wage taxes for the lowest paid. In this connection it is important that Member States agree to refrain from tax competition on capital and energy.

4. **Training** is intangible investment with real benefit to company and worker. We give examples of competence development and extensive company training that retain workers and lead to more jobs. Training is also a key weapon in our fight to reduce long-term unemployment.

5. Measures to facilitate **mobility between companies, regions and countries** will make an important contribution to reducing unemployment. There is a clear correlation between low mobility and high unemployment. Changing this will require new housing market provisions and allowing transfer of pension rights across Member States boundaries.

6. **Flexibility in working hours** - in a day, a week, across the business cycle - has been proven to increase competitiveness, with better response to market, higher customer satisfaction, more secure employment, new jobs. Such flexibility is obtained through local agreements, with sectoral and national agreements providing a general framework. Today's more decentralised labour market is also marked by different and changing tasks as well as novel forms of work organisation often deriving from the application of advanced information and communication technologies. All this implies new challenges to workers and employers, and to their respective organisations, with the need for them to adapt to new forms.

7. The social partners should act in concert to facilitate recourse to **part-time jobs** which can be of especial benefit for groups such as people with family responsibilities, the young and those approaching retirement.

8. More effort should be dedicated to the **cost-benefit analysis of EU social legislation** foreseen in the Maastricht Treaty.

9. The CAG reiterates its belief that modernisation of the labour market, and the fight for more employment in Europe, is not only social policy: it is essential for our **long term economic competitiveness**.

II. LABOUR MARKET, UNEMPLOYMENT AND COMPETITIVENESS

The growth in employment. European unemployment in 1995 stood at 11.1%. Economic recovery since 1993 has had only marginal impact on the number of jobless. This pattern is by no means new. Since 1973, each downturn of the business cycle seems to lead to a further, unprecedented, peak in the unemployment rate. Conversely, economic recoveries provide only temporary relief to the otherwise uninterrupted rise in the unemployment rate. Compared to the US, **unemployment in Europe is much more persistent**, particularly at the individual level. It is true that the probability of losing a job is substantially lower for a European worker than for one in the US; however, following job loss or at entry into the labour force, the probability of overcoming unemployment and finding a job in Europe is far below that in the US. As a result, **unemployment in Europe is typically of long duration.** Long-term unemployment accounts for 42.9% of total unemployment, against 10% in the US and 15.4% in Japan.

The lack of employment opportunities. European economies have also failed to create an adequate number of employment opportunities. The employment gains between 1986 and 1990 were all but lost in the subsequent recession. Since 1980, employment growth in Europe has averaged only 0.15%, in stark contrast to other OECD countries. In Japan, employment growth was 1.26% during the same period. In the US, it reached 1.54%. The difference between Europe and the United States cannot be ascribed to a faster rise in the population of working age in the US. As a matter of fact, the ratio of employment to working age population grew in the US from 71% in 1980 to 77.1% in 1995. During the same period, it stagnated in Europe, passing from 66.2% to 66.3%. **High unemployment rates and limited employment creation have taken a toll on the willingness of many Europeans to keep actively seeking for jobs.** Traditional ways of measuring unemployment are thus bound to underestimate the deterioration in the labour market. Allowing both for discouraged workers (those who would be willing to work but have stopped searching because they have little hope to succeed) and for involuntary part-time work (those who work part-time being unable to find a full-time job) raises the 1993 unemployment rate quite dramatically, from 11.5% to 14.7% in France and from 10.4% to 18% in Italy (Bureau of Labour Statistics, 1995). The exit of so many able workers from the labour market is a forceful indication of Europe's inability to put the available human and productive resources to good use.

