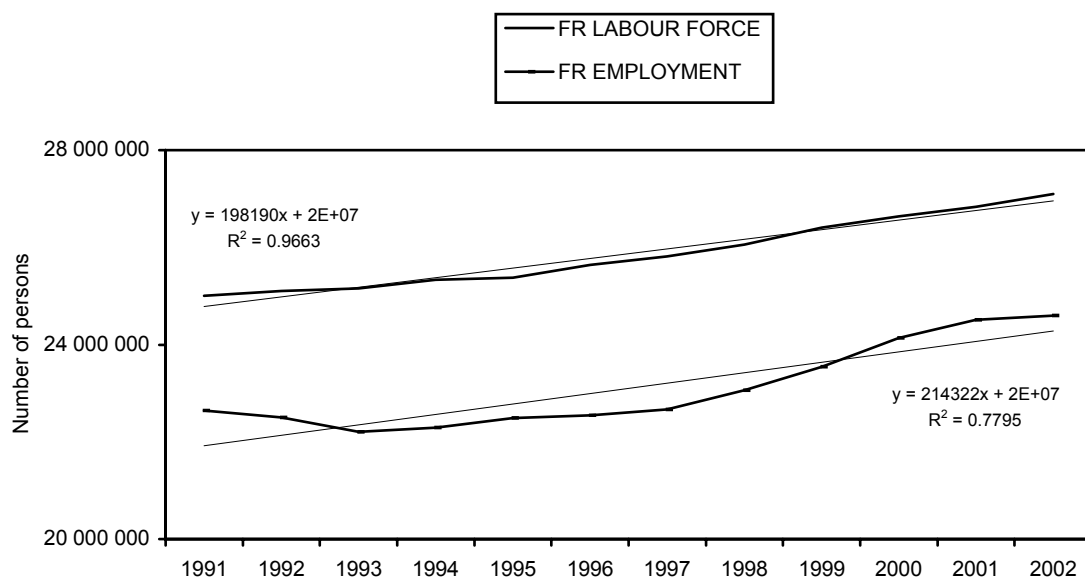
²⁰ Side effects of labour market policies will be tackled below.



Source: DATASTREAM

Figure 14: Employment versus labour force in Sweden

As for France (figure 15), not surprisingly, the ratio is of 1.08, asserting the fact that during the 1990s, the labour market implemented did not have a big impact on unemployment (or at least, the impact was countered by side effects). The fitting is good too, with $R^2= 0.96$ for the labour force and $R^2= 0.77$ for employment.



Source: DATASTREAM

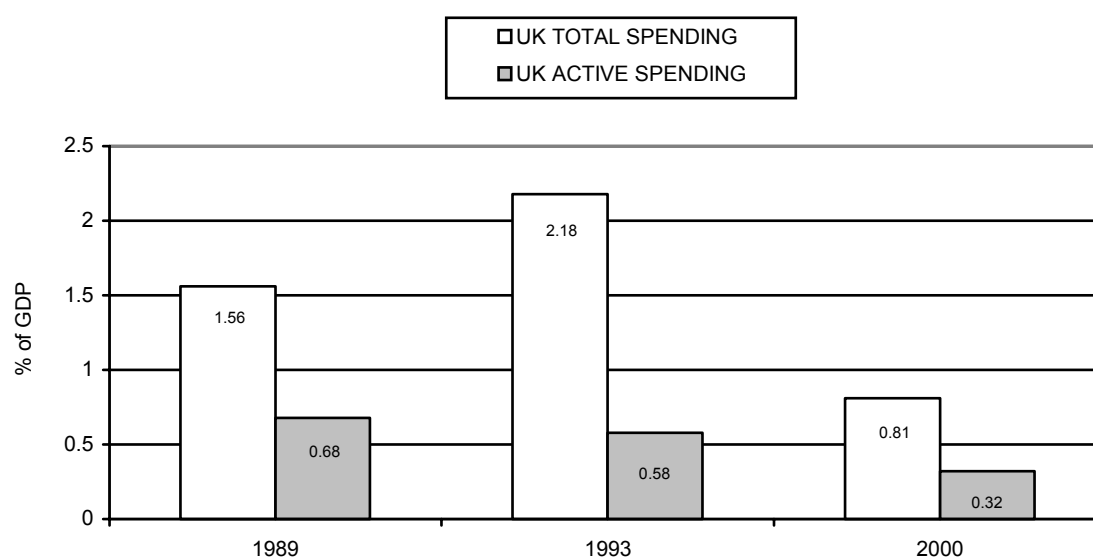
Figure 15: Employment versus labour force in France

2. Breakdown of labour market policies

i. Evolution on labour market policies spending

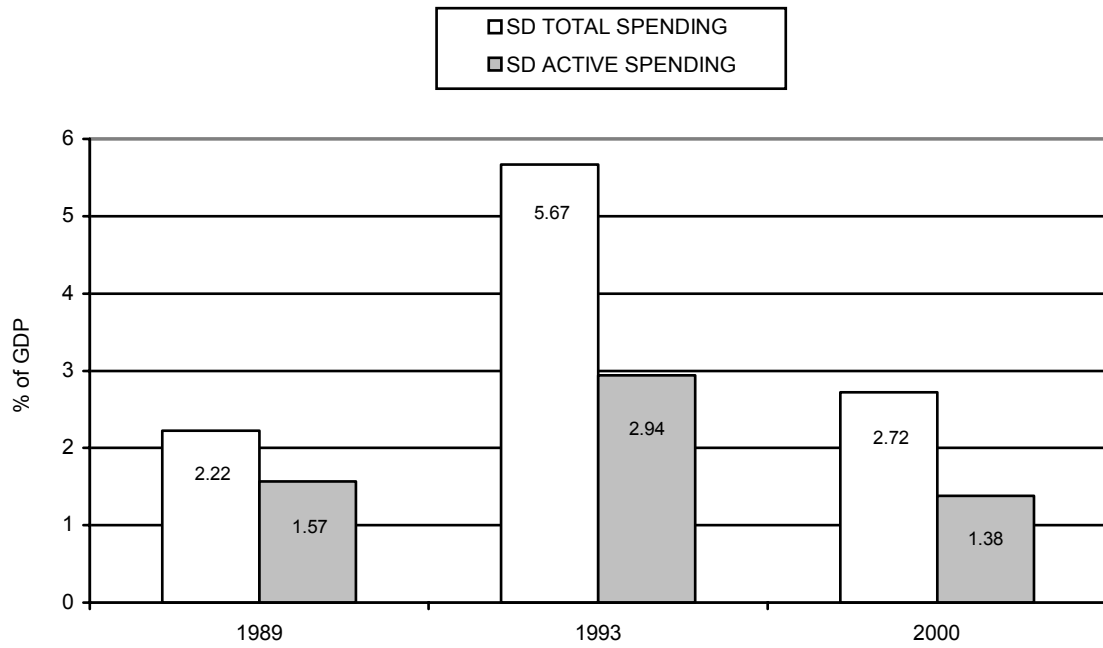
Expansion and enhancement of the effectiveness of active labour market policies (ALMPs) is one of the ten policy guidelines of the OECD Jobs Strategy (launched in 1994) and the EU Employment Guidelines (launched in 1997 after the Amsterdam summit). However, the UK allows less and less spending to ALMPs during the 1990s (figure 16), whereas Sweden changes its strategy after 1993 (figure 17) and France is the only one to follow the guidelines' advice (figure 18).

We notice however the importance given to labour market policies in the three countries during the common recession time in 1993, and especially to ALMPs (except for the UK). Obviously, there is positive correlation between the amount of spending on labour market programmes and the level of unemployment. This explains the bigger amount of spending in France, since it has the higher rate of unemployment, whereas the UK and Sweden have better performances in terms of unemployment, as seen above. However, these hesitations of countries' strategies might be a sign of the lack of evaluations in European countries, regarding the effectiveness of active labour market policies.



