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Addressing Europe's employment crisis: what policies for recovery and reform?

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BACKGROUND

In the aftermath of the financial crisis and the recession it triggered, unemployment in the EU has soared and is currently forecast to exceed an average of 10% in 2010. Amid clear signs that the situation in the financial markets and banking system has improved, European policy-makers are now contemplating their options for tackling the employment crisis.

The choices they face are particularly stark. Unemployment has not even peaked yet, while public finances have deteriorated everywhere as a result of the fiscal expansion used by governments to counter the recession. The debate on the 'EU2020' Strategy – the successor to the Lisbon Agenda – is also well under way. The big policy question, therefore, is where should we go from here?

Pre-crisis framework

The current decline in employment is a setback for efforts to reach the Lisbon Strategy's targets of raising employment rates to 70% of the working-age population – a necessary precondition for preserving the European social model(s).

The Lisbon Strategy put great emphasis on reforming labour markets to facilitate structural change in Europe's economies in response to the challenges posed by globalisation, the rise of the knowledge economy, demographic change and the shift to a low-carbon economy.

As part of this, the concept of 'flexicurity' gradually gained ground as the guiding principle for labour-market policy reforms in Europe. Broadly defined to accommodate the variety of labour-market conditions and social policy approaches across the EU, flexicurity reforms have promoted changes in employment protection legislation to make it easier to fire and hire workers and to normalise so-called 'atypical' forms of employment, such as part-time work.

The latter have, in particular, made it easier for women to juggle family and work responsibilities and remain in the labour force. As a result, the average female employment rate in the EU had already almost reached the Lisbon target of over 60% by 2007.

Flexicurity reforms also aimed at providing workers with sufficient security, with the focus on protecting people and helping them to move quickly between jobs ('employment' security) rather than on protecting jobs *per se*. This was designed to minimise the cost of adjusting to structural change, ease workers' transition from one job to another, and enhance sectoral and geographical mobility.

To this end, emphasis was placed on active labour-market policies, such as the provision of training, programmes to help unemployed workers find jobs, education and skills' policies, incentives in tax-benefits systems for people to actively seek work, and measures to promote self-employment options for unemployed workers.

The programme of labour-market reforms was pursued alongside macroeconomic policies in EU Member States that aimed at medium-term stability. National fiscal policies, in particular, were coordinated under the Stability and Growth Pact in the euro zone and the excessive deficit procedure in the EU as a whole.

The underlying philosophy of these coordination frameworks is

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that fiscal policies should complement monetary policies via the automatic stabilisers (social welfare benefits, etc.) in maintaining price stability, which in the long run would be consistent with full employment. Discretionary fiscal policies that could result in budget deficits and debt accumulation in the medium term were thus, in principle, discouraged.

STATE OF PLAY

The crisis which began with turmoil in the financial sector and triggered the economic downturn only later translated into the employment crisis now facing the EU – and the jobs' market is likely to deteriorate further as the fiscal stimuli are gradually withdrawn and government schemes to help companies retain workers at the height of the recession rather than letting them go ('labour hoarding') start to expire.

A return to Keynes?

Faced with what is arguably the sharpest economic downturn since the 1930s, European governments and central banks used their labour-market, fiscal and monetary policy tools in ways that until recently would have been thought of as unorthodox in the EU policy context.

At the EU level, the fiscal policy and supply-side measures were bundled together under two European initiatives:

a) The November 2008 European Economic Recovery Plan, anchored in the Stability and Growth Pact and the Lisbon Strategy frameworks, earmarked €200 billion for stimulating demand and mitigating the human costs of the crisis.

b) Following the 2009 Spring European Council and three high-level workshops, the European Commission presented a Communication on a 'Shared Commitment for Employment' in June, which set out three priorities for action: 1) to contain employment losses, enhance job creation and increase mobility from sectors likely to decline permanently to more viable ones; 2) to upgrade the labour force's skills and improve the matching of job vacancies with unemployed workers; and 3) to improve access to employment, especially for disadvantaged groups in the labour force.

