Council of the European Union

Brussels, 21 January 2015
(OR. en)

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COVER NOTE

From:	Secretary-General of the European Commission, signed by Mr Jordi AYET PUIGARNAU, Director
date of receipt:	15 January 2015
To:	Mr Uwe CORSEPIUS, Secretary-General of the Council of the European Union
No. Cion doc.:	SWD(2015) 4 final PART 2/10
Subject:	COMMISSION STAFF WORKING DOCUMENT Employment and Social Developments in Europe 2014 Job creation, productivity and more equality for sustained growth Introductory chapter

Delegations will find attached document SWD(2015) 4 final PART 2/10.

Encl.: SWD(2015) 4 final PART 2/10

EUROPEAN
COMMISSION

Brussels, 15.1.2015
SWD(2015) 4 final

PART 2/10

COMMISSION STAFF WORKING DOCUMENT

Employment and Social Developments in Europe 2014
Job creation, productivity and more equality for sustained growth

Introductory chapter

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While the EU has been seeing a recovery from the recession, with output, employment and household incomes growing and unemployment falling, the recovery remains extremely fragile and unequal, as witnessed by the recent downgrading of the GDP outlook in the Commission autumn forecast[1].

At the same time, the employment and social imbalances (and their cross-border impacts) that occurred during the crisis must as far as possible be prevented from happening in the future. The 'key employment and social indicators' scoreboard introduced in the 2014 European Semester should help a close monitoring of key factors - unemployment; young people not in employment, education or training; household income; poverty; and inequality – and will help detect challenges early and enable timely policy responses to be made.

Nevertheless, the EU's prosperity ultimately depends on economic growth, which results from employment growth and productivity growth. In order to develop this further we have looked at those labour market factors that constrain job creation, apart from weak demand and legacy effects from the crisis.

In this respect we particularly identify demographic developments as being liable to constrain future employment growth[2], putting further pressure on ensuring that the best use is made of all available human resources.

In so far as the contribution of employment to overall GDP growth declines over the coming 20 years, then productivity growth will be the only source of increased output in the EU[3] - hence the need to fully understand the links between productivity and education, skill formation and innovation.

After several years of decline, household incomes started increasing again slightly in real terms at the end of 2013. In some countries, very significant declines have led to strong increases in poverty, and together with high household debt levels, this is likely to undermine aggregate demand for some time, especially in countries where inequalities have also increased.

We examine the potential role of well-functioning labour markets and tax and transfer systems to restore a sustainable recovery of household incomes and a reduction of poverty and inequalities.

Unemployment, poverty and inequalities undermine sustainable growth by weakening aggregate demand in the short term and by affecting potential GDP in the longer term

[1] European Commission (2014), 'European Economic Forecast Autumn 2014', Directorate-General for Economic and Financial Affairs, European Economy N° 7/2014.

[2] 'The quantitative evidence shows that in less than 20 years EU employment will almost inescapably start declining in volume due to the intensity of workforce shrinking', Peschner and Fotakis (2013).

[3] Peschner and Fotakis (2013).

through reduced access for many households to education and health services, and hence sub-optimal use of human capital.

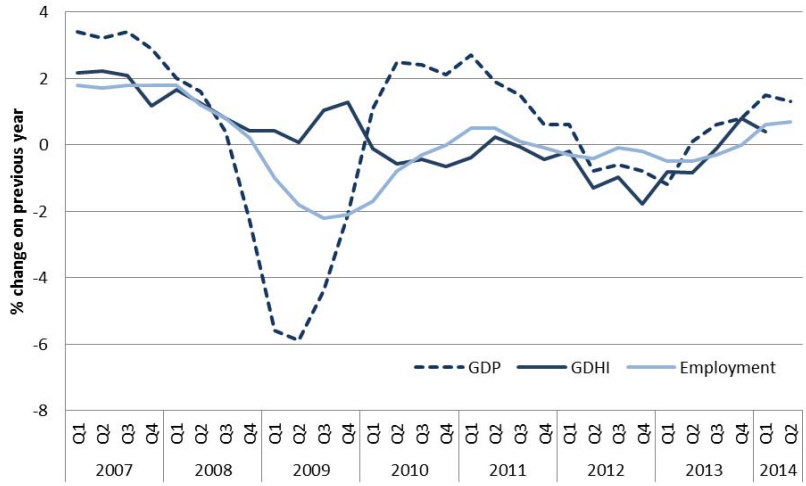
They can also lead to political instability, weaken trust in institutions and undermine the capacity of governments to conduct the reforms that are necessary to ensure that policies and institutions are supportive of growth. Such effects may also have impacts beyond borders and are therefore of common EU concern. Moreover, these effects contribute to increased divergence within the EU, specifically since the start of the crisis and which recently has stabilised at a high level.

The EU economy is facing an uncertain outlook, the recovery is not assured and isolated demand or supply policies cannot bring a sustainable recovery with job growth.

1. GROWTH, JOBS AND HOUSEHOLD INCOMES: RECENT DEVELOPMENTS

Although employment growth in EU28 turned positive at the end of 2013, as did growth in household disposable income[4] after nearly four years of continuous decline (Chart 1)[5], employment rates (for 20-64) remain well below pre-crisis levels (68.4% in 2013 vs. 70.3% in 2008) and a long way off the Europe 2020 target of 75%. While 6.7 million jobs were destroyed between 2008 and the first quarter of 2013, the number of jobs increased by 1.8 million up to the second quarter of 2014. Moreover, a large proportion of the new jobs created recently are temporary or part-time, raising concerns about the robustness of the recovery.

Chart 1: Growth in real GDP, real household disposable income and employment, year-on-year change



Source*: Eurostat, National Accounts, data non-seasonally adjusted [namq_gdp_k]*

The impact of the crisis on employment and the social situation increased as the unemployment rate rose from less than 7% in 2008 to 10.8% in 2013, putting 9 million more people out of work. The effects were unevenly spread across the EU however, with unemployment rates in 2013 still only around 5% in Austria and Germany against over 25% in Greece and Spain.

While the economic recovery is expected to strengthen only gradually, EU employment is foreseen to start growing from this year onwards, leading to a decline in the overall EU unemployment rate towards 9.5% by 2016, according to the Commission autumn forecast.

[4] The real GDHI growth for the EU is a DG EMPL estimation, and it does not include Member States for which quarterly data are missing (eight Member States). The nominal GDHI is converted into real GDHI by deflating with the deflator (price index) of household final consumption expenditure. The real GDHI growth is a weighted average of real GDHI growth in Member States.

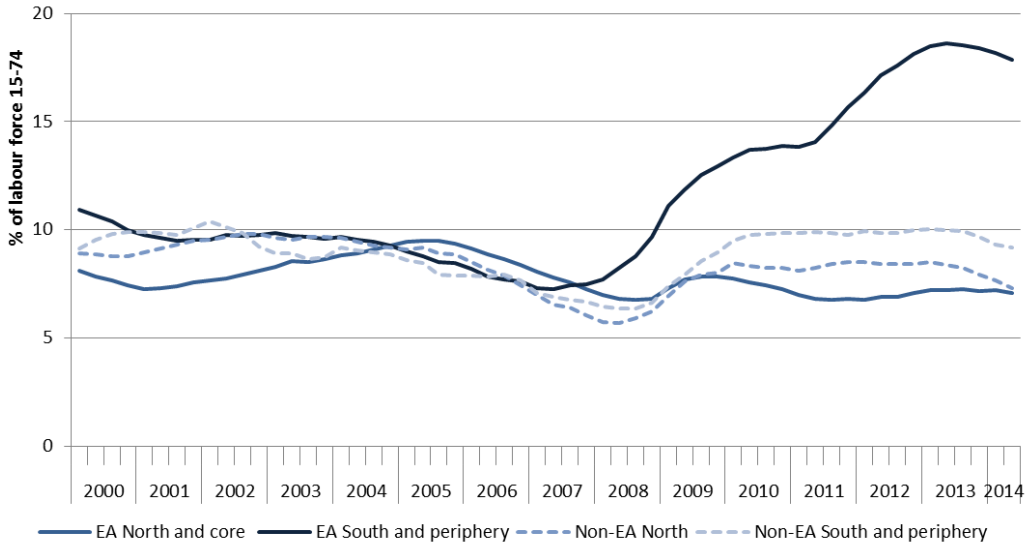
[5] See Section 5 for a detailed analysis of recent trends of the EU GDHI in real terms and its components.

Cross-country differences in employment are large. Between 2008 and mid-2014 most of the jobs were destroyed in Spain (-3.4 million), Italy (-1.2 million), and Greece (-1.0 million), while the number of jobs increased by 1.8 million in Germany, and by 0.9 million in the UK during the same period.

Employment divergence was reflected in cross-country differences in unemployment, particularly in the euro area, with Southern/peripheral countries seeing a massive increase while rates remained stable and low in the Northern/core countries (see Chart 2). The dispersion in unemployment rates is expected to start to decline only gradually, still remaining well above the pre-crisis level.

The convergence in the cyclical positions and the ongoing labour cost adjustment in high-unemployment countries would contribute to further reduce the divergence of labour market conditions in the EU. Nevertheless, the present divergence shows the need to look beyond the traditional macro-economic adjustment channels and consider changes in socio-economic factors and cross-border effects that may influence the depth and persistence of an economic downturn as well as the adjustment capacity of any given economy[6].