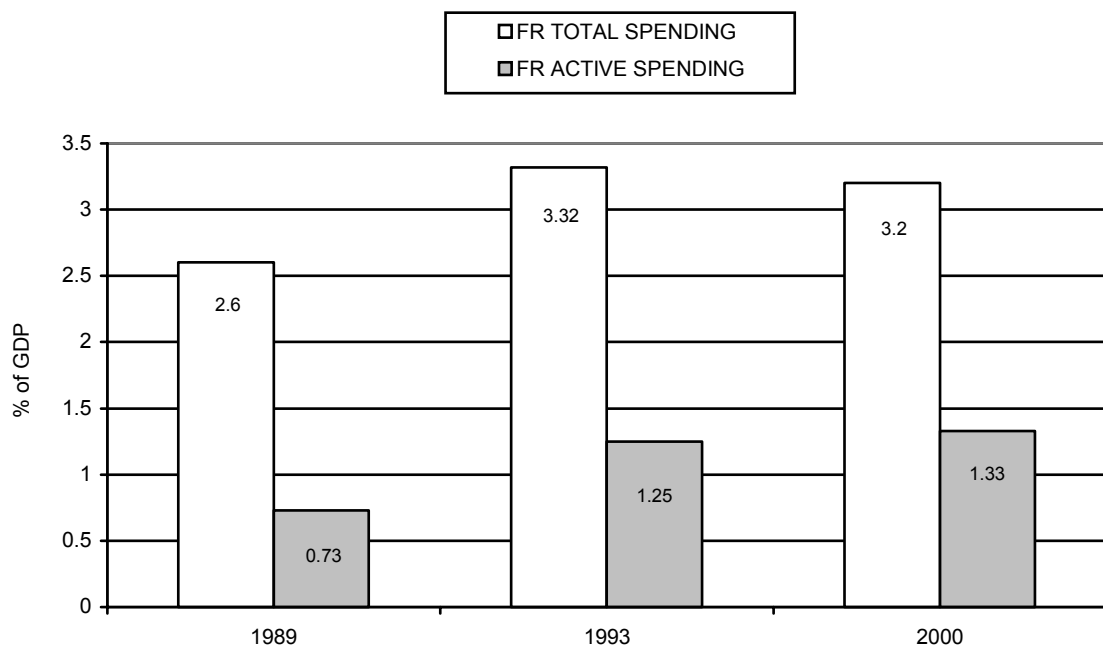
Source: OECD data base on Labour Market Programmes

Figure 16: Spending on labour market programmes in the UK, 1989-2000



Source: OECD data base on Labour Market Programmes

Figure 17: Spending on labour market programmes in Sweden, 1989-2000



Source: OECD data base on Labour Market Programmes

Figure 18: Spending on labour market programmes in France, 1989-2000

ii. Lessons from the microeconomic evaluation literature

The breakdown of labour market policies, which is presented below, sums up the lessons of the recent evaluation literature done on OECD countries during the last decade²¹. The issue that has to be tackled in evaluating the effectiveness of active programmes can be read as follow²²: “How do programme participants perform from the treatment compared to a hypothetical state where they would have waited longer in open unemployment?”.

First, public training programmes (see figure below) tend to be among the most expensive active measures; they help to improve employment opportunities rather than hourly earnings; but they have to respond to four crucial features in order to enhance their effectiveness:

- The need for tight targeting on participants;
- The need to keep the programmes relatively small in scale;
- The need for the programme to result in a qualification or certificate that is recognised and valued by the market;
- The need to have a strong on-the-job component in the programme, and hence to establish strong links with local employers. At the same time, this is likely to encourage displacement.

Second, job-search assistance is the least costly active labour market programme; it has positive outcomes in terms of getting the unemployed back into work faster, particularly if there is a re-employment bonus related to the rapidity of the finding and the length of the new job (as in the US or in Japan).

Third, special youth measures are not proved to be effective by evaluation literatures, due to the complexity of a behavioural factor in disadvantaged youth towards work; an exception is

²¹ mainly from J.P. Martin and D. Grubb (2001), *What works and for whom: a review of OECD countries' experiences with active labour market policies*, IFAU, Working paper 2001:14, Table 2, p.14

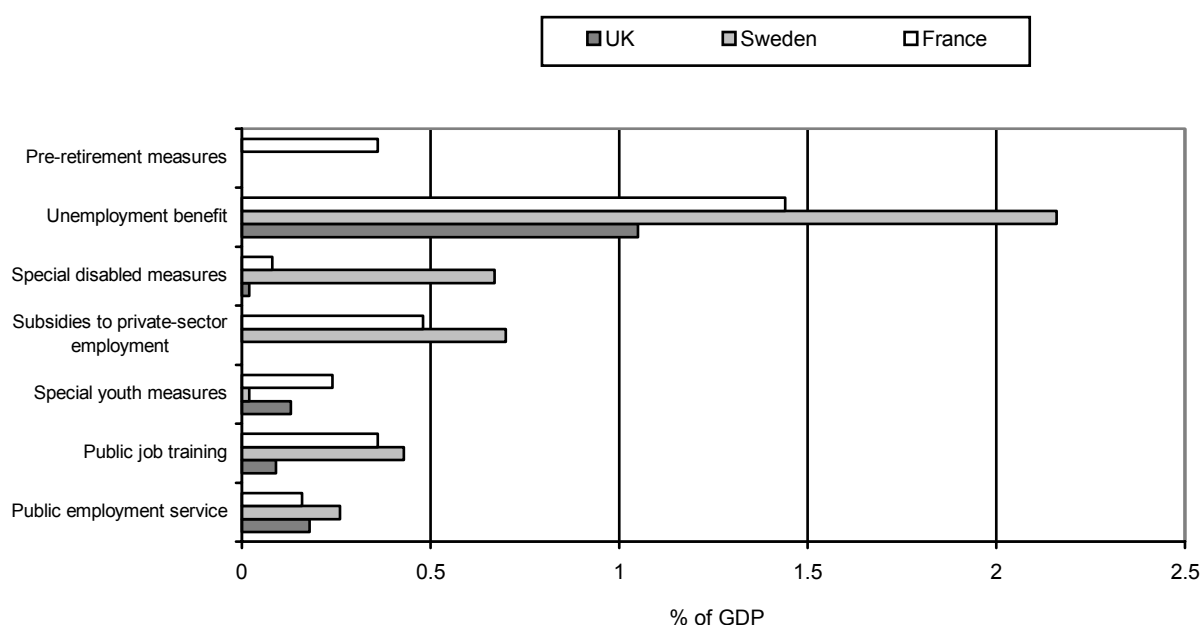
²² in B. Sianesi (2001) for instance, the aim of the study is to evaluate the causal effect of a treatment of interest (active labour market policy defined as one ‘programme’), relative to another treatment (hypothetical non participation on the ‘programme’), on the outcome or response variable Y (job accession), which is experienced by units (individuals registering as unemployed for their first time) in the population of interest. Each unit is thus potentially exposable to any of the 2 treatments.

the UK New Deal for Young People, whose positive effect comes from the employer wage subsidy and the enhanced job search.

Fourth, subsidies to private-sector employment increased sharply in the total spending devoted to active measures in the OECD countries during the 1990s; they may seek to enhance effective labour supply by helping individuals to keep in touch with the world of work, thereby maintaining their motivation and skills, that is to say their human capital; these programmes seem to have a greater impact than public training programmes or direct job creation measures.

Fifth, direct job creation in the public sector has been of little success in helping unemployed people get permanent jobs in the open labour market.

Finally, as regarding passive measures, net replacement rates (i.e. after-tax) in OECD countries are sufficiently large to have potentially significant effects on work incentives and on wage-setting behaviour (leading to an ‘unemployment trap’). Indeed, in 1997, the average rate across OECD countries was 63%, given that Sweden is the most generous country (87%), surprisingly followed by the UK (72%) and France (60%). The better rank of the UK towards France can be explained by the relatively low tax burden in the UK compared to France’s.



Source: D. Redor (1999), “Economie du travail et de l’emploi”, Montchrestien, Paris

Figure 19: Structure of labour market policies in the three countries in 1997

B. Side effects of labour market policies and limits of theories

Successes of labour market policies differ from one country to another. Obviously, there is a gap between expectations and performances. This might be due to the difficulties encountered by theories to measure side effects, as to the gap existing between theories and empirical reality induced by strong hypotheses.