Unemployment and competitiveness. Widespread unemployment represents a major threat to the cohesion of the European society. The view of unemployment as an (unacceptable) waste of existing productive resources is correct, but too narrow. First of all, **high levels of unemployment foster both poverty and emargination.** They therefore erode social cohesion, create a sense of social disfranchisement and may, at times, breed social conflict. Furthermore, they often undermine an individual's incentive to invest in his or her own human capital. Finally, with unemployment in two digit figures, the loss of a job can imply a long spell of unemployment, bringing real hardship. Plant closures can trigger the decline of entire neighbourhoods, even regions. It is difficult for those concerned to accept the logic. As a result, **growing unemployment typically strengthens political pressures in favour of more protectionism**, thereby further weakening the ability of European economies to take advantage of new opportunities and adjust. All these factors undermine our competitiveness. The fight against unemployment is not social policy: it is an economic imperative.

The causes of unemployment. The rise in endemic unemployment can to a large extent be traced back to a set of shocks that hit most industrial countries from the mid-seventies on. These include the two **oil shocks**, which compelled major restructuring of industry; **restrictive demand policies**, aiming to offset the inflationary impact of higher oil prices in 1979 and of the German unification in the early nineties; **high taxes**, also made necessary by the need to finance the rising costs of the welfare state; fierce **competition from newly emerging countries**, that hit labour-intensive sectors particularly hard; a pattern of **technological progress** that has put unskilled labour at a disadvantage. The impact of these shocks was then to some extent exacerbated by the lack of any coordinated response from European policy-makers. Similarly, weak **coordination** did not allow European economies fully to exploit the opportunities offered by a number of favourable developments in the second half of the eighties, with the precipitous fall in real oil prices and decline in inflation and in the nineties, the Single Market.

II.1. The need for a flexible response

Adjusting to a changing environment. Trade and technology are often blamed for rising unemployment. Their effect however is easily misjudged. History, particularly European history, teaches us that **technological progress and expanding international trade in time have always provided opportunities for sustained growth and employment.** By themselves, they cannot and should not take the blame for European unemployment. Technological progress and international competition can, however, be a source of dislocation and job loss, both in the short-run and at a regional level. Workers can indeed be made redundant by increasing productivity at unchanged output or by growing competition from imports. In order fully **to exploit the opportunities offered by trade and technology, firms, workers and governments alike must strive to adapt in a flexible and dynamic way to a continuously changing environment.** It is a great challenge. Firms may realise that cherished products or long-standing management procedures once a source of strength no longer retain their validity and have even become a brake on competitiveness. Workers and unions may find that old practices and even the notion of the life-long job may have become untenable in a steadily changing and competitive environment. Governments need to adapt as well, with policies which are more pro-active, aiming to exploit new opportunities rather than merely manage the problems of adjustment. Policies should be aimed at cushioning the price of adjustment, but they should be designed to protect people, not to protect jobs. Too often these simple messages have been all but forgotten in the past, at great cost to the European economy and to its people.

The need for action. The rise in European unemployment calls for courageous and coordinated action by Europe's policy-makers. We should not forget that things have not always been like this. In the sixties and until the mid-seventies, unemployment in Europe fluctuated around 3%, just half the level in the US. Today, it stands at 11.1%, almost six percentage points above the American level. We can and should do better. We must look at best practices both in Europe and elsewhere to devise a comprehensive strategy against unemployment. We need to examine the experience of other countries. This does not mean that we should try to replicate mechanically what has been done elsewhere. **Labour market institutions have been forged also to reflect the aspirations of European people.** They should not be discarded, rather be reformed after careful scrutiny of their social, political and economic role. For instance, minimum wage regulations are often said to be the main culprits for youth and unskilled unemployment. Yet, these regulations have helped Europe avoid a precipitous fall in the unskilled wage and a deterioration in income distribution. In the US, by contrast, income distribution deteriorated further, and this despite its initially highly unequal pattern. Europe's ability to preserve greater equity in income distribution is even more remarkable given that the unemployment rate among unskilled workers, albeit increasing, is no higher than in the US. All this being said, **the European social model does need to be reviewed and modernised so that it can better cope with the profound economic, social and demographic changes taking place throughout the world economy.** We argue that this reform can best be done by achieving a high degree of consensus among social partners in support of the necessary changes.