Chart 2: Unemployment rates in the EU by group of Member States

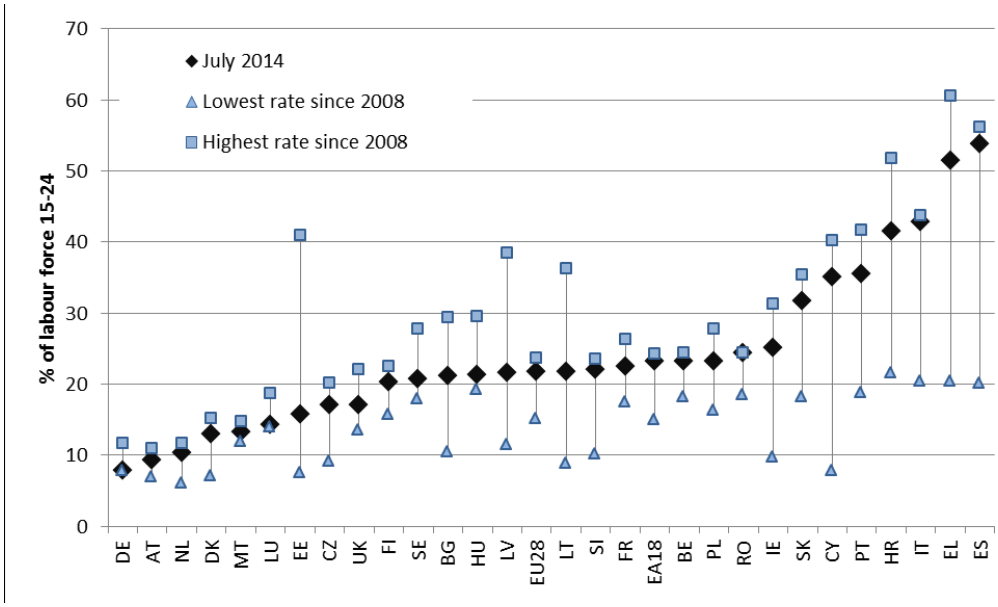


Source*: Eurostat, EU-LFS; DG EMPL calculations.*
Note*: EA North and core: AT BE DE FI FR LU NL, EA South and periphery: EE EL ES IE IT CY MT PT SI SK LV Non-EA north: CZ DK PL SE UK, Non-EA South and periphery: BG HR LT HU RO*

The situation of young people and the long-term unemployed is of particular concern. In almost two thirds of Member States, youth unemployment rates in July 2014 were still close to their historic highs - EU average of 21.7% compared to about 15% in the first half of 2008 - (Chart 3) while the proportion of young people not in education or employment (NEET) reached 13% in 2011 against 11% in 2008 (Chart 4). Again, however, it varies considerably between Member States while remaining higher than before the downturn.

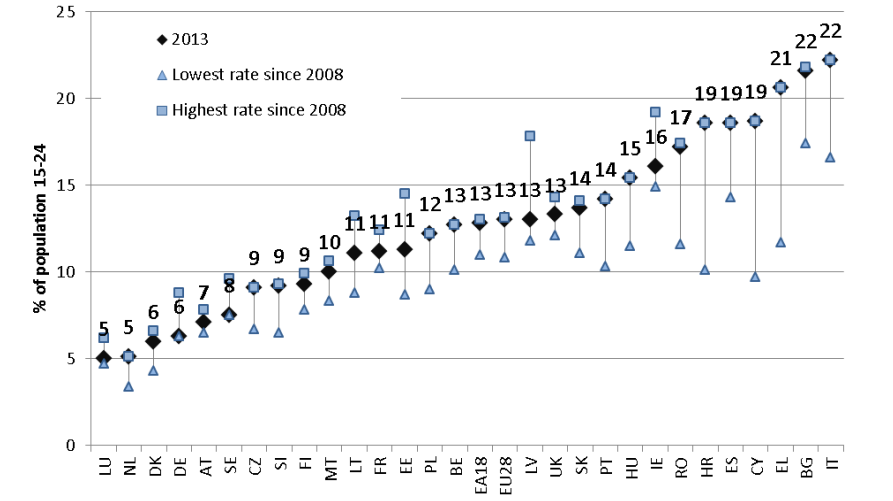
[6] See also Chapter 4 of this issue.

Chart 3: Youth unemployment rates in the EU Member States in July 2014 and the highest and lowest rates since 2008



Source*: Eurostat, EU-LFS data, seasonally adjusted [une_rt_m]*
Notes*: EE HU Jun 2014 UK EL May 2014 CY HR LV SI 2014Q2 RO 2014Q1*

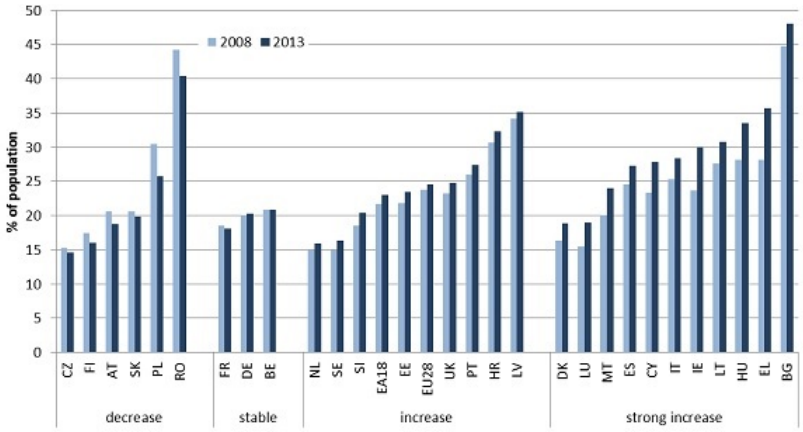
Chart 4: NEET rate for the EU, EA and Member States in 2013 and the highest and lowest rates since 2008



Source*: Eurostat, EU-LFS data [edat_lfse_20]*

Such severe labour market deterioration has had inevitable social consequences with the number of people at risk of poverty and social exclusion rising by more than 6 million since 2008, reaching some 123 million in 2013, and taking us further from the Europe 2020 target of having at least 20 million fewer people in or at risk of poverty and social exclusion.

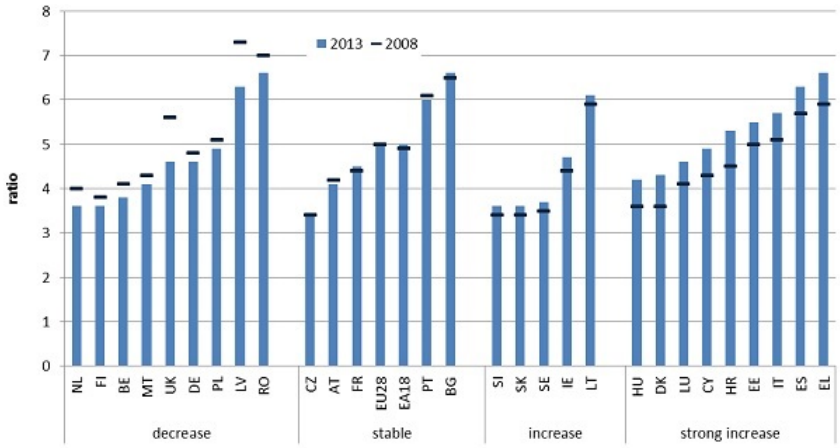
Chart 5: Evolution of the risk-of-poverty or social exclusion, 2008 and 2013



Source*: Eurostat, EU SILC [ilc_peps01], income year 2007, 2012*
Notes*: ES 2013 break in series (classified as strong increase based on 2008-2012 change), AT and UK 2012 break in series, HR 2010 instead 2008 and 2012 instead of 2013, IE 2012 instead of 2013, EU27 instead EU28 in 2008*

Poverty and social exclusion among those of working age (18-64 years) has increased significantly in two thirds of the Member States as a combined result of rising levels of jobless and low work intensity households, and in-work poverty. In Greece, Ireland, Spain, Italy and Hungary, poverty, social exclusion and inequalities have increased significantly from already high levels prior to the crisis.

Chart 6: Inequality of income distribution (income quintile share ratio S80/S20), 2008 and 2013



Source*: Eurostat, EU SILC [ilc_di11], income year 2007, 2012*
Notes*: ES 2013 break in series, AT and UK 2012 break in series, HR 2010 instead 2008, IE 2012 instead of 2013, EU27 instead EU28 in 2008*

2. OBSTACLES TO JOB CREATION

The legacy of the crisis poses significant obstacles to job creation now, which add to many of the obstacles that were present before the crisis and are still in place.

2.1. Weak demand hampers job creation

Weak demand is a major obstacle to job creation. While EU GDP growth was 1.2% year-on-year in the second quarter of 2014, potential growth estimates suggest little room for further acceleration from there under 'no policy change' assumptions. Commission estimates put potential growth in the EU at 1.0% in 2015, accelerating slightly to 1.4% in

2020-23[7]. The sober outlook for potential growth (in combination with high levels of private and public debt for many EU Member States) creates a difficult environment for job creation.

The policy environment remains difficult. Changes that could boost growth are, in the short term, faster wage growth in those sectors and Member States where it has lagged productivity growth and, in the medium term, policies to boost productive investment, specifically in human capital. A more expansionary fiscal stance in the euro area as a whole, within the limits of rules on national budgets would also be helpful[8].

Stronger demand and structural reforms should ideally occur simultaneously, with little impact likely to be expected from structural reforms (such as institutional, product market and labour market reforms) in a weak demand environment. As ECB President Draghi has put it: 'Without higher aggregate demand, we risk higher structural unemployment, and governments that introduce structural reforms could end up running just to stand still. … But without determined structural reforms, aggregate demand measures will quickly run out of steam and may ultimately become less effective.'[9]

Weakness in wage developments

Wages play a dual role in that they not only affect price competitiveness, but also influence domestic demand. In a weak economic environment, the propensity to spend out of labour income (and particularly for those at lower and average earnings and in the context of high private/household indebtedness as is the case in many Member States) is higher than the propensity to spend out of capital income[10].

Chart 7 shows the positive correlation between the change in the wage share and growth in domestic demand over the period 2008-13.

The weakness in the wage share can be linked to the decline in employment, as in the Southern Member States, as well as to weakness in wages. Wages were compressed and price competitiveness restored as a result in (euro-area) Member States with significant external imbalances. At the same time, in some other Member States, wage growth has significantly lagged productivity growth in recent years, pointing to further imbalances, as evidenced in Chapter 4.

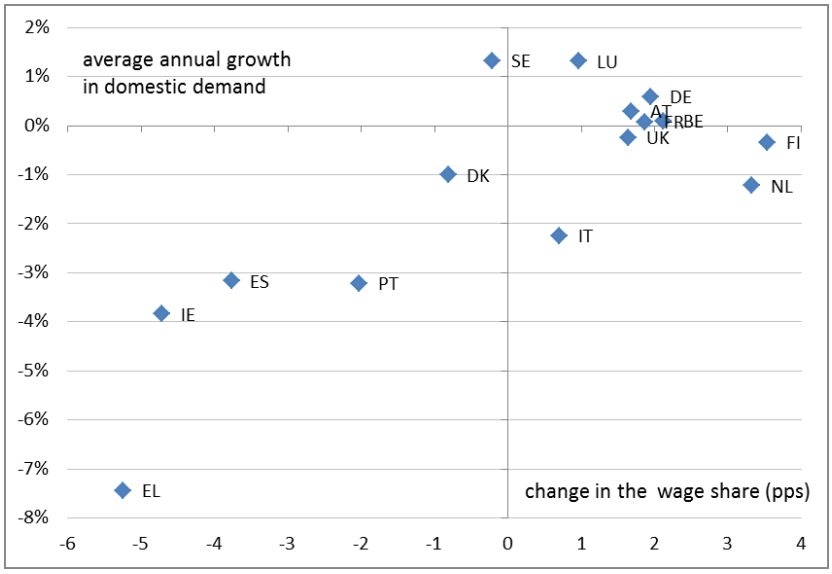
[7] '… the pre-crisis boost to capital accumulation did not lead to increased TFP growth. Post crisis, capital and labour resources are only gradually re-allocated to more productive uses, which further strains potential growth.' From 'The euro area's growth prospects over the coming decade' in European Commission (2013e).