1. Side effects of labour market policies

It is worth to notice that active labour market policies have been implemented in the three countries studied, be they refer to a neo-classical model or not. As we have seen just above, thanks to the microeconomic evaluation literature, a number of effects (intended or side effects) occur on employment when such policies are implemented. To sort out these effects in a macroeconomic viewpoint, we use the Calmfors²³ version for analysing equilibrium real wages and employment, considering the general theoretical framework of these policies (close to new labour market theories). The following figure provides some clues for interpretation:

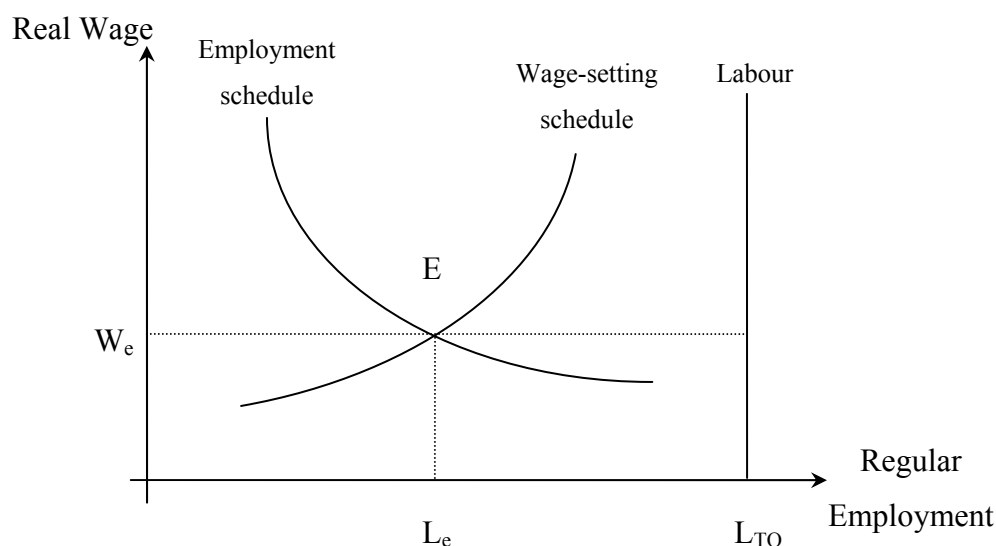


Figure 20: Wage setting and employment

²³ Initially set out by Layard *et al.* (1991), Calmfors modified the wage-setting model in Calmfors (1994), *Active labour market policy and unemployment – a framework for the analysis of crucial design features*, OECD Economic Studies No 22

Because Calmfors explanation of its model (standing out on a similar figure) is clear and simple²⁴, we choose to include it as it is, before to add further comments:

“In the figure, we distinguish between three curves. A downward-sloping *employment schedule* shows how regular labour demand (labour demand excluding participation in ALMPs) depends negatively on the real wage. An upward-sloping *wage-setting schedule* shows how wage pressure depends positively on regular employment. The underlying assumption is that higher regular employment is associated with a higher probability of finding a job if an employee is separated from his present job. This gives employees a better outside option when bargaining with the present employer, which makes it possible to obtain a higher wage. The intersection of the two curves gives the equilibrium levels of real wages [w_e] and regular employment [L_e]. In addition, a vertical line shows the labour force. By deducting participation in ALMPs from the labour force, and comparing the outcome with regular employment, one obtains open unemployment.

The analytical framework can be motivated in several ways. The simplest possibility is to view the employment schedule as an ordinary stock demand for labour, following from the usual marginal productivity condition. The wage-setting schedule may be viewed as the (steady-state) outcome of either collective wage bargaining or unilateral employer decisions on wages in an efficiency-wage framework.”

Then, various effects of ALMPs can be distinguished²⁵: effects on the matching process, effects on the competition for jobs, effects on productivity and the allocation of labour between sectors, direct crowding-out (displacement) effects on regular labour demand. Given that the aim of job-broking and counselling activities for the unemployed by the public employment agencies is to improve the matching process (often regarded as the primary function of active labour market policy), it is important to breakdown the treatment effects as well as the side effects – if any.

²⁴ in L. Calmfors, A. Forslund and M. Hemström (2002), *Does active labour market policy work? Lessons from the Swedish experiences*, IFAU Working Paper 2002:4, Office for Labour Market Policy Evaluation, Uppsala, p.16-17

²⁵ Calmfors (1994) *op cit.*

i. Effects on the matching process

First, referring to our figure, we can easily see that a more efficient matching process shifts the employment schedule to the right, which tends to raise both employment and real wages. In fact, “when deciding whether or not to post a vacancy, a firm compares the expected future revenues with the expected costs (hiring costs and future pay). The expected future revenues depend on how quickly the vacancy is expected to be filled. An increase in matching efficiency increases the probability of filling a posted vacancy at any point of time. Hence, the expected return to posting vacancies increases, and therefore more vacancies are posted. This results in higher employment.”²⁶

But an increase in matching efficiency also shifts the wage-setting schedule to the right, reducing the real wage and increasing employment. The reason comes from the bargaining power of the firm that is raised by the increase in matching efficiency, whereas the job seeker applying for the vacancy does not benefit from a negotiation advantage, under the assumption that employment remains at a steady state. Then, a higher matching efficiency will shift both the employment and wage-setting schedules to the right, increasing thus employment.

However, the effect on the real wage is ambiguous. Moreover, a locking-in effect of training or job creation programmes can occur. Indeed, assuming that programme participation renews eligibility for unemployment compensation (passive measures interact there with active measures), we can expect job seekers to stay on their position (accommodation effect), refusing offers and increasing wage pressure. An additional effect can be the increase of the reservation wage of job seekers comparing opportunity cost of work to their “passive” activity that gives revenue too. Then, the ALMPs may have opposite effects to the first treatment effects analysed: this side effect tends to shift the employment and wage-setting schedules to the left, lowering regular employment (whereas the impact on the real wage is still unclear).

ii. Effects on the competition for jobs

The increase in the degree of competition for available jobs, through the skill enhancing process induced by training programmes in ALMPs, has now to be analysed. This may have a

²⁶ in Calmfors *et al.* (2002) *op cit.* p.17-18

positive effect on labour force participation, since participants in ALMPs are perceived by the firm to be more attractive than the openly unemployed. The labour supply schedule is then shifted to the right in our figure. The wage-setting schedule is also shifted to the right, under the assumption of a steady regular employment level (there are relatively less jobs available than before). This results in reducing real wages, while employment increases.

iii. Productivity effects

Following the increase in competition among job seekers, we can easily say that productivity is also increased. Then, the effect is positive on employment, since marginal product raised by better productivity is allocated to new jobs by the firm. A side effect could obviously be an increase in the reservation wages that may annihilate the former positive effect. This problem also occurs when reallocation of the work force is aimed by the labour market policy (e.g. mobility-enhancing measures encouraging transfers from low-productivity sectors to high-productivity sectors).

iv. Direct crowding-out effects on regular labour demand

Finally, subsidised employment can have important side effects. Indeed, it could occur that the same persons would have been hired also in the absence of subsidies (deadweight effect), or that the subsidies lead employers to substitute one category of workers for another (substitution effect). Such displacement effects tend to reduce both the real wage and regular employment, since the employment schedule (seen as the regular labour demand schedule) is shifted to the left.

All things considered, it appears to be difficult to determine what will be the effect of active labour market policy on employment, if all kinds of interactions are taken into account. Furthermore, unemployment and related welfare benefits, which provide income support to the unemployed while they are searching for jobs, may also have significant effects on work incentives for the unemployed and on the wage-setting behaviour of workers and employers. Passive labour market policies interfere therefore with active labour market programmes (ALMPs) effectiveness. Then, an important issue in evaluating programmes concerns the coordination and interaction between the two components of the labour market policy (active and passive measures). This leads us to evoke the limits of theories. Indeed, the empirical

validity of hypotheses is difficult to assess, which leads to unpredictable effects when implementing theories advice. Therefore, we consider that a comeback on the hypotheses stated by each of the model studied above is now necessary.