Toward a comprehensive strategy. The CAG believes that a sizeable reduction in unemployment is essential to strengthen the competitiveness of the European economy. Devising a strategy against unemployment is however a complex task. Prescriptions may differ between the different countries. No shortcuts are available. While each country retains responsibility for devising its own approach, we believe that **a comprehensive and coordinated European strategy in the fight against unemployment** should be developed. Such a strategy must emphasize the following factors:

(a) **Establishing a growth-oriented scenario.** For this we certainly require financial rigour, a check on inflation and a supportive macroeconomic framework to avoid insufficient demand hampering employment growth. We also must move more rapidly to full implementation of the Single Market Programme.

(b) **Implementing the infrastructure investments** necessary to manage and fully exploit opportunities offered both by new technologies and completion of the Single Market.

(c) **Promoting the growth of small and medium-sized enterprises**, known to be the major source of employment growth in Europe.

(d) **Promote life-long learning** so as to allow workers flexibly to adapt to the continuously changing needs of modern economies.

(e) **Promoting a new system of industrial relationships**, based on a cooperative approach between firms and unions to strengthen the ability of firms to compete in the international economy and provide workers with enhanced protection against the risk of unemployment.

(f) **Modernising the institutions governing the labour market and the other markets which have hampered employment performance.** Any proposed policy should aim at controlled deregulation, or reregulation, in all these markets (for labour, goods and services and capital) where institutional barriers stifle competition and employment growth, and at reforming so as to strengthen social institutions underlying our welfare systems.

The CAG has already stressed many of these factors, particularly the need for infrastructural investment, the role of small and medium-sized enterprises and the benefits of life-long education and learning. In this Report, **we focus on the role of macroeconomic policies, the need for incisive labour market reforms and the scope for a new approach to industrial relations.** We try to draw indications from companies and countries across Europe: In attempting this task, we have been surprised to discover that no benchmarking analysis of Europe's experience with labour market reforms and evolving industrial relations has ever been conducted. We hope that the bottom-up approach taken in this Report will allow Europe to identify lessons from best practices and to develop effective policy recommendations.

II.2. Establishing a growth-oriented scenario

A supportive macroeconomic framework. Macroeconomic policies can provide a major contribution to reducing unemployment by creating the conditions for sustained, non-inflationary growth. Three key variables have a shared responsibility in the maintenance of stable, low inflation. These are **monetary policy, fiscal policy and the evolution of wages.** Even if the ultimate responsibility for price stability lies with monetary policy, the more fiscal policy and wage behaviour are in line with the objective of low inflation, the more accommodating monetary policy can be. Macroeconomic policy can take into account the beneficial effects of structural reform in labour markets. Reform can, for instance, allow faster growth in output and employment without igniting inflation. Similarly, **the benefits of structural reform in terms of lower unemployment will not materialise if the macroeconomic stance is too restrictive.** A supporting macroeconomic policy is required to ensure that any potential increase in supply is matched by an expansion in aggregate demand.

The role of fiscal policies. Fiscal policies can play a crucial role in smoothing the impact of economic fluctuations. In the long-run, fiscal policies must be designed so as to prevent expanded government borrowing crowding out private investment and growth. Moreover, expansionary budgetary policies may clash with the Maastricht criteria. **The reduction in deficits should not, however, be accomplished by indiscriminate cuts in public investment expenditures,** as too often has been the case in the past. This temptation must be strongly resisted. In line with its previous Reports, the CAG recommends that the programme for infrastructural investment (in particular, Trans European Networks) be implemented as scheduled. This will boost the process of European integration as well as employment. We also believe that the Maastricht criteria regarding budget deficits should be interpreted in such a way as to acknowledge the crucial role that productive public investment (that financed, for instance, by the EIB) plays in enhancing competitiveness, employment and growth. Finally, we share the belief that the effectiveness of fiscal policy, both as a macroeconomic policy instrument and as a major influence on the pattern of resource allocation, would be greatly improved by the development of a common European fiscal policy.