[8] See also Draghi (2014).

[9] Draghi (2014).

[10] The wage share, which is compensation of employees divided by GDP, is also equivalent to the real unit labour cost which measures real (price-adjusted) compensation per employee adjusted for productivity and is a measure of price competitiveness. See Annex 1 of Chapter 5, 'Wage developments in the European Union during a severe economic downturn' of European Commission (2013c).

Chart 7: Changes in the wage share and growth in domestic demand, 2008-2013, %



Source: AMECO, ALCD0 and OUNT

Weak (capital and social) investment

Stronger investment not only supports growth in the short-term but also brings longer-term benefits. The evidence is now that the EU economy is investing far too little, with the overall share of investment standing at 17.3% of EU GDP in 2013, 2.7 pps below the average from 1995-2002[11].

Evidently, the weakness in private investment is linked to the weak economic outlook, while public investment has been under pressure from fiscal consolidation, leading some observers to reassess the appropriateness of the overall fiscal stance for the euro area[12]. It also explains the incoming Commission President's intention to present an ambitious Jobs, Growth and Investment Package[13].

The social consequences of low growth are such that there are clear benefits from an expansion in social investment across a range of areas: active labour market policies; early childhood education and care; preventive healthcare; health and safety at work; retraining and lifelong education; and human capital more generally (see also European Commission, 2013b).

In the area of education and training, including continuing and work-based learning, many Member States could improve the quality of their delivery systems. This is crucial to raise skill levels[14] and, as a result, the productivity of the workforce. It is, moreover, particularly pressing, given that expenditure on education fell between 2007 and 2011[15]

[11] Similarly, the 2013 investment share is below its 1995-2002 average in seven out of the nine largest EU Member States (France and Sweden being the exceptions).

[12] See Draghi (2014).

[13] See Juncker (2014).

[14] This need is suggested by the results from the recent OECD Survey on Adult Skills (PIAAC), see OECD (2013).

[15] 2011 is the latest year for which data are available.

in almost half of the Member States and even where it increased, did so by less than total government expenditure.

Education and skills are highly relevant to employers, with employer survey data showing that Member States whose employers look at human capital in a holistic manner (motivation, training, education at all skills levels) and value it highly achieve higher levels of competitiveness (see Chart 32).

2.2. Crisis legacy reinforces some obstacles to job creation

Job creation has been hampered by many obstacles, some of which have been reinforced by the lingering effects of the crisis.

Access to finance and the role of small and young firms

Small- and medium-sized enterprises[16] are traditionally seen as the motor of employment growth with, for example, EIM Business & Policy Research (2012) finding that, between 2002 and 2010, 85% of net new jobs in the EU were created by SMEs.

In the US, between 2002 and 2007, 58% of the net job gains in the private sector came from SMEs[17] and, after the job losses in 2008 and 2009, the share of SMEs was 51% of the gains from 2010 to 2013[18]. By contrast, between 2010 and 2013, employment in SMEs in the EU fell by 0.5%[19]. When excluding the construction sector, which employed one in seven SME workers in 2008, this turns into a slight increase of 0.3%, dwarfed by a 2% rise among large firms (see Chart 8).

Some of the under-performance of SMEs since 2010 may be due to SMEs reduced access to finance, with SMEs being more dependent on external financing.

To date, and in many Member States, credit availability to the non-financial sector remains weak, due to both supply and demand factors including sector restructuring and the deleveraging that followed the financial crisis[20]. Moreover, bank lending rates in the vulnerable Member States remain high despite recent ECB actions[21], and this has mainly affected SMEs.

Limited access to finance is also likely to have curbed the number of start-ups which is of concern given the evidence that, among SMEs, young firms account for a major share of net job growth[22]. The lack of dynamism in the employment record of SMEs since 2010

[16] SMEs, defined as those with less than 250 employed persons. The official EU definition combines this with a condition on either the turnover or balance sheet total, see http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/sme-definition/index_en.htm

[17] Here also defined as firms with less than 250 employed persons.

[18] Own calculations based on Bureau of Labor Statistics, Gross Job Gains and Losses, from Business Employment Dynamics (BDM). Note that there is an ongoing debate in the US about the role of SMEs in creating new jobs with papers using varying definitions of SMEs.

[19] European Commission (2013a).

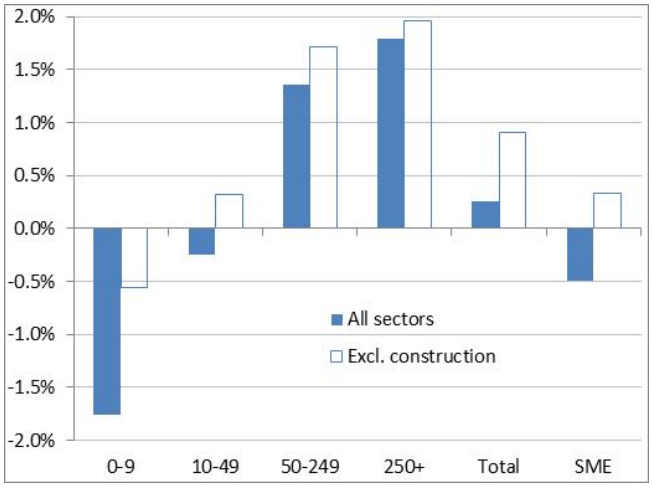
[20] See ECB (2014) and Turner (2014).

[21] They remain above the rates seen in the core countries.

[22] See, for example, Haltiwanger et al. (2010) and Lawless (2013).

shows the potential positive employment impact of appropriate solutions to financial sector problems and support for business start-ups.

Chart 8: Evolution of EU employment by firm size, 2010-2013



Source*: European Commission (2013a)*
Note*: Sectors covered are Nace R.2 B-J, L,M,N*

Policy uncertainty

A further hangover from the crisis that has blocked job creation in the recent past, and which risks continuing to do so, is policy uncertainty. Arpaia and Turrini (2013) used an indicator of policy uncertainty[23] that 'significantly (influences) the euro area unemployment rate indirectly, via economic activity, and directly'. Moreover, they find that 'policy uncertainty impacts mostly the process of job creation'. In this respect the strong relationship between the indicator of policy uncertainty and the Economic Sentiment Indicator (ESI[24]), together with the rise in the latter since autumn 2012, suggests that policy uncertainty has come down in the last two years[25].

Looking forward, changes to EU governance, specifically in the financial sector and the fiscal area, have the potential to further reduce policy uncertainty. Nevertheless, high private and public debt burdens in many Member States, with associated sustainability concerns, as well as the uncertain effects of structural reforms in some Member States, may hamper this reduction.

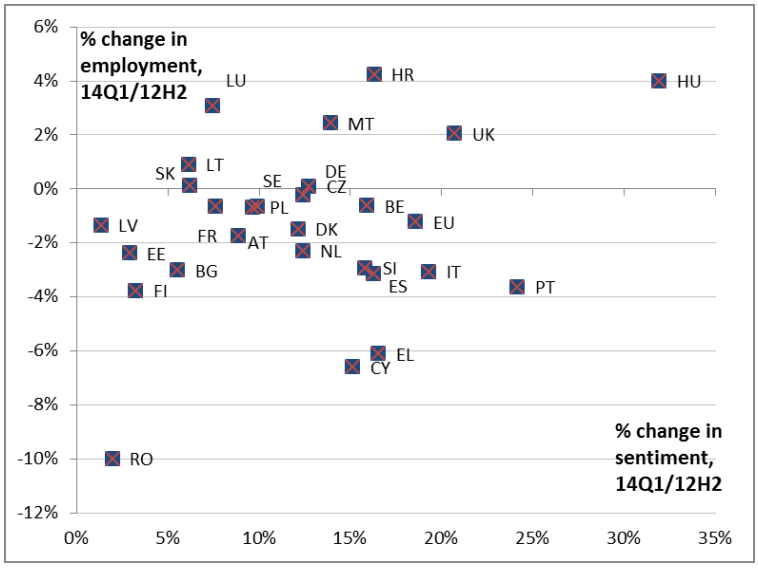
Policy uncertainty can be addressed to some extent through raising awareness by European and national policy makers of the potential positive effects of structural reforms and improvements in EU governance. On structural reforms, more clarity on the timing of its effects, usually with short-term costs but only medium-term benefits, would be generally helpful.

[23] Arpaia and Turrini (2013) measure policy uncertainty as an index constructed from two sub-indices, one made up from counting some uncertainty-related words in newspaper articles, and another one measuring the extent of disagreement among forecasters on some variables.

[24] The ESI, whose purpose is to track GDP growth, is calculated by the Commission on the basis of confidence indicators resulting from the Joint Harmonised EU Programme of Business and Consumers Surveys. The correlation between the indicator of policy uncertainty and the ESI evidently has a negative sign and the policy uncertainty index anticipates swings in the ESI.

[25] The ECB also found that economic policy uncertainty came down but still remains somewhat higher than its pre-crisis average level, see ECB (2013), Box 4.

Chart 9: Economic sentiment and employment, changes between the second half of 2012 of the first quarter of 2014

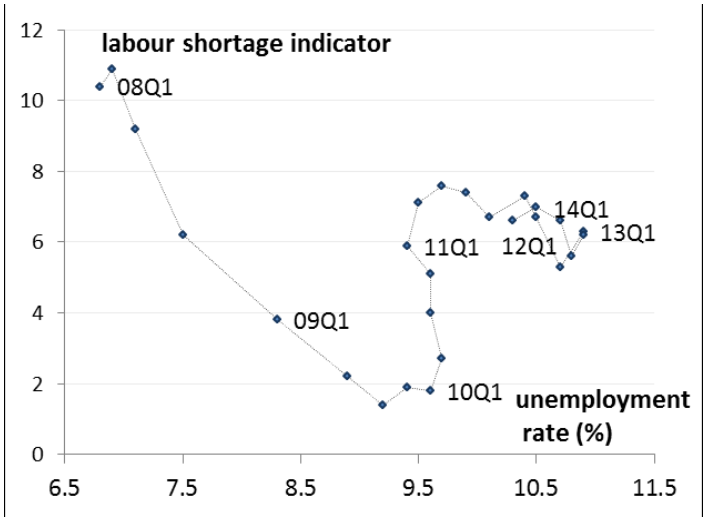


Source*: Eurostat, ei_bssi_m_r2 and lfsi_emp_q*

The addition of the scoreboard of key employment and social indicators to the Europe 2020 monitoring framework has the potential to bring a better assessment of the situation in individual Member States, which could pave the way for more policy fine-tuning at national level. It should also help in taking better account of the social impact of economic policies. Finally, stronger involvement of the social partners in the policy process at EU level, and in the Member States, would serve to promote a wider 'ownership' of policies and their delivery in a lasting way.