2. Limits of theories: a comeback on hypotheses

Hypotheses constitute the basement of theories. However, some of them are fundamental (or strong), whereas others are secondary (or feeble).

Strong hypotheses cannot be relaxed without transforming the logic of the system build, since they participate to the argument architecture. Indeed, theoretical models need determinist hypotheses to reflect reality by the mean of logic. By opposition, feeble hypotheses can easily be relaxed, since their main utility is to facilitate the development of the model, by simplification of the issue.

In order to improve the matching between theoretical models and reality – and thus to permit empirical studies – economists must seek either to relax the inappropriate hypotheses (if they are feeble), or to add hypotheses that lower the strong ones. We will here insist on the strong hypotheses of each theory.

i. Limits of the standard neo-classical theory

In the standard neo-classical theory, the competitive and individual framework implies flexibility in real wages and prices that are perfectly anticipated by the agents (no monetary illusion). The equilibrium on the labour market (compatible with a frictional unemployment) depends then basically on the degree of flexibility, which is yet difficult to measure and to improve.

Moreover, the firms are supposed to be similar and to seek only for a maximisation of their profit. The organisational and human aspect of the firm is thus ignored. Yet, it can play an important role in the production function and in the choice of job seeker to accept a job or to refuse it. However, it is difficult to modelled.

Finally, institutions (i.e. trade unions, unemployment aids...) are considered as control organs and supposed to introduce rigidities in the market. Their intervention must then be limited. Hence, institutions are out of the model. Yet, their existence is evident and their intervention cannot easily be fought without side effects.

ii. Limits of the New Labour Market Theories

The new labour market theories also lie on the hypothesis of a substantial rationality, but in an imperfectly competitive economy (errors in anticipation are allowed). Moreover, asymmetry in information is assumed, regarding labour supplier and firms.

Then, the labour market differs from traditional markets and wage rigidity is recognised, as well as the heterogeneity of the market (insiders/outsideers).

Finally, the power of trade unions and employers' association are taken into account. The main difficulty lies then in the complex method that aim at giving micro-economic basements to macro facts.

iii. Limits of the institutions' theory

The starting point of the institutions' theory is the bounded rationality of agents. This assumes an inefficient diffusion of information, as well as an uncertainty element in available information and an inefficient treatment of it by agents. Institutions are then necessary to support the labour market, which is considered to be specific. The feeble point here is to know how to implement institutions (as trade unions) that are more efficient than individuals and aim to enhance general interest instead of individual interest?

Finally, the preponderant weight of informal rules, difficult to assess and to modelled as well, leads institutions' theory to use other methods of analysis (borrowed to sociology or anthropology for instance), and hence enlarges the field of economy too much to result in strong conclusions.

If the ‘Swedish model’ has often been regarded as a model for other countries to emulate before the 1990s, as it performed the best, the United Kingdom became the reference in labour economics’ discussions of the 1990s. Indeed, its unemployment rate over the period is sensitively lower than its European neighbours’ since 1993, and still today, with a constantly decreasing shape. The key of success seems to be the high flexibility of the British labour market. Indeed, the structural reforms implemented during the 1990s enhanced each component of labour market flexibility, i.e. employment, wages and labour organisation.

The analysis of labour market policies’ effects on the matching process, competition, productivity and regular labour demand through the wage-setting and employment model revealed, however, side effects of labour market policies. These led us to analyse the difficulties encountered in implementing theories’ recommendations based on strong hypotheses. Therefore, the next step will be to analyse the impact of institutions on labour market policies’ performances and thus to show that no model can be seen as a panacea.

IV. Impact of institutions on the labour market's achievements

General lessons as to what type of labour market programme is more effective can be cross analysed and shared across countries, only if institutions frameworks are included in assessment. Indeed, differences in wage behaviours, for instance, can easily be related to the institutional characteristics of labour markets.

Unemployment analysis is classified into three broad categories, according to Blanchard and Wolfers:

- The ones that focus on the role of adverse macroeconomic scenarios.
- The ones that focus on the role of institutions.
- The ones that focus on the interaction between institutions and macroeconomic conditions.

We are there interested in the role of institutions on labour market policies' effectiveness. Then, we will first deal with the role of institutions (A), before to focus on analyses, which tackle the question of interaction between institutions and shocks (B).

A. Clever institutions' design may influence countries performances

The institutional framework of the UK is characterised by flexible labour laws are, which has for consequence flexible wages and low national insurance contributions. In addition, trade unions do not have an important weight on bargaining. Actually, the fragmentation and the decentralisation of the collective bargaining were implied by the New Deal. The British labour market can then be said to be flexible. However, the countries with the highest unemployment rates are not necessarily the rigid ones. The differences of flexibility on labour markets are then insufficient to justify the diversities of unemployment performances across countries. In this section, we will present the main conclusions of evaluations model made by economists tackling the question of institutions' impact on labour market performances, before to build employment networks' representations for each of the three countries.

1. Unemployment is affected by labour market institutions

Belot and van Ours²⁷ present a “theoretical and empirical framework to investigate how unemployment is affected by different labour market institutions such as labour taxes, unemployment benefits, employment protection, union bargaining power and (de)centralisation of bargaining”. They argue that complementarities between labour market institutions can be exploited to improve labour market performance. Their empirical analysis deals with eighteen OECD countries over the period 1960-1995.

The analysis of stylised facts suggest that high unemployment is associated with:

- Generous unemployment benefits;
- High unionisation associated with bargaining coordination;
- High taxes.

Moreover, the change in institutions, in case of structural reforms, must be done in the same time, the United Kingdom being an obvious example. Indeed, since institutions interact with each other, their effects on the equilibrium employment rate depend on each other. Two institutions are complementary when, in a particular institutional framework, the effect of one of them is reinforced by the other. “Since institutional frameworks vary strongly across countries, similar institutional reforms will have very different effects on the unemployment rate. Some reforms are implemented not only because of their direct favourable effect on the unemployment rate but also because of their interaction with other future reforms, whose effectiveness would then be enhanced. Therefore, [...] the clever design of a labour market reform could lie in the exploitation of these complementarities²⁸.”

Empirical studies made by Belot and van Ours (2000) show that Sweden rather suffered from the negative interactions between the policies implemented and the initial institutional setting. The latter, however, “was ‘favourable’ in the sense that the bargaining position of the worker

²⁷ The evaluation issues are discussed in detail in M. Belot and J.C. van Ours (2000), *Does the Recent Success of Some OECD Countries in Lowering their Unemployment Rates Lie in the Clever Design of their Labour Market Reforms?*, IZA Discussion Paper No 147, Bonn, Institute for Labour Studies. Below we simply summarise the results of the evaluation study.

²⁸ M. Belot and J.C. van Ours (2000), *op. cit.*, p.10

was weak, but the reforms were wrong, i.e. their direct effect pushed the unemployment rate upwards²⁹.”

As for France, the failure of the labour market structural reforms come from the wrong combinations of policies implemented during the period considered. “The increases in both tax rate and the replacement rate and the fall in the employment protection moderated strongly the effects of the fall in union density and the increase in union coverage³⁰.”

In conclusion, “two elements seem crucial. First, the nature of the reforms implemented and second, the way it is amplified or moderated by the rest of the institutional framework. The ideal reform combines a negative direct effect and the exploitation of complementarities in the institutional framework. Some countries, where the bargaining position of the worker is quite strong will probably have to do more efforts to reach the success than some others, benefiting from a favourable institutional framework³¹.” This could justify the bad results of France labour market policies.

Then, labour market rigidities that *do not raise* unemployment significantly include:

- Strict employment protection for labour standards regulations;
- High benefits associated with pressure on the unemployed to take jobs (through reducing the duration of benefits or influencing the ability – or willingness – of the unemployed to take jobs);
- High unionisation levels accompanied by high levels of bargaining coordination.

To conclude, Belot and van Ours’ study emphasises the role of institutions in labour market policies’ effectiveness. In this respect, following a liberal way, the United Kingdom introduced structural reforms aiming at enhancing the functioning of its labour market, through more flexibility. This cannot be seen as a panacea, since each labour market has its own characteristics that belong to a more global framework. We shall then build, in the next section, employment networks for each country, in order to emphasise the specificity of each country that has to be taken into account when implementing policies.