The scope for monetary stimuli. In recent years, monetary policies have eased considerably, with ex-post short-run real interest rates in Germany falling from a high of 5 % in 1992 to 2.3 % in 1995. Over the same period, the real interest rate differential between Germany and the US dropped from 5.1 % to minus 1.6 %. **Further declines in real interest rates in Europe are both possible and necessary.** At present, however, they are precluded by continuing exchange rate uncertainty, credibility problems in the peripheral countries and a widespread fear that the **European Monetary Union** may be associated with laxer anti-inflationary policies. All this hampers growth by discouraging both domestic and foreign direct investment. These problems can only be exacerbated if the schedule for monetary unification is delayed. The CAG believes that **the resolution of monetary uncertainty is an essential step toward lower interest rates.** It may even require acceleration, certainly not delay, along the path toward monetary unification.

The role of wage policies. The task of macroeconomic policies would be made easier if wage settlements could also incorporate the objective of low inflation. Employers and the unions naturally have conflicting interests in the wage-setting process. All social partners should, however, acknowledge that a stable macroeconomic environment is a necessary prerequisite for high and sustained growth. Recurring spurts of inflation have a negative impact on growth. They discourage investment and force policy-makers to take corrective measures. Since 1993, however, wage restraint in Europe has overshot the target of 1% below productivity gains set in the Commission White Paper on Growth, Employment and Competitiveness. Moderate wage growth should prompt policy-makers to adopt policies supporting growth, otherwise moderation in wage bargaining could merely result in weak aggregate demand, not growth in employment and output. Appropriate behaviour in wage negotiations is therefore a necessary counterpart to any employment policy, both for micro and for macroeconomic reasons. **Moderation in nominal wage demands is necessary to avoid an inflationary spiral and to allow growth to proceed uninterrupted.** At the same time, **moderation in real wage demands can "buy" more employment by favouring a more labour-intensive pattern of growth and by boosting competitiveness and investment.** Finally, in addition to the wage level, the wage structure is bound to play a crucial role in determining employment performance. In particular, **more flexible wage differentials can enhance employment opportunities for disadvantaged workers** (young people, the low-skilled, workers in less favoured regions, etc.). Achieving the three goals of nominal and real wage moderation and relative wage flexibility may require a differentiated approach. **Nominal and real wage moderation may be facilitated by a centralised incomes policy framework; the goal of relative wage flexibility calls for a decentralised approach.** An appropriate institutional framework, that recognises the differences in wage institutions across the EU, will have to emerge to reconcile these different objectives. Incomes policies can play a useful role in this process. They can also be instrumental in ensuring that a reduction in inflation is not achieved through higher unemployment. Incomes policies must not, however, be seen by social partners as a way to extract concessions from central government which, in the end, end up aggravating the budgetary situation.

II.3. Reforming labour market institutions and building new industrial relations

Reconciling social protection and flexibility. Introducing a more flexible regulation of the labour market has been the focus of much oblate on unemployment. With respect to labour market institutions, greater flexibility first of all means removing limitations that have impeded the birth and development of several market segments (for instance agencies for temporary workers are still forbidden in some Member States). This is also an issue involving the regulation of several product markets (for example, restrictions on retail opening hours) and the institutional environment for the development of non-traditional activities (such as the non-profit sector). Recognising the need to strike a balance between the need of firms for flexibility and that of workers for security, **part-time work and temporary contracts** can increase employment opportunities for groups such as people with family responsibilities, young people and the elderly and offer a palatable alternative to early retirement. More widespread use of temporary contracts will also contribute to employment growth. Finally, **reform of welfare systems must emphasise limiting labour supply disincentives produced by certain welfare mechanisms and boosting labour demand, by lowering non-wage labour costs, particularly for less-skilled and disadvantaged workers.** In the second part of the Report, we take a closer look at Europe's experience with labour market reforms, with a view of identifying best practices which combine the objective of social protection with the need to improve the functioning of labour markets and reduce long-term and youth unemployment.