Fiscal policies thus expanded generously to make up for the shortfall in private demand in the wake of the credit crunch. Unprecedented amounts of public money were committed to rescuing financial institutions that were deemed 'too big [to be allowed] to fail', adding further to the deterioration in public finances. Central banks across the EU slashed interest rates and all but started throwing bank notes from the proverbial helicopter to provide liquidity in dried-up financial and money markets.

Although fiscal interventions have arguably succeeded in fending off a depression, they do not seem to have averted the possibility of an employment crisis. However, the employment crisis would have probably emerged earlier and been even deeper had it not been for the fiscal stimuli, or if the recession had turned into a depression.

Turning flexicurity 'on its head'

Measures aimed at the supply side of the economy and the labour market were also used. The importance of active labour-market policies, such as programmes to upgrade skills and match market needs with the supply of labour, was underlined once again, especially for more disadvantaged job-seekers. For example, some governments also subsidised social security contributions for low-skilled workers.

Flexicurity policies took an unusual guise in response to the crisis, as several Member States introduced public (financial) support schemes to encourage businesses to enter into temporary short working-time arrangements with their employees until the economic crisis eased. These measures have so far proved the most effective in containing employment losses, although at the expense of productivity growth, especially given the sharp decline in output that countries such as Germany suffered last year. They enhanced job, as opposed to employment, security.

These arrangements can be effective as long as they are temporary and aimed at firms which would not have suffered had it not been for the credit crunch. However, the longer the economic stagnation lasts, the more difficult it becomes to judge which firms still fall within this category, and public funds risk drying up.

As this distinction becomes increasingly blurred, these schemes can at times run counter to Single Market principles. Overall, therefore, while the policy responses to the crisis can be credited with having averted a depression and temporarily prevented an even bigger slump in employment, they are, for the most part, unsustainable for a long-drawn-out recession and slow recovery of the type we are now witnessing.

PROSPECTS

European policy-makers are currently caught between a rock and a hard place. The employment crisis has only just begun, but the accumulated public deficits and debts will limit considerably the tools available to tackle this crisis for several years.

It is against this backdrop that the debate over the EU2020 Strategy is taking place. In contemplating what policies are needed to deal with the current and future employment crisis, it is important to remember that despite (or perhaps because of) the difference in policy responses in different Member States, the economic crisis has only heightened the challenges that European policy-makers face in responding to long-term trends such as globalisation and demographic change, rather than eliminating them or reducing their importance.

Risks of a prolonged jobs crisis

The current employment crisis will lead to losses in the human capital accumulated through the previous investment in education and training, especially if it is as prolonged as many fear. Long-term unemployment has been shown to erode workers' skills and often discourages them from continuing to actively look for employment. It could thus limit the potential for innovation (green or otherwise) in the medium to long term.

The decline of knowledge-intensive sectors such as financial services will set back Europe's transformation into a dynamic knowledge economy, adding to the burden of structural adjustment necessary to maintain and enhance the EU's competitiveness.

All this is very likely to increase the burden on already-stretched pension and healthcare systems, as the demands on them will grow while their resources will be further constrained. Long-term unemployment not only leads to lower tax revenues and social security contributions, but is also associated with poor health and a greater temptation for governments to 'offload' older unemployed workers into early retirement.

Under these circumstances, the effort required to steer public finances back onto a sustainable path in the medium to long term would become even more painful.

Flexicurity in hard times

Where does that leave the flexicurity labour-market reform strategy? Under conditions of weak demand, any benefits from increased flexibility to fire and hire will not be immediately evident. To make things worse, the deterioration in public finances across Europe – and especially in those countries where unemployment has risen the most – suggests that public money to finance active labour-market policies adequately will be scarce.

Flexicurity reforms should not be abandoned. However, the focus must be on creating the conditions to provide employment security first, before resuming the push for greater flexibility in hiring and firing workers. These conditions include not only well-targeted policies to help employees move swiftly from one sector to another, but also – and most importantly – to achieve adequate job creation rates.

Pressing ahead with labour-market reforms that would make it easier to fire and hire alone would accelerate job losses. Unemployment would rise sharply and become a real threat to more people. In response to this, more families may decide to sell their homes to pay outstanding debts (such as mortgages) or increase their savings to guard against future income losses. This in turn could lead to lower property values and dampen demand still further, thus making the choices facing policy-makers even more difficult.