²⁹ M. Belot and J.C. van Ours (2000), *op. cit.*, p.20

³⁰ M. Belot and J.C. van Ours (2000), *op. cit.*, p.21

³¹ M. Belot and J.C. van Ours (2000), *op. cit.*, p.21

2. Employment networks

An employment network can be defined as an articulated system that links education, employment and social protection together. There are various employment systems. In our case, the employment system of the UK differs from the one applied in France or in Sweden. Since each employment market has its proper coherence and logical working, the success of labour market reforms will depend on the respect of this framework's design.

i. British employment model

In the UK (see figure below), the employment model generates employment, thanks to high flexibility in labour market institutions. However, the social protection is not very extensive, in comparison to Sweden or France, and turnover is important in the secondary market (low level of qualifications), given the high decentralisation in negotiations. In addition, the access to superior studies is not free. The system creates exclusion, whose fight is one of the government's goals, thanks to the development of the 'Workfare' State. Job seekers might then benefit from a developed social aid, provided they participate to training programmes.

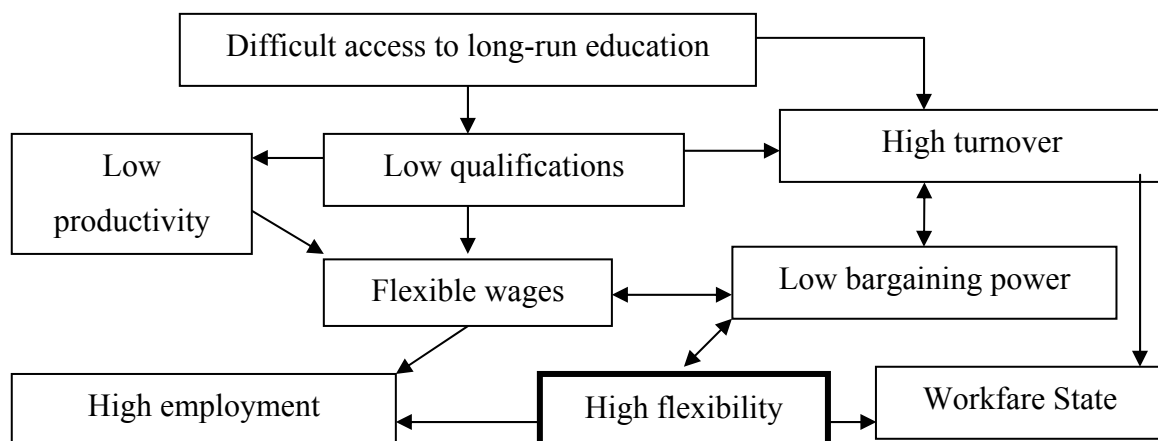


Figure 21: United Kingdom employment network

ii. Swedish employment model

In Sweden (see figure below), the employment model results in a tight labour market. No one is let aside by the social protection system, which results in low exclusion as well. Access to education is easy, but a disincentives effect of labour markets on work provides low activity rates. Concerning wage bargaining, there is a branch centralisation and high unionisation degree, but low coordination. However, extensive labour laws provide employment protection. Finally, unemployment is low but employment is too. Active labour market policies have recently been reformed according to this scheme (Sweden needs higher activity rates).

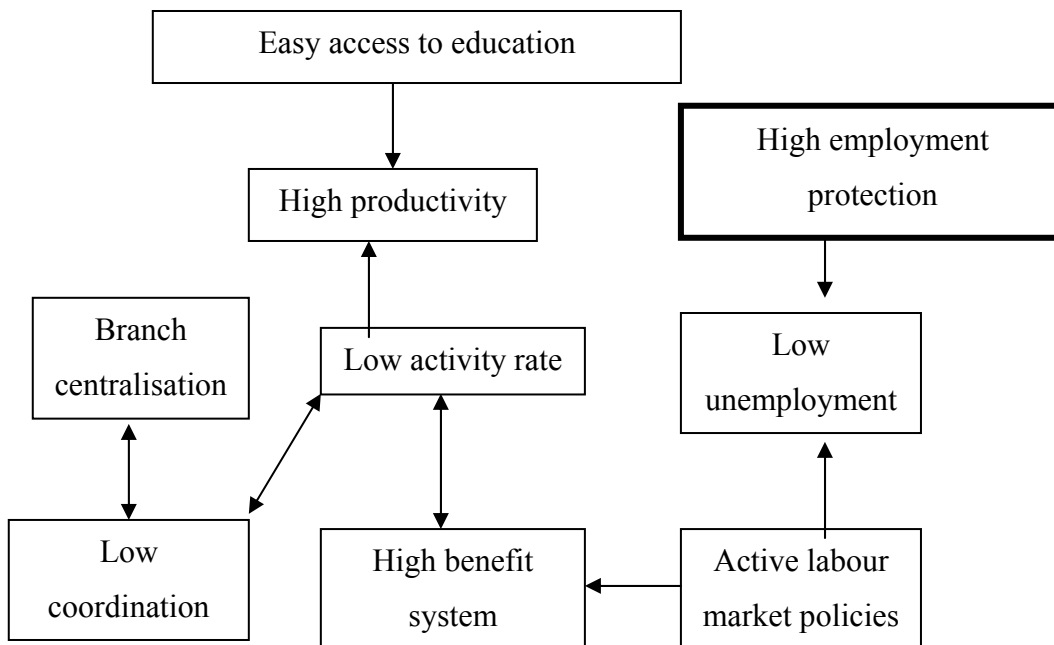


Figure 22: Sweden employment network

iii. French employment model

In France (see figure below), the employment model generates unemployment and exclusion, but avoids implosion thanks to a developed system of social protection. Indeed, education is free and makes the access to superior studies easy; then qualifications are high and employment is mostly on the primary market, i.e. the one which is constituted by high structured and pyramidal internal markets where internal promotion is dominant. The

secondary market, which is constituted by unorganised internal markets with a high turnover, is not encouraged. Job seekers benefit from a developed social protection in France.

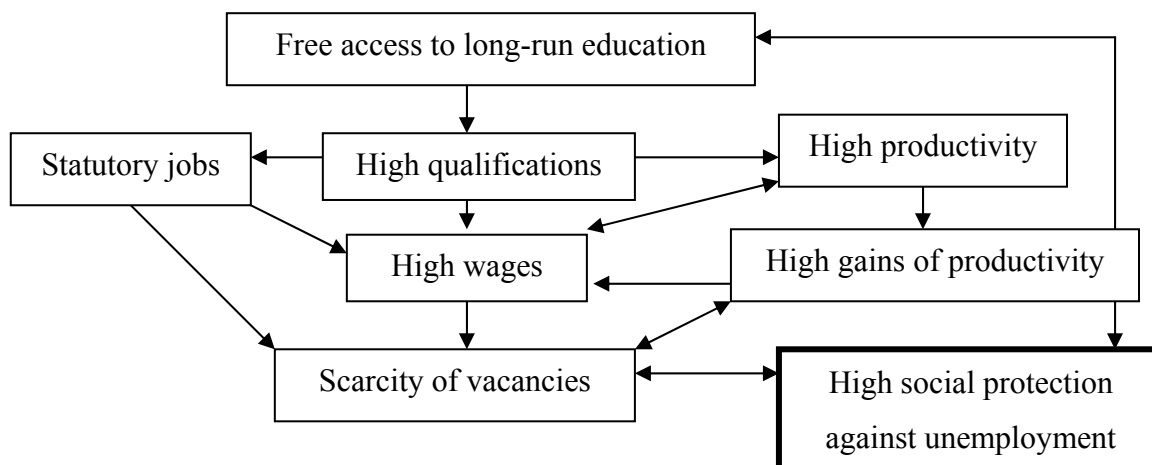


Figure 23: France employment network

B. Approach based on institutions and shocks

The approach based on institutions and shocks relies on a simple mechanism that accounts for both the evolution of unemployment and its variation across countries. The identification of sensible and credible macroeconomic variables to be interacted with institutions means, however, that these variables are typically not mean reverting, and therefore they are more than simple shocks to the equilibrium unemployment level of each country.