For a cooperative approach to industrial relations. Greater flexibility is often interpreted as tilting the balance of power in favour of employers. It can therefore be opposed by trade unions. Yet a more positively flexible labour market could, in many circumstances, benefit both workers and firms. For this to come about, it is essential that greater flexibility be achieved through a collaborative approach linking unions and employers. This is the essence of the Confidence Pact that President Santer has proposed to Europe's social partners. **A cooperative approach to a different organisation of work within the firm will improve industrial relations, allow greater worker participation in decisions and potentially lead to better product quality.** The latter in fact represents an essential component in any strengthening of the competitiveness of the European economy. Collaboration between unions and employers is also essential to achieve greater flexibility in working hours, thereby allowing firms to achieve a better match between utilisation of the labour force and fluctuations in product demand, while at the same time protecting workers against sudden layoffs. Overall, more flexible working hours will allow more effective use of the firm's productive capacity. It will lead to a reduction in labour costs and possibly to an expansion in employment. Similarly, unions and employers should strive to achieve a less restrictive approach to individual job descriptions so as to allow both more flexible utilisation of the existing labour force and improved incentives for on-the-job individual learning and the accumulation of human capital. In the third part of this Report, we look at several experiences in Europe in which a flexible and participative approach to industrial relations benefited both firms and workers.

III. LABOUR MARKET REFORM

Credibility and confidence are essential to generate the desired degree of labour market flexibility without creating greater uncertainty and hardship, and to avoid the waste of productive resources that arises from industrial conflict and loss of motivation.

Confidence Pacts and collective agreements can bring about a change in attitudes, moving away from the logic of conflict towards one of mutual understanding and cooperation. There are countries that have already taken steps in this direction. More action is needed, at both EU and Member State level, taking into account national characteristics.

In the following, we examine a number of collective agreements and (more or less developed) nation-wide confidence, or social, pacts. Labour market reforms are then examined, along with the lessons to be drawn, in a number of key areas: youth unemployment, the low-skilled unemployed, minimum wages, unemployment and poverty traps, long-term unemployment and (regional) labour mobility. Finally, we put forward concrete policy proposals.

III.1. A supporting framework: collective agreements and confidence pacts

At a time where structural adjustment is needed, a certain amount of **decentralisation of wage and employment negotiations becomes desirable.** Collective agreements at the sectoral or plant level take into account the local situation. The confidence, or social, pacts can give an **overall macroeconomic coherence.**

Collective agreement in the German chemical industry

90,000 jobs have been lost in the German chemical industry since 1991. This agreement concerns 605,000 employees:

- a limited nominal wage increase (2%) in return for a moratorium on job cuts from June 1996 till June 1997;

- a lower wage for new entrants (including trainees) during their first year of employment: 95% of the normal wage, reduced to 90% for long-term unemployed workers;

- an official statement by social partners to encourage flexibility in working hours and differentiation, promote part-time work and the hiring of trainees;

- employees over 55 to have access to flexible part-time arrangements paying 85% of the previous wage and spread over five years; new workers to be hired to take the jobs made available;

- overtime work to be compensated by reduced working hours later, rather than by wage payments.

Macroeconomic policy and confidence pact in Ireland

There is an explicit wage moderation agreement between the Irish government, employers and employees. Nominal wages may increase in line with anticipated inflation; rises in real wages must remain below productivity growth. This agreement has allowed Ireland to take full-advantage of the beneficial effects of sound fiscal policy (with a sharp reduction in the public debt that reduced the debt burden and eventually contributed to a rise in household disposable income) and of devaluation of the Irish pound. The recovery, initially due to export growth, is continuing now fuelled by growth in domestic demand (private investment and consumption). The expected GDP growth rate for 1996 is expected to continue to exceed significantly the EU average. The increase in domestic demand has benefited the local (labour intensive) service sector. The Irish unemployment rate remains high however, as a result of increasing participation rates.

The 1993 social pact in Italy

The agreement signed by the social partners in July 1993 related to incomes policy, wage negotiation procedures and labour market issues including short term contracts. Two formal round tables bringing together government, employers representatives and workers are now scheduled every year (in May and September), to facilitate consultation between social partners before definition of the principal economic policy objectives.