Politically, this option would certainly be even harder to sell than in 'normal' times. The forecasts of a weak and 'jobless' recovery in the next few years would delay any economic gains that greater flexibility in hiring and firing workers could deliver for even longer.

Given the tight public budget constraints of the next years, measures promoting employment over job security should be prioritised. Active labour-market policies and lifelong learning would facilitate the reallocation of labour from declining to dynamic sectors in the medium to long term, provided the right balance is struck between income support and incentives to find employment.

However, ensuring that unemployed workers have the right skills and incentives to search actively for jobs in new dynamic sectors will not be enough to get them back into employment unless those jobs are created. For this to happen, demand has to pick up.

As it is likely to be a long time before financial institutions across Europe restore credit flows to normal levels, and as private-sector demand is likely to remain subdued for some time to come, the only source of demand growth could be macroeconomic policies. But can these continue to stimulate demand in Europe and if so, should they?

What policies for recovery and reform?

The risks of choking off recovery cannot be overstated, not only from the view point of consolidating public finances sooner rather than later but also from that of supporting effective labour-market reforms. With a handful of exceptions, European governments can afford to sustain some fiscal stimulus during 2010 to ensure that the recovery has gained a firm footing. From that point onwards, however, fiscal adjustment will have to gather pace to return public finances to a sustainable path.

In the meantime, governments should refocus their expansionary measures, lay out reform programmes that will increase the credibility of their consolidation plans, and coordinate their fiscal exit strategies in order to make the most of the collective fiscal space for action.

If the exit from fiscal expansion is to be delayed, the content of fiscal stimuli should be shifted so that they, at least, support long-term objectives as well. Reallocating spending from unsustainable paths (such as protecting jobs in declining sectors) to activities that have the potential to foster stronger and greener growth in the future (such as investment in public infrastructure, active labour-market policies and training programmes) are cases in point. Focusing any tax rate cuts on activities that could foster green innovation is another example.

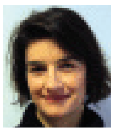
The current critical economic situation provides a window of opportunity for pressing ahead with reforms that will ensure the sustainability of pension and healthcare systems and make room in the future for the provision of public services that are vital for competitiveness, such as education. Some commentators have suggested, for example, that if the retirement age was increased by a couple of years, this would make a substantial contribution to reducing the current debt-to-GDP ratios, not only because of the resulting savings in public funds, but also thanks to the higher consumption by households that a longer working life could make possible. Unlike attempting to introduce labour-market reforms promoting flexibility at this stage, pension reforms could be agreed now to increase the credibility of the fiscal consolidation process and enacted a few years hence when economic conditions have improved.

Coordinating national fiscal consolidation programmes across the EU is also highly desirable to mitigate the adverse effect that public spending cuts could have on job creation. The Stability and Growth Pact has so far not proved to be a very credibly fiscal coordination tool, even at the best of times. As dealing with the fiscal aftermath of the crisis will inevitably take a good part of the next decade, a strengthened framework for fiscal coordination should be part of the agreement on the EU2020 Strategy.

Given the sharp deterioration in public finances and the current undershooting of inflation targets, steering fiscal policies back to normality is more urgent than with monetary policy. Exit strategies for fiscal policies should therefore come first. It will then be important for central banks to support growth and help spur domestic and external demand, provided that inflation remains within the price-stability target. This would serve to speed up job creation and minimise long-term unemployment, facilitating and increasing the effectiveness of labour-market reforms by enhancing employment security and reducing budget deficits and debts.

Given the tight constraints under which policies across the spectrum of demand and supply will have to operate to help European economies recover and pursue greater competitiveness and social cohesion, maximising coordination between them would decisively shape the recovery path from – and long-term consequences of – the current employment crisis.

However, the effectiveness of policy coordination to date has left quite a lot to be desired, even before the crisis. Devising incentive structures and frameworks within which such coordination can be achieved more effectively and across the policy arena should be high up on the EU2020 agenda. Whether the ongoing negotiations will deliver this remains to be seen.



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