1. Direct impact and interactions' effects of institutions

Nunziata³² (2002) assesses in his model the long-term impact of institutions on the equilibrium level of unemployment. In this model, the explanatory variables are represented by all factors *directly* influencing the equilibrium level of unemployment (i.e. employment protection, unemployment benefit replacement rate, unemployment benefit duration, net

³² The evaluation issues are discussed in detail in L. Nunziata (2002), *Unemployment, Labour Market Institutions and Shocks*, Nuffield College, University of Oxford. Below we simply summarise the results of the evaluation study.

union density, bargaining coordination, tax wedge³³) and the shocks that cause unemployment to deviate from equilibrium (i.e. labour demand shock, total factor productivity shock, money supply shock, long-term real interest rate, terms of trade shock – these are all mean reverting, except for the real interest rate).

Regarding the estimations results, the model is able to produce a quite satisfactory explanation of the unemployment patterns in OECD countries during the 1960-1995 spell.

In dynamic simulations, labour market institutions can explain around 55% of the 6.8% increase in the average European unemployment rate from the 1960s to the 1990s (63% excluding Germany). Regarding the contribution of each institutional dimension:

- The change in the benefit system is the most relevant (contributing 39%);
- Increases in the tax wedge (26%) is relevant too;
- Shifts in union variables (19%) is quite important;
- Changes in employment protection regulations (16%) too.

The combination of benefits and taxes are responsible for 2/3 of that part of the long-term rise in European unemployment that our institutions explain.

Nunziata's main findings are the following:

- Labour market institutions have a direct significant impact on unemployment in a fashion that is broadly consistent with their impact on real labour costs.
- The benefit variables have a significant positive effect, reinforced by their interactions.
- The tax wedge has a positive effect that is lowered by high levels of coordination.
- The increase in union density has a positive effect that is offset by high levels of coordination.
- Coordination in wage bargaining has a direct negative effect, and a negative effect through the interactions with taxation and union density.
- Stricter employment protection does not seem to have a significant impact on the unemployment level, although it increases unemployment persistence.
- Stricter fixed term contract regulations have a significant positive impact on unemployment. The regulations of temporary work agencies are not significant.

³³ Tax wedge = direct + indirect + labour tax rates

- The effects of controls for the labour demand shock, the terms of trade shock and the total factor productivity shock are consistently significant, and have the expected sign.

Then, broad movements in unemployment across the OECD can be explained by shifts in labour market institutions. To be more precise, changes in labour market institutions explain around 55% of the rise in European unemployment from the 1960s to the first half of the 1990s, much of the remainder being due to the deep recession observed during the latter period. Other studies have been done on the question of interaction between institutions and shocks and their impact on the labour market performance. Next point presents the main lessons of recent OECD countries' evaluation attempting to explain the increasing unemployment of the last decades.

2. Institutions and shocks: lessons from the recent evaluation literature³⁴

First, Layard *et al.* (1991) present a dynamic model where institutions are interacted with shocks, or factors that may influence unemployment in the longer term. These are, from the 1970s:

- Wage pressure;
- The benefit replacement ratio;
- Real import price changes;
- Monetary shocks.

They affect unemployment through their interactions with time invariant institutions, different sets of institutions affecting the degree of unemployment persistence, the impact of wage pressure variables, including the replacement rate and import prices, and the effect of monetary shocks. Their model explains the data better than individual country auto-regressions with trends.

Then, Blanchard and Wolfers (2000) concentrate on the combined role played by institutions and macroeconomic conditions. They identify a set of macroeconomic variables that may explain the increase in European unemployment. These are:

- The decline in total factor productivity growth (through the slow wage adjustment to the new equilibrium);

³⁴ from L. Nunziata (2002), *op. cit*

- The real interest rate increases (through the negative effect on capital accumulation);
- The adverse shifts in labour demand.

Although the effects of these shocks are not supposed to persist in the long run, their interaction could explain part of the European unemployment time series in recent decades. Indeed, a decline in total factor productivity, accompanied by slow wage adjustment to the new equilibrium, could have pushed up unemployment in the 1970s; then, the real interest rate increases in the 1980s could have negatively affected capital accumulation, maintaining high levels of unemployment in that period. Finally, an adverse shift in labour demand (originated through a reduction in labour hoarding) may be responsible for the high unemployment levels of the 1990s.

These trended variables may explain the general increase in unemployment in Europe, while the cross sectional variation across countries can be imputed to their different institutions. Indeed, the impact of the shocks on unemployment is mediated by labour market institutions.

The most important institutional effects are:

- The benefit replacement rate;
- Benefit duration;
- Union density;
- Union coordination.

Henceforth, in countries where the labour market is slowly adjusted, macroeconomic instability contains a particularly high risk of aggravation of structural unemployment, whereas in countries where there is a high flexibility in the labour market, cyclical fluctuations of unemployment do not induce a growing structural unemployment. These results are in line with our former analysis of the British, Swedish and French unemployment.

Finally, Fitoussi *et al.* (2000) draw on the contribution of Phelps (1994) that identifies a set of five macroeconomic shocks (real interest rate, productivity growth, real oil price, tax rate, and inflation rate) potentially relevant to the explanation of the increase in unemployment since the 1970s in most OECD countries. The variables suggest are:

- The reduced expectations of productivity growth in the 1970s (inducing an increase in the effective cost of capital);
- The increase in the expected real interest rate in the 1980s (inducing an increase in the effective cost of capital);

- The increase in income and services from the private assets of employees;
- The increase in social benefits relative to real wages net of taxes³⁵.

They find that institutions can explain around 50% of the difference in the coefficients. The fixed effects depend positively on the benefit replacement ratio, union coverage and density; and negatively on coordination. The sensitivity to shocks parameters depends positively on benefit duration and union density; and negatively on coordination and active labour market programs.

To conclude, research on labour market institutions in the industrialised countries provides evidence that sustainable stability on the labour market is not asserted by firms, public administrations or other employers alone, but by a network of economic, political and social institutions, regulations and policies. In this respect, employment networks' representations are useful to identify the labour market framework's design.

Additionally, the approach based on both institutions and shocks suggest that the driving force behind high unemployment levels could be the set of adverse macroeconomic shocks, as the restrictive monetary policy led in France during the 1990s to respond to EMU criteria. Importantly, shocks are shown to be insufficient to explain the variation in the evolution of unemployment across countries and institutional information is needed to account for that.

³⁵ The increase in social benefits relative to real wages net of taxes resulted from the welfare state reforms of the 1960s and 1970s, the productivity slowdown from the 1970s and the oil crisis of the 1970s.

V. Conclusion

A. Findings and limits of the study

To find a job, a job seeker must accept a job offer that corresponds to his qualifications. Then, there are three conditions for the return to employment:

- There must exist a job offer;
- This offer must correspond to the job seeker qualifications;
- The job seeker must accept it.

These three conditions are necessary, but none of them is sufficient. If one of them is not satisfied, then the return to employment cannot happen. Moreover, these three conditions refer to three different aspects of the labour market: respectively, the labour demand, the suitability between demand and supply, and the labour supply. This sums up the difficulties encountered by an economic policy that aims to reduce unemployment. It must tackle all of the three aspects at the same time. The global coherence is then the key of success, in preference to the question of which device to adopt³⁶.

Indeed, since the underlying causes of unemployment are diverse and most likely to vary among target groups, geographical regions as well as over time, neither the ‘Swedish model’, nor the ‘British model’ can be credited to be a panacea. The particularity of the ‘French model’ that does not succeed in reducing unemployment, though implementing European recommendations build on succeeding stories’ emulation, gives a good example of the importance of countries’ specificity in the implementation of policies.

Although theories provide valuable frameworks to analyse the labour market and build employment strategies, they fail in integrating institutions in their argument. Moreover, their strong hypotheses are not easy to verify empirically. Thus, theories must remain normative and their use has to be done carefully. The complexity of the labour market functioning still needs more research to be fully understood. In this respect, the development and harmonisation of labour force surveys according to standard definitions allow to do meaningful comparison across countries. However, while indispensable in comparative labour

³⁶ demonstration borrowed to Y. l’Horty in “Les nouvelles questions de l’emploi”, *Cahiers Français* No 304, sept-oct 2001

market analysis, data cannot correct for the significant cross-country variation of institutional and structural factors shaping the overall labour market picture, notably in countries where active labour market policies play a major role. Econometric models are then useful to take these changes into account.