The July 1993 agreements gave Italy for the first time a formal, organised system of industrial relations. They define negotiating rules between employers and employees, both at national (for each sector) and at plant levels. The national level determines minimal wage increases. With the end of automatic wage indexation following confirmation of suppression of the *scala mobile*, wage negotiations take place every two years. If no consensus is reached after three (respectively six) months, wages are automatically increased by an amount equal to 30% (respectively 50%) of the forecast inflation rate. Conciliation procedures have been set up. At the decentralised level, wage increases are linked to productivity gains or to quality improvements.

The agreement also stipulated that the Italian government would set up and implement an economic programme aimed at stimulating the economy and increasing employment (including spending on R&D, infrastructure, urban renewal), especially in the South.

These agreements helped Italy avoid inflation after the steep devaluation of the lira. The strong economic recovery that followed in 1994-95 (mainly driven by exports) led to record capacity utilisation rates. Investment and private consumption expenditure remain relatively low however. This follows from uncertainty regarding public investment programmes, restrictive fiscal policy and wage moderation.

The role of collective agreement and confidence pacts

Similar examples of collective agreements and social pacts could be taken from other countries (including Belgium, France, Germany, The Netherlands). **From an EU point of view, it is important to ensure that wage moderation does not become synonymous with wage competition and/or create deflation.** Wage **moderation is to be seen as part of an overall macroeconomic strategy.**

III.2. Youth employment

The unemployment rate of young workers (under 25) is substantially higher than the aggregate unemployment rate (often twice as high) in almost all countries, including the US. In Europe, the rise in the aggregate unemployment rate has made the problem unacceptably more acute. Unemployment among the young is on average over 20% and, in some countries, over 30%. The issue is now of primary concern. **Youth unemployment higher than the national average is related to various factors: inadequate training, minimum wage constraints, employment regulations (via their effects on flows in and out of unemployment).** Over recent years, a number of policies aimed at reducing youth unemployment have been implemented. We examine here the effects of active labour market policies implemented in France. Minimum wage effects will be discussed later.

Training programmes in France

Various types of active labour market policies were implemented in France in the second half of the eighties. They provided subsidised job opportunities and on-work training for young unemployed workers. The policies differed in the amount of training provided, the length of the employment contract and the nature (private or public) of the employer. Training usually involved both the private employer and a vocational training agency. Incentives for a private firm to enter such a scheme were the opportunity to take on labour at a rate below the official minimum wage and exemption from all social security contributions.

Econometric evaluation of the effects of these policies on the employability of the beneficiaries has been made on the basis of panel data. The main results can be summarized as follows:

(i) firms select the relatively more educated or experienced workers;

(ii) a subsidised training scheme has a significant impact on the employability of the young workers and the probability of becoming long-term unemployed is reduced by 50% for workers with relatively low educational attainment;

(iii) the higher the training content of the scheme, the higher the probability of obtaining a stable job in the future; whatever the educational level of the beneficiary, public jobs (TUC) have the lowest impact on the probability of leaving unemployment;

(iv) for the workers concerned by these schemes, the duration of unemployment benefits has no impact on the probability of becoming long-term unemployed; benefit duration has a positive effect on chances of getting a stable job at the end of the period of unemployment.

The effect of training policies for the young

These results imply that **specific, carefully targeted and structured training policies involving private firms can help young workers enter the labour market.** They are especially useful for those who have a reasonably good educational attainment level (secondary school). Similar conclusions have been reached in other countries. Germany provides the best-known example of a very comprehensive and successful training and apprenticeship system. The French case study shows that good results can be obtained in other countries. **An important element of these schemes is the incentive that is given to private firms to participate, in the form of lower wage costs,** in part supported by the worker (the wage is below the official minimum rate), in part by the state (exemption from social security contributions). In Germany, 70% of jobs for young people are apprenticeships which pay from 26% to 37% of adult wages. Private companies may contribute (and in some countries do contribute) to this effort by subsidising or funding schools. Although the macroeconomic effects of such policies may, by themselves, be limited (as subsidised workers may take place of other workers or might have been hired anyway), they do contribute to reducing the relative unemployment rate of young workers.