Skills mismatches

Chart 10: Beveridge curve for the EU



Source*: Eurostat, ei_bsin_q_r2 and une_rt_q*
Note*: The labour shortage indicator is the % of manufacturing firms pointing to labour shortage as a factor limiting production.*

Skill mismatch - the discrepancy between the qualifications and skills that individuals possess and those that are needed by the labour market – is a structural problem. Due to the intense job destruction and its concentration in certain branches of economic activity a strong increase in structural mismatch has taken place since the start of the crisis. The

evidence set out below points to increasing levels of skills mismatch in the EU, further aggravating current labour market difficulties[26].

In this context, the upward shift in the EU Beveridge curve (with a higher indicator for labour shortage for a given unemployment rate) suggests more labour market mismatches (see Chart 10). These mismatches are mostly linked to skills, as it seems that the sectoral mismatch follows a cyclical pattern (Arpaia *et al.*, 2014).

Table 1 shows that, when comparing the period since 2010 with 2008-09, the Beveridge curves for about half of the Member States seem to have remained stable. This includes a group of Member States which had seen a continuous increase in unemployment until recently and for which it might be still too early to assess the possibility of a shift in their curve (Greece, Spain, Cyprus and Portugal). However, the other half (including most of the large Member States) saw an outward shift, while an inward shift was only seen in Germany[27].

Table 1: Shifts in Beveridge curves between 2008-2009 and 2010-2014Q1

Shift? A given unemployment rate goes together now with a …	Valid for the following Member States:
higher indicator of labour shortage	(EU) BG, DK, EE, FR, HR, IT, LV, LT, NL, PL, SI, SK, UK
similar level of the indicator of labour shortage	BE, CZ, EL, ES, CY, LU, HU, MT, AT, PT, RO, FI, SE
lower indicator of labour shortage	DE

A serious mismatch in skills inevitably affects economic competitiveness and growth, increases unemployment, undermines social inclusion, and generates significant economic and social costs. This is a serious matter of concern given that one in three European employees is considered to be either over-qualified[28] or under-qualified for the jobs that they do, with the mismatch being especially high in Mediterranean countries (Chapter 6 in European Commission, 2013c).

Countries with high rates of over-qualification[29] share some common characteristics. They tend to have lower levels of public investment in education and training, lower levels of expenditure on labour market programmes, and more rigid and segmented labour markets, with the impact mainly affecting younger male workers on non-standard contracts.

The skills mismatch is not only a current problem, however, since it risks becoming bigger over time when the recovery accelerates and broadens, and new jobs will require new skills which are not necessarily available in sufficient numbers.

An effective reduction in the level of skills mismatch requires action on both the supply and demand side. In this respect reforms designed to increase the flexibility and

[26] See Chapter 6, 'The skill mismatch challenge in Europe' in European Commission (2013c).

[27] In the absence of structural changes, the unemployment rate and the vacancy rate (approximated here through the labour shortage indicator), would move along the curve during economic cycles. A booming economy then sees a lower unemployment rate associated with a higher vacancy rate and vice versa in case of a downturn.

[28] 'Over-qualified' does not mean that too much has been invested in the worker's human capital, just that their current employment does not make sufficient use of the skills and competences they have acquired.

[29] Countries with high over-qualification rates are Greece, Italy, Portugal, Cyprus, Lithuania, Spain and Ireland.

responsiveness of educational and training systems - including those to ensure the recognition of skills acquired outside of formal education or in another country - will need to be balanced by the creation of sufficient innovative and high-skilled jobs.

Tackling skills mismatches should also involve a significant degree of anticipation as, going forward, job creation will require different or higher skills and competencies (see Section 4.1), pointing to the need to invest in skills and adaptation of business strategies and human capital.

Low working hours and changes to work organisation

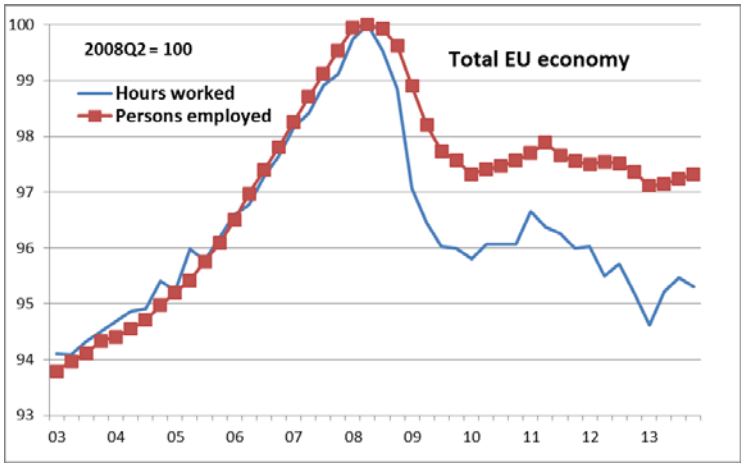
Since mid-2008 the total number of hours worked has fallen much more than the total number of people in employment (see Chart 11), and has continued to drop even as employment levels have stabilised (since mid-2010). This suggests that employment growth in headcounts may disappoint when economic growth accelerates, in so far as employers can be expected to increase hours of existing employees first before hiring additional workers.

This overall decline in hours worked is, of course, linked to an increased reliance on part-time employment, but also to a reduction in the average number of hours worked by full-time workers, falling from a weekly average of 41.0 in 2008 to 40.6 in 2013.

The number of those employed part-time exceeds the 2008 level by 8%, with a particularly significant increase for men and young people. Moreover, among those part-time employed the share of involuntary part-timers – i.e. those who would prefer to be working full-time - increased from just over 20% of the total in 2004 to almost 30% in 2013, with the proportion of male workers at 40%.

The increased reliance on part-time employment is linked to the uncertainty in demand prospects both during and since the crisis as well as to more flexible work organisation models that accommodate both companies' and workers' needs. While it may lead to higher employment numbers in the short term, it gives a misleading impression of the volume of employment and may equally give a misleading impression of the quality and sustainability of many of the jobs.

Chart 11: Evolution of hours worked and persons employed in the EU, 2008Q2=100



Source: *Eurostat, namq_nace10_e*

As a result of all these developments, the share of full-time employed persons in total employment fell by some 2 pps between 2002 and 2008, and again between 2008 and 2013, leaving the total number of full-time employed in 2013 5% below the level of 2008, with the risk that ongoing structural changes associated with technological changes and globalisation may reinforce such developments[30].

Apart from its effect on job creation, fewer working hours also weigh on household incomes and consumption, in particular if part-time jobs are concentrated at the bottom of the wage distribution.

2.3. Recurrent obstacles

This section focuses on the roles of labour taxation, undeclared work and labour mobility for job creation.

However, it does not focus on employment protection (which is analysed in Section 3), as the impact of employment protection legislation on the aggregate labour market seems less significant than the impact on specific groups[31]. EPL needs to be looked at as part of an overall labour market picture[32]. For example, some of the Member States that were most resilient in the crisis had and have quite high EPL; see for example the EPL values for Germany, Sweden, the Netherlands and the Czech Republic (Chart 27).

Labour taxation

For employers the level of their labour costs is a key determinant of their capacity to create jobs. An important part of labour costs is labour taxation, which affects both labour demand and labour supply. Cutting labour taxation can reduce labour costs and hence encourage employers to employ more workers[33]. At the same time, empirical evidence shows that a high level of labour taxation (as well as its design) can hamper the labour supply of workers[34]. In particular, the interaction of labour taxation and social benefits can create disincentives to work for specific groups such as young people, low-income workers, single parents, second-income earners and older workers.

In view of the negative labour market effects of high labour taxation, the EU has consistently asked many Member States to shift taxation away from labour onto other tax

[30] See Chapter 3 of ESDE 2014.

[31] See Scarpetta (2014).

[32] See also Section 4.1., 'The institutional balance of a healthy labour market: EPL, activation and support', in Chapter 1.

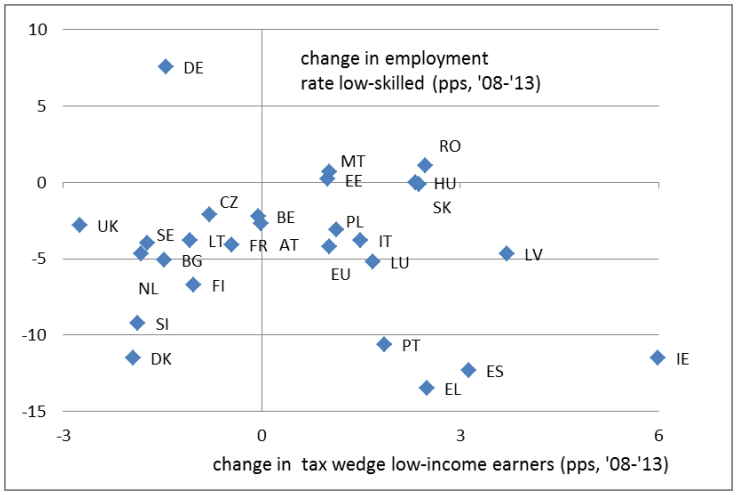
[33] The tax wedge on labour includes personal income tax, social security contributions of employers and employees and payroll taxes. In a perfectly competitive labour market with flexible wages, only the size of the total tax wedge matters since different components of the tax wedge exert identical effects on employment (see Chapter 4 of European Commission, 2013c).

[34] Theoretically, the overall effect of labour taxation on labour supply is uncertain or ambiguous. See also the summary of the theoretical and empirical literature on the impact of direct taxation on employment in OECD (2011).

bases in order to stimulate employment creation[35]. The benefits could be particularly high if tax reductions were targeted at the most vulnerable groups in the labour market, while recognising that the outcome might differ significantly between Member States depending on their characteristics and the composition of their workforce.