B. Concluding remarks: implications for the European labour market policy

There are two types of problem for European policies. First, different levels of equilibrium unemployment (associated with the maximum output obtained without inflationary pressure) exist throughout Europe. The European Central Bank has therefore to deal with contradictory national needs. Second, labour markets are likely to produce asymmetric shocks, such as differing wage claims across countries subject to the nature and organisation of industrial relations. Indeed, the behaviour of labour markets in Europe has not been identical across countries, during the 1990s.

Then, a set of recommendations done in a uniform way would it be applicable in such different countries? Our study leads to the conclusion that it is not as easy as it seems, since institutions play an important role in labour market policy's success. Then, two ways of implementation are possible: either the institutional framework of each country is changed by the mean of structural reforms in order to be adapted to the global recommendations, or the recommendations are specified in order to permit a free adaptation of countries' policy to their particular institutional context.

The European Union has, in recent years, emphasised active labour market programmes as an important means to reduce long-term structural unemployment. Indeed, one main purpose of these active measures is to increase unemployed workers' employability either by facilitating their job search, improve their work habits or increasing their human capital. Yet, the European Union recommendations remain a general orientation and each country has the power to implement its policy according to its institutional framework. But the growing European Union of the next decade will probably induce more labour mobility and thus transfers of workers, as of habits, between labour markets. A common framework could then become necessary, in order to avoid asymmetric shocks. The answer to such a question needs further research on the asymmetry and complementarities between European labour markets.

Glossary

Adverse Selection: there is adverse selection in insurance for instance, when risky agents are ready to pay a higher price for insurance, since they know that they are risky (whereas insurance does not know). Thus a phenomenon of natural bad selection for the insurance occurs, due to information's asymmetry. This leads to inefficiency of the market.

Bounded Rationality: it describes a situation, where individuals do not have at their disposal all the elements necessary to make the best choice; thus, they choose solutions that are only acceptable.

Equilibrium: it describes a situation where “nothing is moving”, because agents are not induced to modify their plans, given the available information on the market and constraints supported by agents; at the equilibrium point, there is compatibility between agents' plans.

Flexibility: in a flexible economy, i.e. where there is no obstacle to individuals' transactions, there is a permanent adjustment trend between demand and supply.

Information's Asymmetry: situation where an individual has got more information than another (about a good for instance), which can bound or prevent transactions.

Labour Demand: it represents the firms' demand of workers, since firms need workers to produce.

Labour Economics: set of theories and observations concerning the way labour relationships (inside firms or in the community as a whole) are organised.

Labour Market: place where transactions are concluded, assuming a confrontation between demand and supply.

Labour Market Policy: structural policy, which tackles the problem of unemployment by acting directly and in the long term on the labour market.

Labour Supply: it represents the workers' supply of labour, since workers need work to earn wages.

Monetary Illusion: an individual is subject to monetary illusion if, when observing an increase in the price of the good or service he is selling (actually due to an increase in the general price level), he believes that his purchasing power is also increased, whereas it is not.

Moral Hazard: there is moral hazard when one of the contractors can act in a way that harmed the other contractor, either because the latter is less informed, or because the contract is not complete (some eventualities are not taken into account).

Perfect Expectations: all the agents forecast correctly (without mistakes) what will happen, during their whole life.

Perfect Competition: situation assuming the transparency of the market (agents are perfectly informed on the quality and price of all the products) and the mobility of the factors (labour and capital are directed towards the best earnings).

Rational Expectations: agents may do mistakes in their expectations, since unforeseen shocks might occur (unforeseen increase in money supply, for instance).

Substantive Rationality: situations where individuals have a total knowledge of the possibilities offered as a whole and decide according to the maximisation program of their utility under revenue constraints.

Unemployment: situation happening when full employment of available workers does not occur. Its origin is difficult to assess, as its measurement. See p. 12-14 for further considerations.

Walrasian: adjective used to indicate a perfectly competitive situation, first described by Léon Walras.

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IFAU: Office for Labour Market Policy Evaluation

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Appendix 1

EU Employment Guidelines, 1997

Source: European Community web site

PILLAR 1: EMPLOYABILITY

The first of the four pillars focuses on *employability* and on tackling the *skills gap*. Whilst skill development and lifelong learning remain a key objective for the whole workforce, there is a particular emphasis in this part of the Guidelines on ensuring that young people and the unemployed (particularly the long-term unemployed) are equipped to take advantage of new employment opportunities in the fast-changing labour market. A key element of the employability pillar is the recognition of the need for early intervention, before individuals become long-term unemployed, and the provision of help which is customised and targeted to individual needs. Also noteworthy is the inclusion, for the first time, of clear quantified targets for Member States in giving a new start to young and long-term unemployed people, and in increasing access to training for the unemployed.

IMPROVING EMPLOYABILITY THROUGH:

(1) Tackling youth unemployment and preventing long-term unemployment

In order to influence the trend in youth and long-term unemployment, the Member States will develop preventive and employability-oriented strategies, building on the early identification of individual needs; within a period to be determined by each Member State, which may not exceed five years and which may be longer in Member States with particularly high unemployment, member states will ensure that:

- every unemployed *young person* is offered a new start before reaching six months of unemployment, in the form of training, retraining, work practice, a job or other employability measures;
- *unemployed adults* are also offered a fresh start before reaching twelve months of unemployment by one of the aforementioned means or, more generally, by accompanying individual guidance.

These preventive and employability measures should be combined with measures to promote the re-employment of the long-term unemployed.

(2) Transition from passive measures to active measures

Benefit and training systems — where that proves necessary — must be reviewed and adapted to ensure that they actively support employability and provide real incentives for the unemployed to seek and take up work or training opportunities. Each Member State:

- will endeavour to increase significantly the number of persons benefiting from active measures to improve their employability. In order to increase the numbers of unemployed who are offered training or any similar measure, it will in particular fix a target, in the light of its starting situation, of gradually achieving the average of the three most successful Member States, and at least 20%.

(3) Encouraging a partnership approach

The actions of Member States alone will not suffice to achieve the desired results in promoting employability. Consequently:

- the social partners are urged, at their various levels of responsibility and action, to conclude as soon as possible agreements with a view to increasing the possibilities for training, work experience, traineeships or other measures likely to promote employability;
- the Member States and the social partners will endeavour to develop possibilities for lifelong training.

(4) Easing the transition from school to work

Employment prospects are poor for young people who leave the school system without having acquired the aptitudes required for entering the job market. Member states will therefore:

- improve the quality of their school systems in order to reduce substantially the number of young people who drop out of the school system early;
- make sure they equip young people with greater ability to adapt to technological and economic changes and with skills relevant to the labour market, where appropriate by implementing or developing apprenticeship training.

PILLAR 2: ENTREPRENEURSHIP

The second of the Guidelines' four pillars derives from the recognition that the creation of more and better jobs requires a dynamic and enterprising climate for businesses to expand and hire workers. This pillar is, therefore, about *entrepreneurship*, defined in a broad way, to cover the start-up and running of new enterprises, the development of existing enterprises, and the encouragement of initiative within large firms. It also supports measures to generate new sources of employment (including self-employment), and to create networks among enterprises and between enterprises and local authorities.

DEVELOPING ENTREPRENEURSHIP THROUGH:

(5) Making it easier to start up and run businesses

by providing a clear, stable and predictable set of rules and by improving the conditions for the development of risk capital markets. The new facilities offered by the European Investment Bank (EIB)(1) combined with the Member States' efforts will enable new businesses to be set up more easily. The Member States should also reduce and simplify the administrative and tax burdens on small and medium-sized enterprises. To that end the Member states will:

- give particular attention to reducing significantly the overhead costs and administrative burdens for businesses, and especially small and medium-sized enterprises, in particular when hiring additional workers;
- encourage the development of self-employment by examining, with the aim of reducing, any obstacles which may exist, especially those within tax and social security regimes, to moving to self-employment and the setting up of small businesses.