III.3. Low-skilled unemployment

The unemployment rate of low-skilled workers is usually above that of high-skilled workers. This is true in the US as well as in the Union. This phenomenon was already observed in the late seventies. **Low-skilled workers have, however, been especially hard hit by the economic trends of the last twenty years.** Their relative unemployment rate has risen in most EU countries. Low-skilled unemployment now represents, on average, 50% of total unemployment in Member States - more than 60% in some. This situation can be explained either by the so-called **"ladder effect"**, by which high-skilled workers take the jobs of the low-skilled when the economy is hit by a negative macroeconomic shock, or by a genuine **structural change in the demand for labour** not matched by corresponding changes on the supply side or by relative wage costs. Both phenomena reflect **downward rigidity at the lower end of the wage scale.**

Improvement in the macroeconomic performance of European economies would contribute to solving this problem. Rigidity in relative wage costs is nonetheless an important issue. It can be tackled in several ways: by a decrease in minimum wage levels or cuts in taxes on labour, by subsidising low-skilled employment, by a mixture of these three. Tax wedges are now so high (the total wedge stands at around 40% of the cost of labour in many EU countries, with 24% coming from employer contributions) that a substantial relative cost change can be achieved in this way, without affecting take-home pay.

Social security contribution exemption in Belgium

In November 1993, the Belgian government decided to reduce employers' social security contributions for low wages (up to 42,000BF) by 50%. The exemption is progressively reduced for higher wages and disappears for wages above 60,000BF. The exemption from social contributions amounts to a 10% decrease of the total cost of wages for the lowest end of the scale. The direct loss of revenue to the Belgian government is less than half a percentage point of GDP.

The effects of such a policy are not easy to evaluate, especially taking into account the need to make up for revenue lost from other taxes (VAT, CO_2, withholding tax on interest income, etc.) or from cuts in other expenditure. Employment gains can come from a slow-down in capital-labour substitution as well as from genuine employment creation, for instance in services. Furthermore, it takes time for all the effects to appear. Macroeconometric models suggest employment gains of the order of 0.5% to 1% of total employment (some 22,000 to 35,000 jobs), or alternatively around 10% to 20% of the number of unemployed workers with low educational attainment. These are not negligible figures. Full exemption from employer social contributions for those at the lowest wages would double them.

Incentives to employ the unskilled

Exempting low wages from employer social security contributions could contribute significantly to improving the relative position of the low-skilled, without increasing income inequality. There is perhaps one caveat. Significant job creation for the least-skilled workers is only possible in the service sector. **A number of personal, and local, services are now kept out of the formal labour market (underground economy, do-it-yourself, unsatisfied needs) because of excessive costs and inadequate incentives. The change in relative cost needed to bring these services back into the official market is probably much larger** (compared to 10% in the above example). Such a radical change can only be obtained via well-targeted and specific initiatives aimed at fostering demand-solvency and "structuring" the supply side. An EC study on possible local employment initiatives in France, Germany and the UK estimates the employment potential of such actions at around 400,000 jobs a year. Several countries have taken steps in that direction (service vouchers in France; local employment agencies in Belgium; a new law in Germany aiming at reducing administrative and financial costs of job creation in the personal service and healthcare sectors).

III.4. Minimum wages

A decrease in minimum wages should help create new jobs for the most vulnerable workers, as suggested by the above examples concerning youth and low-skilled unemployment. Still, the effect of minimum wages on employment remains a much debated issue. Case studies in the US have suggested that a decrease in minimum wages may have little, or even negative, impact on employment. In Europe, France and the United Kingdom provide two contrasting cases.

Minimum wages in France

There is an economy-wide minimum wage (Smic), fully indexed to the cost of living and partially indexed to labour productivity. The government may (and on several occasions did) decide additional increases. From 1967 to 1986, the minimum wage increased steadily relative to the average wage. Since then, it has remained fairly stable. In the seventies, the ratio was similar to that in the US (around 0.45). It continued to rise during the first half of the eighties (up to 0.50) and then remained fairly stable, while it steadily decreased in the US (down to 0.36 in 1989). The proportion of workers paid at the minimum wage more or less doubled in France over the period (12% in 1987), while it was almost cut in half in the US (5% in 1988, against 9% in 1981).