The optimal design of tax shifts from both an employment policy and social policy perspective is a complex task, requiring distributional impacts to be addressed. For example, the regressive effects of substituting VAT for labour taxes can be mitigated by compensating targeted groups (unemployed, retirees) and by focusing on standard rather than reduced rates and exemptions[36]. Similarly, green taxes linked to car ownership represent a lower tax burden for the lower income groups than taxes on heating and energy, and a proper taxation of imputed rent has socially favourable effects.

Chart 12: Tax wedge on low-income earners and the employment rate of low-skilled



Source*: OECD Taxing Wages, Eurostat, lfsa_ergaed*
Note*: Tax wedge: single earner, earning 67% of the average wage. Low-skilled: ISCED levels 0-2*

The desirability of some tax shifts could also be linked to other policy goals. A shift from labour towards green taxation also provides incentives for moving to a more green and resource-efficient economy, which could bring more sustainable and high-quality employment[37].

Targeting a reduction in the labour tax wedge to the groups facing the greatest challenges can maximise the employment effects of the reform limiting at the same time its fiscal costs. Simulations with DG EMPL's Labour Market Model for nine selected Member States show a pronounced employment impact when employers' social security costs for young workers are lowered by an amount equivalent to 0.1% of GDP, financed by higher VAT[38]. Tax shifts away from labour can reduce labour costs, in particular for the low-skilled and the young where such reductions can have a strong impact and are most

[35] The Eurogroup recalled that the 'overall tax burden in the euro area is above the OECD average and is skewed towards labour' (Eurogroup, 2014).

[36] See the conclusions of Chapter 4 in European Commission (2013c): "increasing standard VAT rates has less socially detrimental effects than curtailing VAT reduced rates and exemptions"

[37] European Commission (2014c) provided estimates of possible employment gains.

[38] More simulation results, with reductions targeted at other groups, can be found in Chapter 4 of European Commission (2013c). See also Chapter 3 of this issue.

needed. This makes handling the distributional implications of such shifts even more important.

Undeclared work

Undeclared work is categorised as paid activity that is lawful in itself, but not declared to public authorities[39]. The existence of undeclared work distorts the evidence on job creation in so far as only declared work is actually measured and counted and, more generally, it is seen to undermine conventional growth-oriented economic, budgetary and social policies. From a macro-economic perspective, it decreases tax revenues and may undermine the financing of social security systems. From a micro-economic perspective, it tends to distort competition between firms and to reduce efficiency since informal businesses typically avoid accessing formal services and inputs (e.g. credit) and hence tend to remain small.

Moreover, undeclared work is frequently associated with poor working conditions, limited prospects of career progress and a lack of social protection.

The scale and nature of undeclared work is influenced by many factors. Economic factors include the direct and indirect incidence of taxation and the 'cost' of complying with complex tax and labour regulations, as well as the penalties (or lack of them) related to enforcement[40].

Various features of the current labour market and social situation are likely to have been conducive to the growth of informal work, such as the increasing length of unemployment spells, the situation of relatively disadvantaged groups, and the pressure on wages and household incomes more generally. From the demand side, a difficult business environment may also have encouraged employers to seek to evade or limit tax liabilities by resorting to undeclared work.

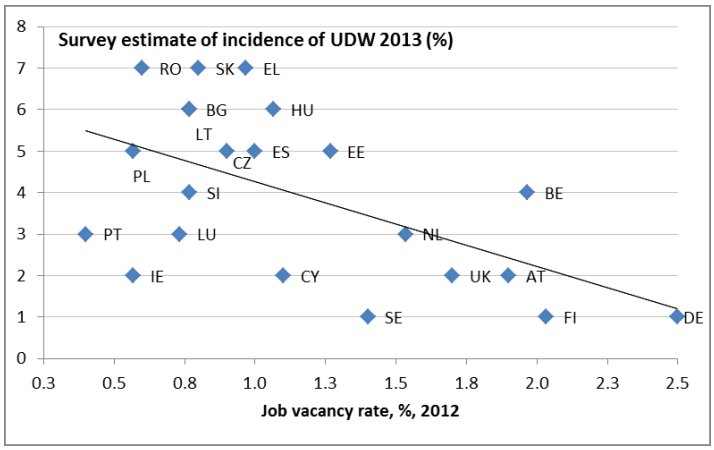
Tax evasion and inequality are closely connected. Higher levels of inequality are associated with a higher probability of tax evasion while tax evasion may increase income inequality, especially with respect to a situation of full tax compliance[41].

[39] Formally, the definition adopted by the European Commission is: '…any paid activities that are lawful as regards their nature but not declared to public authorities, taking into account differences in the regulatory system of Member States', European Commission (2007), p. 2.

[40] See also Chapter 4, 'Undeclared work: recent developments' in European Commission (2014a).

[41] See the conclusions of Chapter 4 in European Commission (2013c).

Chart 13: Job vacancy rate and undeclared work



Source*: Eurostat, jvs_q_nace2 and Special Eurobarometer survey 402, 2013, question 10: 'Sometimes employers prefer to pay all or part of the salary or the remuneration (for extra work, overtime hours or the part above a legal minimum) in cash and without declaring it to tax or social security authorities. Has your employer paid you any of your income in the last 12 months in this way? '*

Lack of mobility

Intra-EU labour mobility can play an important role in alleviating some of the conjunctural challenges faced by EU labour markets, notably by mitigating unemployment in hard-hit regions and countries and in addressing labour force shortages in more resilient ones, by contributing to a more efficient allocation of human resources across the single market, thus mitigating skills mismatches[42].

However, intra-EU labour mobility remains limited in comparison to other OECD countries (such as the US, Canada or Australia) and as a proportion of the overall size of the EU labour market. While one in four EU citizens say they would consider working in another EU country in the next ten years[43], until 2013 only around 3.3% of the EU economically active population resided in another Member State. In half of the Member States, only around 1% or less of the working-age population has moved to another EU country in the last ten years (see Chart 14) – and this is around 0.5% or less in large Member States, including Italy and Spain, despite being affected by high unemployment.

There is evidence that the current levels of mobility are below what could be expected from the EU as well as below the measured mobility intentions, especially as far as movements between euro-area Member States are concerned[44]. Indeed, due to substantial differences in unemployment rates between southern and northern Member States, the rising number of persons wanting to move has partly materialised in increased mobility from South to North since 2011 but only to a limited extent.

Mobility flows in the EU have reacted to the economic conditions, though not to the extent needed to have a real equilibrating role against the huge imbalances across EU labour markets. The limited intra-EU mobility is due to the many barriers such as differences in language and culture, administration, taxation, social security systems

[42] Jauer et al. (2014).

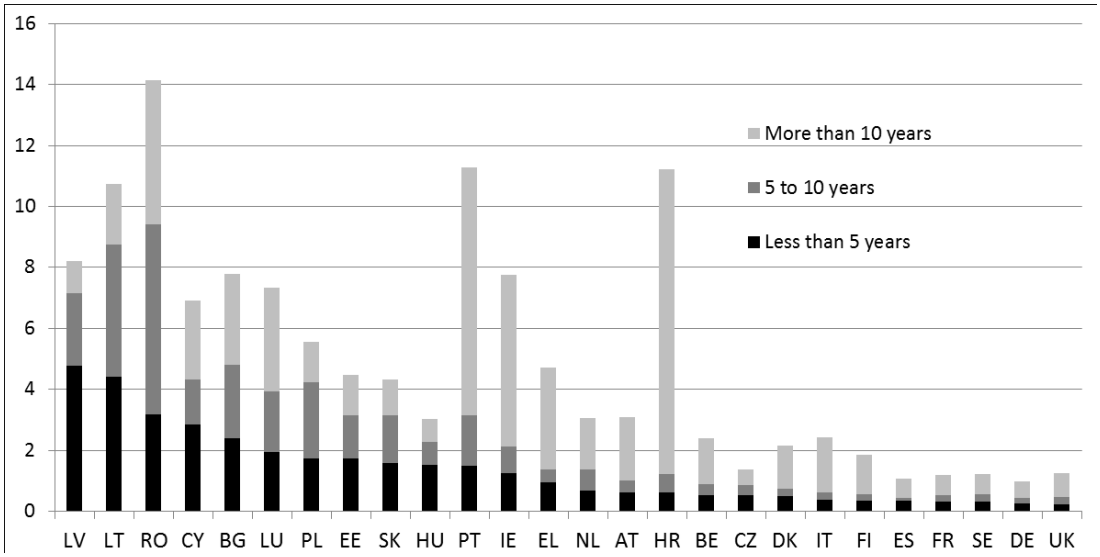
[43] European Commission (2013f).

[44] European Commission (2013d).

(including lack of portability of benefits) and mutual recognition of professional qualifications.

The main driving factor behind mobility between Member States is work, although family reasons and the wish to study abroad also play a role. In terms of labour mobility flows over the last decade, the main drivers seem to have been income and wage differentials, particularly between Eastern and Western Member States (Chart 14) where income differentials have been greatest[45].

Chart 14: Mobility rate by Member State of origin by years of residence (2013)



Source: DG EMPL calculations based on Eurostat EU-LFS.

Notes: The mobility rate is the number of working-age citizens living in another Member State in 2013, as a percentage of the working-age population of the country of citizenship. Figures for MT and SI are too small to be reliable. Figures for CY, DK, EE, FI, LU and SE are not reliable due to the small size of the sample.

This also suggests that the progressive narrowing of the income gap between EU Member States plus the movement of many activities in both manufacturing and service sectors from West to East in order to benefit, at least in the short term, from lower wages, should, in the long run, lead to a decrease in the size of the flows from East to West, already visible for some countries (such as Czech Republic or Slovenia). For the euro-area Member States, by contrast, current changes in relative levels of unemployment may increasingly act as a 'push factor'[46].

In terms of 'pull factors', the employment opportunities in the destination country seem to have been the most crucial driver, while generosity of the welfare systems or the legal regime[47] has had limited influence. As a result, there is no evidence in the data that welfare tourism is significant in scale or impact in the EU[48].

[45] Among euro-area Member States, a certain level of convergence in income had been achieved, at least before the crisis.

[46] See also the article 'Recent trends in the geographical mobility of workers in the EU' in European Commission (2014b).

[47] i.e.: applying restrictions during the transitional arrangements phase.

[48] See Guild et al. (2013) and Juravle et al. (2013).