(6) Exploiting the opportunities for job creation

If the European Union wants to deal successfully with the employment challenge, all possible sources of jobs and new technologies and innovations must be exploited effectively. To that end the Member States will:

- investigate measures to exploit fully the possibilities offered by job creation at local level, in the social economy and in new activities linked to needs not yet satisfied by the market, and examine, with the aim of reducing, and obstacles in the way of such measures.

(7) Making the taxation system more employment-friendly

and reversing the long-term trend towards higher taxes and charges on labour (which have increased from 35% in 1980 to more than 42% in 1995). Each Member State will:

- set a target, if necessary and taking account of its present level, for gradually reducing the overall tax burden and, where appropriate, a target for gradually reducing the fiscal pressure on labour and non-wage labour costs, in particular on relatively unskilled and low-paid labour, without jeopardising the recovery of public finances or the financial equilibrium of social security schemes. It will examine, if appropriate, the desirability of introducing a tax on energy or on pollutant emissions or any other tax measure;
- examine, without obligation, the advisability of reducing the rate of VAT on labour-intensive services not exposed to cross-border competition.

(1) The EIB has established, following Amsterdam, a Special Action Programme for job creation, with a special emphasis on support and venture capital financing for SMEs

PILLAR 3: ADAPTABILITY

As we have already noted, part of the diagnosis of the employment challenge is that there is a need for greater *adaptability*; on the part of businesses, but also on the part of the workforce. The third pillar focuses, therefore, on the adaptability of enterprises and workers to changing technology and markets, industrial restructuring, and the development of new products and services. It covers adaptability in terms of the organisation of work, working patterns and contracts, as well as adaptability in terms of regulatory and training systems. It recognises explicitly that a balance must be struck between the need of businesses for flexibility, and the needs of employees for security and employability, and that striking this balance will not always be an easy task.

ENCOURAGING ADAPTABILITY OF BUSINESSES AND THEIR EMPLOYEES THROUGH:

(8) Modernising work organisation

In order to promote the modernisation of work organisation and forms of work:

- the social partners are invited to negotiate, at the appropriate levels, in particular at sectoral and enterprise levels, agreements to modernise the organisation of work, including flexible working arrangements, with the aim of making undertakings productive and competitive and achieving the required balance between flexibility and

security. Such agreements may, for examples, cover the expression of working time as an annual figure, the reduction of working hours, the reduction of overtime, the development of part-time working, lifelong training and career breaks;

- for its part, each Member State will examine the possibility of incorporating into its law more adaptable types of contract, taking into account the fact that forms of employment are increasingly diverse. Those working under contracts of this kind should at the same time enjoy adequate security and higher occupational status, compatible with the needs of business.

(9) Support adaptability in enterprises

In order to renew skill levels within enterprises, Member States will:

- re-examine the obstacles, in particular tax obstacles, to investment in human resources and possibly provide for tax or other incentives for the development of in-house training;
- they will also examine any new regulations to make sure they will contribute to reducing barriers to employment and helping the labour market adapt to structural change in the economy.

PILLAR 4: EQUAL OPPORTUNITIES

The final pillar of the guidelines prioritises *equal opportunities*, with the twin social and economic objective of modernising societies so that women and men can work on equal terms with equal responsibilities, to develop the full growth capacities of European economies. It recognises both the social need to counter discrimination and inequalities between women and men, and the economic loss resulting from not making full and effective use of the productive capacities of all sections of the population.

In addition to this focus on closing the *gender gap* in Europe's economic and social life, this pillar emphasises the integration of *people with disabilities* into working life. This is an important first step towards recognition that the full integration of disabled people is a fundamental issue of equal opportunities. This, in turn, is a move also towards a wider implementation in the employment field of the important new anti-discrimination clause of the Amsterdam Treaty, under which the Council may take:

".. appropriate action to combat discrimination based on sex, racial or ethnic origin, religion and belief, disability, age or sexual orientation" (Article 13).

STRENGTHENING THE POLICIES FOR EQUAL OPPORTUNITIES THROUGH:

(10) Tackling gender gaps

Member States should translate their desire to promote equality of opportunity into increased employment rates for women. They should also pay attention to the imbalance in the representation of women or men in certain economic sectors and occupations. Member States will:

- attempt to reduce the gap in unemployment rates between women and men by actively supporting the increased employment of women and will act to reverse the under-representation of women in certain economic sectors and occupations, and their over-representation in others.

(11) Reconciling work and family life

Policies on career breaks, parental leave and part-time work are of particular importance to women and men. Implementation of the various Directives and social partner agreements in this area should be accelerated and monitored regularly. There must be an adequate provision of good quality care for children and other dependants in order to support women's and men's entry and continued participation in the labour market. The Member States will:

- strive to raise levels of access to care services where some needs are not currently met.

(12) Facilitating reintegration into the labour market

The Member States will:

- give specific attention to women, and men, considering a return to the paid workforce after an absence and, to that end, they will examine the means of gradually eliminating the obstacles in the way of such return.

(13) Promoting the integration of people with disabilities into working life

The Member States will:

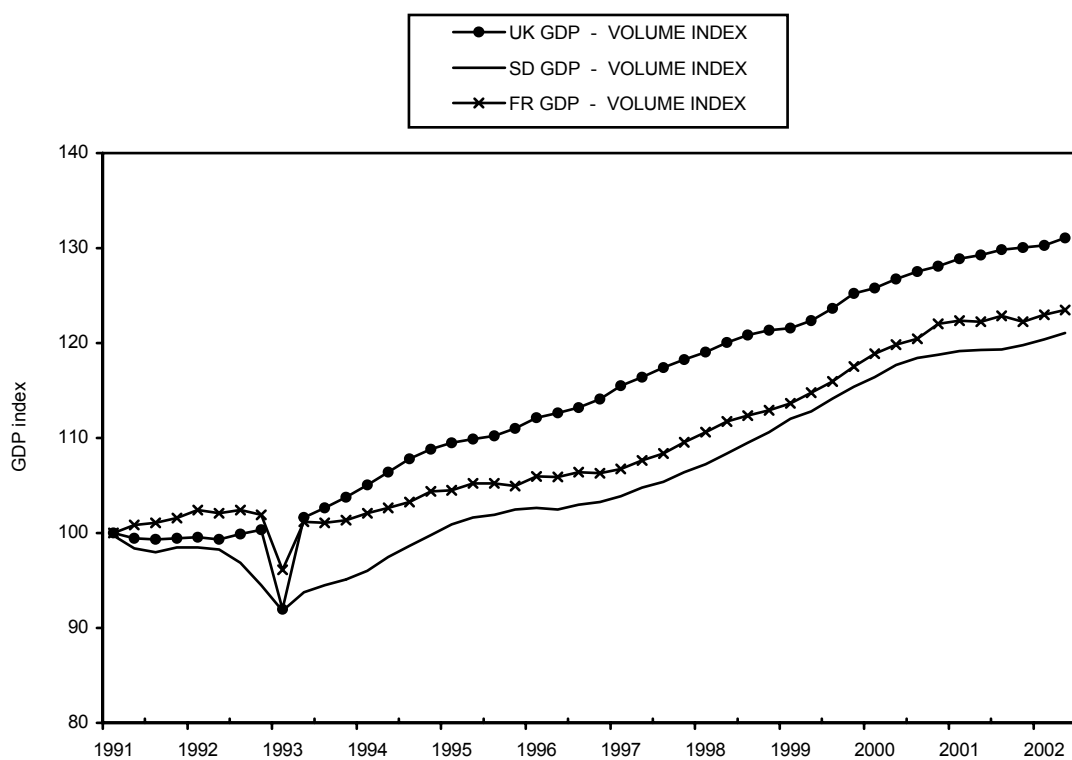
- give special attention to the problems people with disabilities may encounter in participating in working life.

Appendix 2

Gross Domestic Products during the 1990s

Source: OECD

A common recession occurred in 1993 in Europe (in S1 1993 for the UK and S2 1993 for Sweden and France).



Source: DATASTREAM

Figure 24: GDP in the three countries from 1991