The effect of the minimum wage on employment in France remains much debated. Econometric analysis of its effects on youth as opposed to adult employment indicated that the Smic has a significant long term effect on young workers's wages, little effect on adult (25 and above) wages. The effects on youth employment are negative though limited. Looking at the effect of the minimum wage on low- compared to high-skilled employment, the effect seems potentially larger, although the link between the minimum wage and the average low-skilled wage rate is not firmly established.

Minimum wages in the UK

There is no economy-wide minimum wage. During the eighties, Wage Councils provided a system of industry-based minimum wages, setting minimum pay for low-paid workers not covered by collective agreements and representing around 10% of total employment. At variance with other EU countries, the ratio of minimum to average wages has decreased in the UK since 1979. The ratio of the minimum to average hourly wage in Wage Council sectors dropped from 0.82 in 1979 to 0.68 in 1990. Wage Councils were abolished in August 1993.

Several microeconometric studies suggest that changes in minimum wage significantly affected wage dispersion. There is no strong evidence, however, that they significantly affected employment in the sectors directly concerned.

The effect of minimum wages

The impact of the minimum wage on employment is not easy to assess, probably because it depends on other inter-related factors. Its effect may vary from one sector to the other, depending, *inter alia*, on the degree of openness of the sector considered. It must be judged in the context of other policies and institutions (for instance, unemployment benefit levels). **Simple dismantling of the minimum wage system may have more impact on wage inequality than on employment.** To the extent that economic policy seeks to strike a balance between solidarity and economic efficiency, **the aim should rather be specific, targeted minimum wage adjustments**, especially to create more job opportunities for those (re)entering the labour market.

III.5. Unemployment and poverty traps

Tax and transfer systems have progressively become more sophisticated. Complexities lead in some cases to extreme distortionary effects. **Marginal tax rates are sometimes so high at low income levels as to discourage people of**

working age and unemployed workers from taking a job in the regular economy.

Unemployment traps in Belgium

In Belgium in 1993, a jobless married couple with no unemployment benefit entitlement would have received a transfer of 26,000BF per month (minimex). Both husband and wife would be allowed to earn, each month, up to 6,000BF as earned income (about one fifth of the net monthly minimum wage rate). This implies that they would probably never accept a full-time job offering them less than 32,000BF (or even 38,000BF), net of taxes.

Ways of eliminating unemployment and poverty traps

There are probably many examples like this in most EU countries. Every effort should be made to avoid this type of situation, while at the same time maintaining our commitment to alleviate hardship for the poor. Some people have suggested simplifying our present welfare systems by issuing benefits (as social dividend or participation income) independently of employment status, thus replacing existing forms of social transfers (unemployment benefit, family allowance, pension, etc.). Such a system would eliminate unemployment traps, but it could be extremely costly to implement. An earned-income tax credit (as used in the US) may provide an alternative, and easier to administer, solution. **The combination of unemployment benefits and earned-income credit is comparable to a subsidy per worker (focused on the low-paid), independently of employment status. It could thus help eliminate unemployment traps.** The difference from participation income is that these transfers are only paid to workers.

III.6. Long term unemployment

Long-term unemployment represents on average in EU countries about 50% of total unemployment. It is less than 10% of the total in the United States. The European figures do not take into account all workers in early retirement or social assistance schemes. This depressing situation is the outcome of several factors and we have already discussed some of them under youth unemployment, the weakened position of low-skilled workers, the effects of unemployment traps.

Long-term unemployment is related to the characteristics of the unemployment benefit system. It is not only the level, or the duration, of unemployment benefit that matters, but also all the institutional features of the system. The more the system can be monitored so as to avoid abuses, the more it can afford paying generous unemployment benefits without creating long term unemployment.