Labour mobility could be fostered through developing more targeted interventions to better support cross-border jobseekers and employers and improving job matching across borders. The new Directive on free movement of workers[49] will certainly contribute to making it easier for people working or looking for a job in another country to exercise their rights in practice.

Moreover, various observers[50] have pointed out the need for a series of various other measures such as improving the transferability and tracking of supplementary pension rights, addressing concerns for taxation of cross-border pensions, improving the cross-border recognition of professional qualifications, tackling administrative obstacles for cross-border workers and their families and, finally, giving more support for language learning.

3. WHO WILL BENEFIT FROM JOB CREATION?

The Commission autumn 2014 forecast envisages employment growth of around 0.7% annually in 2014-16, but with the benefits liable to be unevenly spread across Member States and sections of the population. The logical question then is who is likely to benefit most from the creation of jobs?

This section starts by looking at those two groups on whom the legacy of the crisis weighs most, namely youth and the long-term unemployed. Next, it takes a broader look at the employment rates of various groups, the possible reasons for the differences in employment rates and possible ways to help curb these differences, with some attention to the issues of employment protection legislation and segmentation.

In this long period of labour market weakness, with 2016 employment still expected to be 0.5% below the 2008 level according to the latest Commission forecast, job search has been (and still is) a difficult process for many workers, with lasting effects, specifically those who searched for an entry (youth) or a re-entry (unemployed) into the labour market - the two groups we analyse here in detail.

3.1. Youth: more education and better skills can lessen the impact of lack of experience

The current labour market challenges facing young people are the result of underlying structural problems which have been aggravated by the crisis.

Young people have to overcome two difficulties as a result of their lack of work experience: firstly, they are likely to be less productive initially compared to existing workers, and, secondly, employers will be uncertain about their likely reliability as individuals. On the other hand, their recent education and better skills (e.g. ICT,

[49] Directive 2014/54/EU of the European Parliament and of the Council of 16 April 2014 on measures facilitating the exercise of rights conferred on workers in the context of freedom of movement for workers.

[50] See OECD (2014), Dhéret et al. (2013) and Bertelsmann Stiftung (2014).

language) may compensate for a lack of work experience, especially if it is seen to be relevant.

Young people often remain outsiders in countries with particularly segmented labour markets, experiencing lower employment rates, more precarious employment conditions and higher unemployment rates than the overall average.

While the employment rate of those aged 25 or over fell by a little more than 1 pps between 2007 and 2013, much larger falls were recorded for those aged under 25. All these developments come with an education gradient in the sense that people younger than 35 who have left education since at least three years have lower chances of being in employment than people with more education who have left education since less than three years ago (Table 2).

When they are employed, young people are more likely to be subject to more precarious employment terms and conditions[51] with some 43% being on temporary contracts - a share that has increased since 2007, while it has declined for those aged 25 or more. However, the share working on temporary contracts varies significantly across Member States, reflecting their different labour market regimes, being less than 10% in Romania and Lithuania and more than 60% in Portugal, Spain, Poland and Slovenia.

Table 2: Employment rates of young people (aged 18-34 years old) not in education and training by educational attainment level, EU-28

Educational attainment level	years after	2007	2008	2009	2010	2011	2012	2013
Total	3 years or less	75.2	76.2	72.0	71.1	71.2	69.9	69.5
Total	Over 3 years	78.2	78.5	75.6	74.9	74.5	73.6	72.8
Pre-primary, primary and lower secondary education	3 years or less	53.2	52.1	43.9	42.8	42.9	37.1	38.4
Pre-primary, primary and lower secondary education	Over 3 years	65.4	64.7	59.2	57.4	56.1	54.2	52.5
Upper secondary and post-secondary non-tertiary education	3 years or less	72.1	73.4	68.9	67.9	67.3	65.6	65.1
Upper secondary and post-secondary non-tertiary education	Over 3 years	80.3	80.9	78.3	77.9	77.5	76.5	75.5
First and second stage of tertiary education	3 years or less	84.0	84.4	80.9	80.0	80.3	79.5	78.6
First and second stage of tertiary education	Over 3 years	89.9	89.9	88.5	87.8	87.7	86.9	86.5

Source: Eurostat, edat_lfse_24
Note: "years after" refers to years since completion of highest level of education

Similarly, young people have a higher than average share of part-time employment (almost one out of three), with a larger than average increase in the share since 2007. In 2013, one out of four male workers under 25 had a part-time job, against one out of fifteen male workers aged 25 or older.

[51] These jobs often come with less pay, less security, less training and fewer pension rights.

As a result of the lower earnings associated with temporary and part-time jobs[52] young people with a job run a higher than average risk of experiencing in-work poverty. However such terms and conditions are not always one-sided. In Member States such as Germany, the Netherlands, Luxembourg, Austria, and Denmark, temporary contracts include a significant portion of apprenticeships or other employment forms linked to education and training, which are generally seen as providing effective stepping stones into regular and secure employment[53].

High unemployment of young people also affects the 25-29 age group – with a rate of 14.5% in 2013, rising to 28% for the least educated group. Overall, one out of three unemployed people aged 15-24 has currently been unemployed for 12 months or more, compared with one out of four in 2009, increasing their risk of becoming detached from the labour market.

The social problem is particularly acute for young people who are neither in employment nor in education and training (NEET) with the NEET rates having increased most for those aged 20-24 and 25-29 since 2007. For the 20-24 years old, the NEET rate for the EU currently stands at over 18.5% in 2013, an increase of more than 3 pps since 2007.

NEET rates for 20-24 year olds show a clear North-South divide within the EU, ranging from less than 10% in Luxembourg, the Netherlands, Denmark, Austria and Germany (but also Malta) to above 25% in Croatia, Bulgaria, Spain, Cyprus, Greece and Italy.

Best practices point to the value added of measures which improve school-to work transitions and, more generally, labour market insertion. Moreover, a comprehensive framework of EU measures exists to help tackle youth unemployment[54], the main ones being the Youth Guarantee[55], reforms of vocational education and training systems, support for public employment services and EURES (the pan-European job search network). The focus on the under-25s may not come at the expense of the 25-29 age group, which also requires policy attention due to a similar lack of job opportunities.

[52] 'The in-work poverty rate is on average almost two times higher for people working on temporary contracts or part-time' - Chapter 4, 'Is working enough to avoid poverty? In-work poverty mechanisms and policies in the EU' in European Commission (2011a).

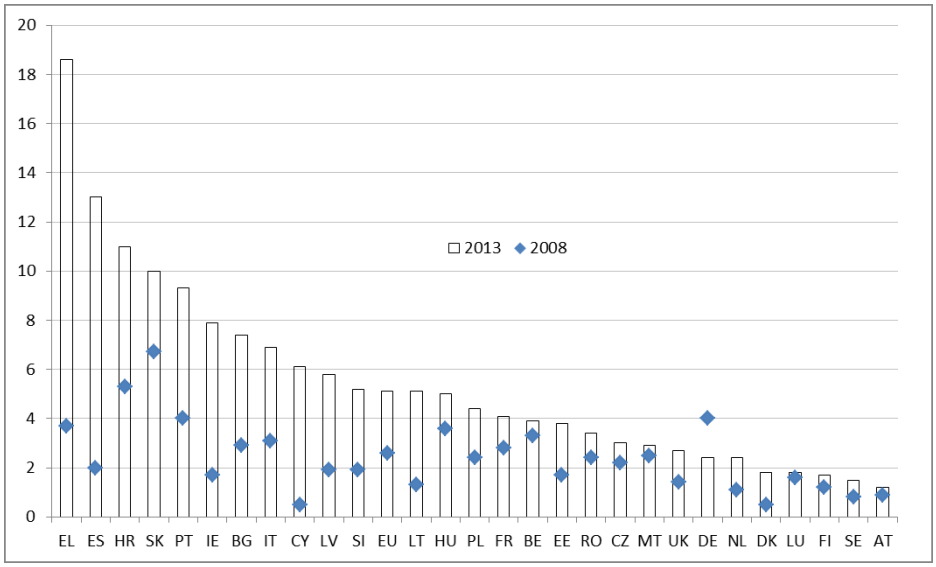
[53] See also ‘Special Focus: Youth labour market adjustment and temporary contracts’ in European Commission (2013d).

[54] See European Commission (2014d).

[55] The Youth Guarantee seeks to ensure that Member States offer all young people up to age 25 a quality job, continued education, an apprenticeship or a traineeship within four months of leaving formal education or becoming unemployed.

3.2. Long-term unemployment has doubled, different policies can help prevent and tackle it

Chart 15: Long-term unemployment rates, 2008 and 2013



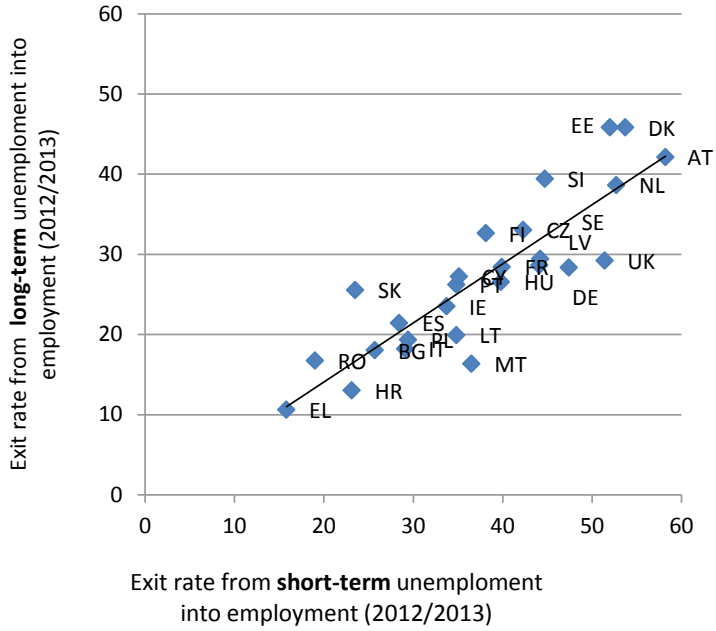
Source: Eurostat, une_ltu_a.

While long-term unemployment (unemployed since 12 months or more) has increased in most Member States in recent years, doubling between 2008 and 2013 at EU level, the problem is particularly acute in some Member States, notably Spain and Greece (Chart 15). In recent months, very long-term unemployment (since 24 months or more) has continued to increase, while overall unemployment has declined modestly.

Long-term unemployment affects some specific groups more severely than others: men, young people or low-skilled workers and, particularly, those employed in declining occupations and sectors, whose skills often need upgrading. In this respect, the most recent data on labour market transitions shows that inflows into unemployment have returned close to pre-crisis levels, but that outflows to employment have fallen for both short- and long-term unemployed.

