Europe is caught mid-river in labour reforms

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European unemployment has fallen to a level not seen for more than 25 years. Long-term unemployment has been declining even more: Europe is no longer a place where half of all job-seekers have been on the dole for more than 12 months, as in the mid-1990s.

The disappearance of mass unemployment is not the result of a shrinking pool of labour; in fact the average employment rate in the European Union has increased by more than 6 per cent in 10 years. This is the only area in which Europe is approaching the ambitious economic targets set at the Lisbon summit in 2000.

These developments are the result of reforms that have reduced employment protection and increased the rewards attached to participating in the labour market. Larger immigration to countries with the biggest regional unemployment differentials, Italy and Spain, has also been important. It has contributed to remarkable wage moderation in Europe, by preventing the overheating of local labour markets where there is a shortage of native workers.

Governments, however, are not capitalising on these successes. In France, a long negotiation on the reform of labour contracts ended last week with very modest results. In Germany, pressures are mounting to increase state involvement in wage-setting after parliament introduced a relatively high minimum wage for postal workers. In Italy, unions and employers' associations collude in seeking to appropriate part of the fiscal surplus. In several countries, large pay rises are being requested for civil servants, which will affect private sector wage contracts. And one day after the European Central Bank's warning against "second-round" effects of inflation on wage-setting, President Nicolas Sarkozy promised fully to index the wages of French public sector workers.

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European job creation in the past 10 years occurred at the cost of low productivity growth. The division between highly flexible temporary contracts and rigid permanent contracts induces asymmetric adjustment of companies to shocks: in good times, employment increases more than in the past; in bad times, downward employment adjustment is still constrained by rigid contracts. This increases average employment in companies relative to output, reducing labour productivity. Migrant workers do not carry with them capital stock, which means that the influx of immigrants into jobs entails a decline in capital use per worker.

These factors are responsible for a deceleration of labour productivity growth since 2000 and negative productivity growth in countries experiencing the largest employment gains. Significantly, employment growth has been stronger in low-growth "old Europe" than in fast-growing "new Europe".

The trade-off between employment and productivity growth is linked to the fact that we are still in the middle of the river in reforming labour markets and largely unprepared for managing migration. Pressures to go backwards are strong. It is a mistake to start setting industry-specific wage minimums, as recently done in Germany, as this exposes governments to stronger pressures from national lobbies and leapfrogging games across industries. There is also no reason to reintroduce even the mild forms of income policy adopted in several countries in preparation for monetary union. Centralised wage-setting is not an appropriate instrument after monetary union, as macroeconomic shocks are more regional or industry-specific in nature. Thus, national union-based systems of industrial relations are ill-suited to address new demands for microeconomic adaptability.

Social pacts should aim for productivity gains by improving the management of migration and reducing the division between temporary and permanent contracts. To encourage higher productivity together with higher employment, governments could make a firm commitment – compatible with the institutional characteristics of their national fiscal systems – not to tax future labour productivity gains, by stabilising, in real terms, labour taxes per hour of work.

Such a commitment would force governments to reduce expenditure. It is a credible commitment, as it is easier to give away something you do not yet have than to give away something that is already incorporated into your budget. Employers and workers would have to decide among themselves how to split the (untaxed) productivity gains. Such a commitment by governments would also explicitly link growth and fiscal consolidation.

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