The overall state of the economy remains a powerful factor in determining changes in levels and flows to and from long-term unemployment, but there are also strong country-specific effects with some Member States (such as the Netherlands, Sweden or Finland) ensuring high transition rates back to employment in contrast to others, for instance Slovakia, Greece and Bulgaria (see Chart 16).

Chart 16: Exit rate from short-term unemployment (less than one year) and long-term unemployment (more than one year) into employment between 2012/13



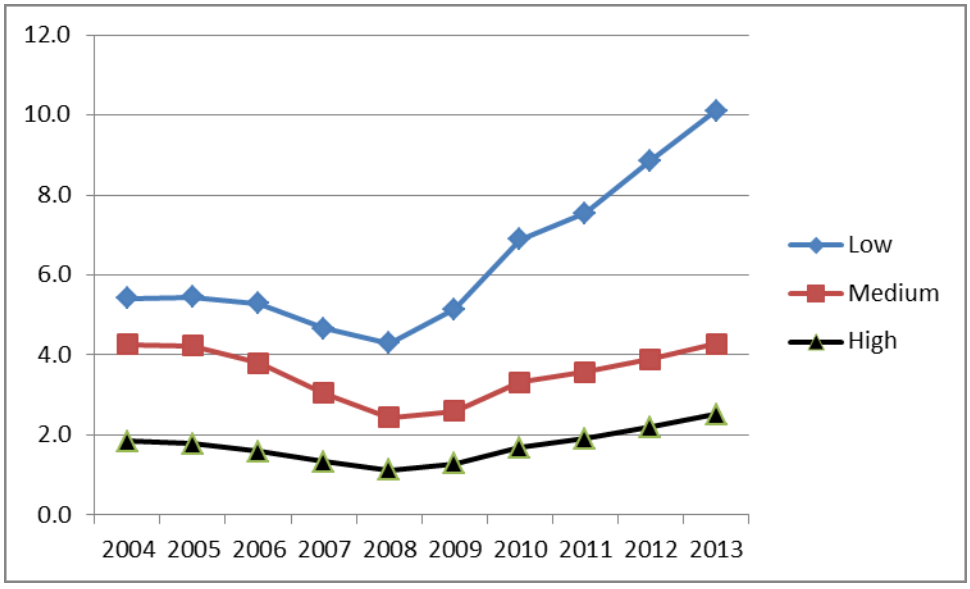
Source: Eurostat, EU-LFS, ad-hoc transition calculations based on longitudinal data. No data for BE and LU. Exceptions to the reference year: NL: 2011/12 instead of 2012/13.

In general, one in five of the long-term unemployed in the EU has never worked, three quarters of them being below 35 years of age, creating a strong risk of marginalisation. In Member States where temporary contracts play an important role, repeated multiple spells of short-term unemployment are a widespread phenomenon.

Participation in education and training helps to exit out of unemployment

Since 2008, the gap in long-term unemployment rates between low-skilled workers on the one hand and highly skilled and medium-skilled workers on the other has widened significantly (see Chart 17). In addition, low-skilled workers (and the unemployed) tend to participate less in training.

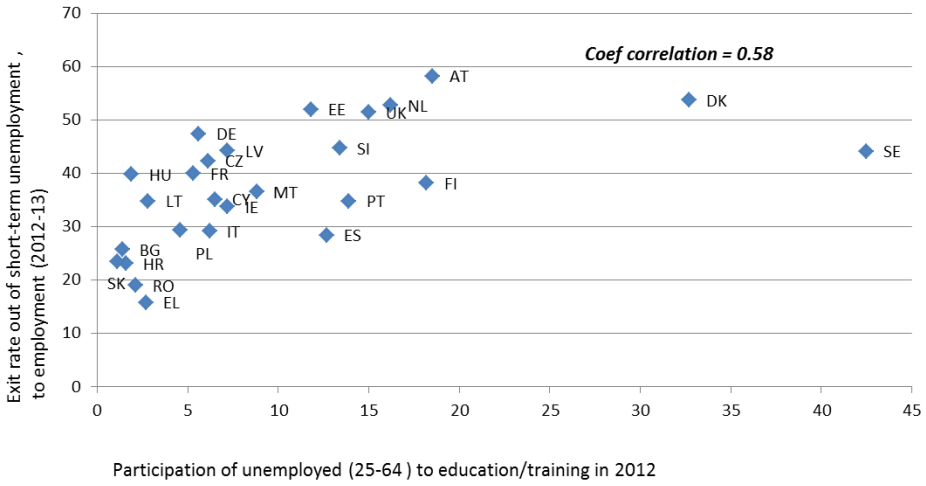
Chart 17: Long-term unemployment rates by skill level (% of labour force), 2004-2013



Source: EMPL calculations based on Eurostat data

Chart 18 shows that, in general, a higher participation of unemployed people in education and training comes with a higher exit rate out of short-term unemployment. The positive impact of participation in lifelong learning on economic performance is also illustrated in Section 4.3.

Chart 18: Participation rate of unemployed in education/training (in 2012) and exit rate out of short-term unemployment to employment (2012-13)

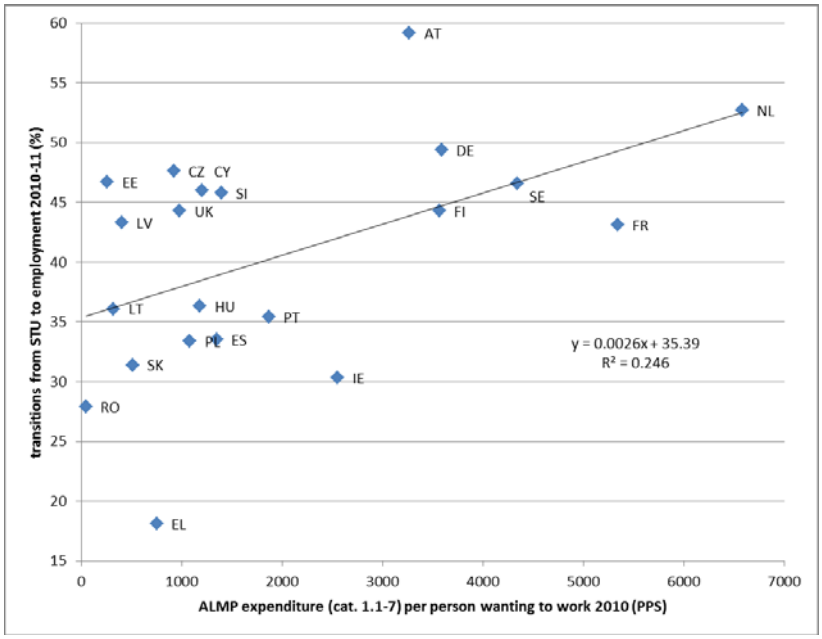


Source: Eurostat, EU-LFS, ad-hoc transition calculations based on longitudinal data

Member States' labour market performance is linked to activation, lifelong learning and coverage of benefits

The countries that spend most on active labour market policies (ALMP) per person wanting to work are among those with the highest exit rates out of short-term unemployment (Chart 19). Similarly, Member States with low levels of ALMP spending prior to the recession, but who increased or maintained their ALMP spending per person wanting to work (e.g. UK, EE, LV, SK and CZ), were better able to contain levels of unemployment.

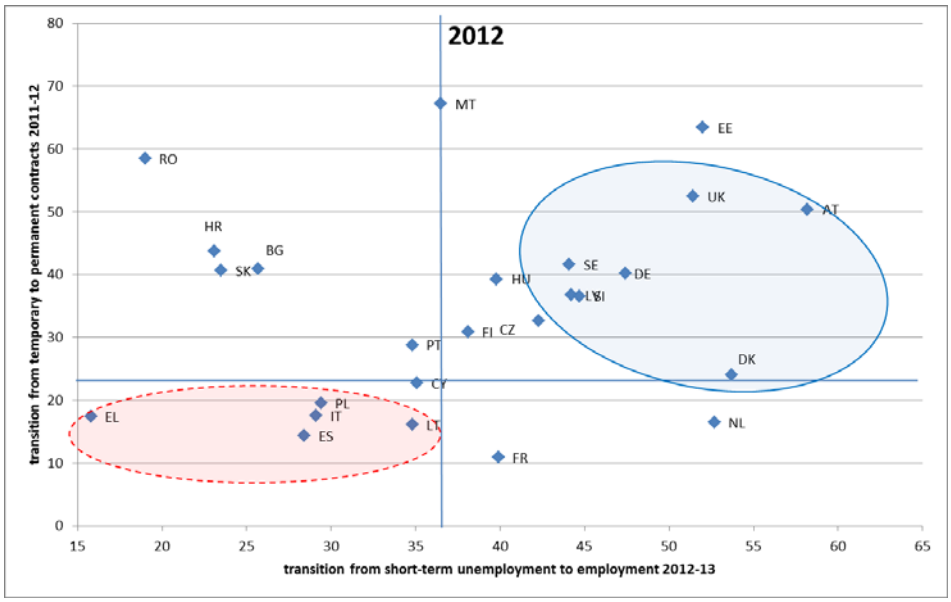
Chart 19: Higher spending on activation is associated with higher exit rates out of short-term unemployment



Source: Eurostat, EU-LFS, ad-hoc transition calculations based on longitudinal data and LMP database

Chart 20 shows that some Member States (identified as 'top labour market performers' in Chart 21) combine high returns to employment with the high transitions from temporary to permanent contracts, while others ('bottom labour market performers' in Chart 21) have lower transition rates in both cases.

Chart 20: Transitions from short-term unemployment to employment (2012-13) and from temporary to permanent contracts (2011-12)



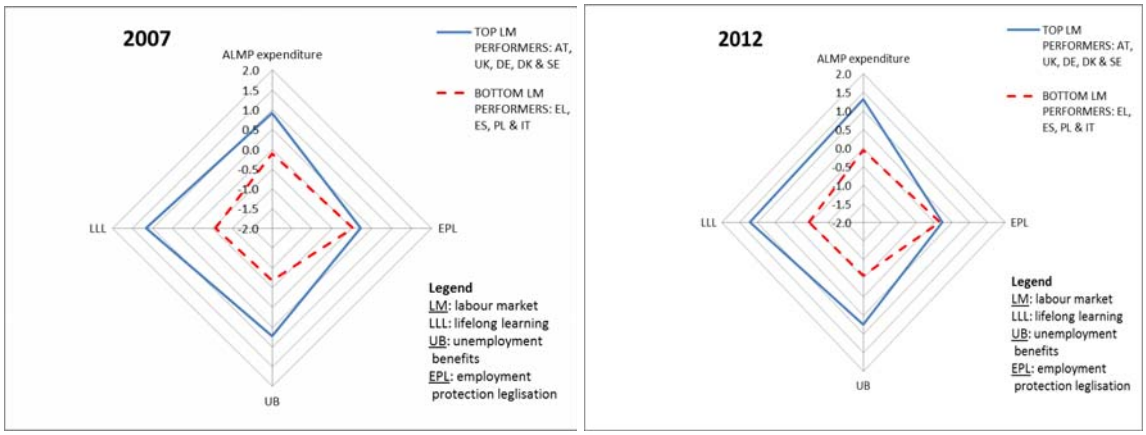
Source: Transitions from temporary to permanent contracts from Eurostat, EU-SILC.; transitions from short-term unemployment to employment from Eurostat, EU LFS, ad-hoc transition calculations based on longitudinal data.
Note: Blue line marks the EU average. 2010-11 values used for CY, HR, HU, MT, PL, PT, RO, SE and SK for transitions from temporary to permanent contracts and 2010-11 value used for NL short-term unemployment to employment transition.

Chart 21 illustrates the potential benefits of combining policy actions in that the countries with the best labour market performance – in terms of returns to employment from short-term unemployment and transitions from temporary to permanent contracts in 2012 – have significantly higher spending on ALMP, stronger activation conditionality, a higher

participation in lifelong learning and higher coverage and adequacy of unemployment benefits than the countries with the lowest performance.

During the crisis, countries with the lowest performance did reduce the strictness of their employment protection legislation, bringing some convergence of the protection of regular employment, but they did not improve on the other dimensions that seem also to have relevance, see also Chapter 1 of this issue.

Chart 21: Activation, lifelong learning and adequate coverage of unemployment benefits are associated with better labour market performance



Source: ALMP and UB spending data from Eurostat LMP database, Lifelong learning data from Eurostat (trng_lfs_02), data on opinions of managers (part of LLL component) is from IMD WCY executive survey and IMD World Competitiveness Yearbook 2012, eligibility requirements and job-search conditionalities for unemployment benefits are from Venn (2012) and EPL index is from the OECD database.
Note: The labour market institutions index is a composite Z-score index of EPL (permanent contracts and gap between permanent and temporary contracts v3), ALMP (expenditure in % of GDP and activation conditionalities), lifelong learning (participation rates of total population and opinions of managers about skills from IMD WCY executive survey) and unemployment benefits (expenditure per person wanting to work in PPS, eligibility criteria and coverage). 2008 EPL values were used for 2007 due to availability of data. The EPL values were all turned into negative values so that the lowest EPL gap and lowest EPL value for permanent contracts had the highest Z-score. The eligibility requirements (part of UB indicator) and job-search conditionalities for unemployment benefits have only 2012 data available in both years. The UB spending for 2012 uses 2011 values, expect for EL and UK for whom 2010 values are used. The mean value in 2012 for each indicator is that of the 2007 scores in order to be able to compare the 2012 scores with those of 2007. For 2012 ALMP expenditure 2011 values used for CY, ES, IE, LU, MT and PL, and 2010 values used for EL and UK. For EPL in 2007 for EE, LU and SI, 2008 values were used.

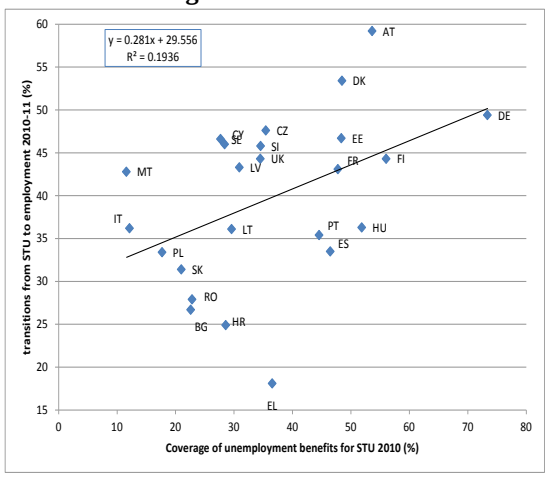
Returns to employment are linked to the coverage and adequacy of unemployment benefits

All other things being equal, there is some evidence that people receiving unemployment benefits have a better chance of taking up a job than non-recipients[56], and that adequate and widely available systems of income support do not prevent or discourage returns to employment (See Chart 22, Panel A – coverage and B – adequacy). This is likely the case for systems that are well designed (for example, reducing generosity over time) and accompanied by appropriate conditions (job search requirements, participation in training). Research also shows that receiving adequate income support also provides workers with enough time to search for a job matching their skills and/or to strengthen those skills where necessary.

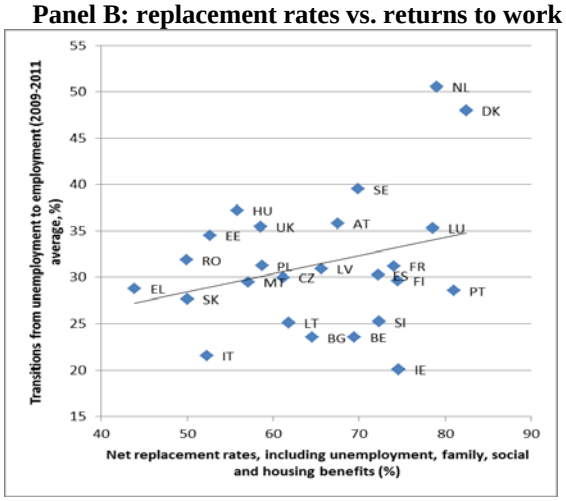
[56] See also Chapter 1 in European Commission (2014a).

Chart 22: Higher coverage and adequacy of unemployment benefits are associated with higher returns to employment

Panel A: coverage vs. returns to work



Panel B: replacement rates vs. returns to work



Source: Panel A: EU LFS, DG EMPL calculations. 2012 value used for coverage of UK in 2010. 2011-12 value used for transitions of DE and PT. No data available for BG, IE, LU and NL. Panel B: DG EMPL calculations based on Eurostat, EU-SILC 2009–10–11 longitudinal data and OECD-EC tax-benefit model.

However, the coverage of unemployment benefits for the short term unemployed varies greatly across Member States, ranging from less than 20% to more than 50%. This is due to variations in eligibility criteria and in the average time spent in employment, as well as to differences in the duration of benefits and in take-up rates. The coverage of last resort (means-tested) schemes that support the long-term unemployed who have no entitlements to other benefits also varies a lot. While both unemployment benefits and social assistance schemes are increasingly associated with activation measures (job-search support, access to training, individualised support), low coverage undermines the effectiveness of activation in encouraging and supporting actual returns to work.

This suggests that in order to restrain and reduce long-term unemployment, it is first necessary to reduce the inflow into unemployment, by supporting labour demand, while using measures such as short-time work arrangements in difficult times. In addition, the newly unemployed need to be supported to return as quickly as possible to employment, through appropriate activation and support measures. Policies addressed specifically at the long-term unemployed can then be most effectively deployed.

3.3. The structural issue of raising the labour market participation of specific groups

Overview: a higher employment rate among women, older people, young people and migrants is needed

The resilience of an economy depends in part on ensuring continuous wide-ranging labour market participation for all groups of workers. However, over time[57], convergence in this respect has only been for some groups (Chart 23).

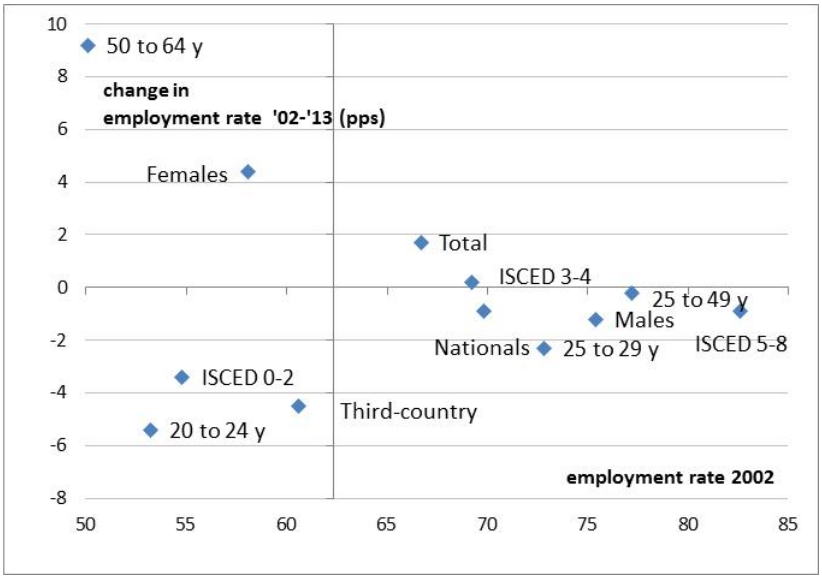
Taking the total as the benchmark, three groups can be distinguished. A *first group* consists of women and those aged 50-64 year of both sexes, which has shown some

[57] Unfortunately, no comparative data is available prior to 2002.

convergence in their employment rates even though in 2013 these still lagged behind the average employment rate of the total workforce by 6 and 9 pps respectively. Those aged 50-64 year saw a large increased in their employment rate overall, but with big differences between those aged 50-59 - with a rate of over 70% - and those aged 60-64 – with a rate of less than 35% in 2013.

The labour market situation of women and older workers will be analysed in further detail.

Chart 23: Some convergence in employment rates by groups, EU-28



Source: Eurostat, lfsa_ergan and lfsa_ergaed
Notes: Third-country nationals: series start in 2005 instead of 2002. Levels of education: ISCED 0-2: Pre-primary, primary and lower secondary; ISCED 3-4: Upper secondary and post-secondary non-tertiary; ISCED 5-6: First and second stage of tertiary education.

A *second group* consists of third-country nationals, workers with a low level of education (ISCED 0-2), and young people aged 20 to 24 years, who already lagged behind the average in 2002 and have performed weaker than average since.

Compared to the overall average in 2013, the employment rate of national workers is 0.5 pp higher, while the rate of foreign workers is 6.5 pps lower. Among foreign workers, a large divide has opened up between foreigners from another EU Member State (2.5 pps above the average) and third-country nationals (more than 12 pps below).

The skills of third-country nationals residing in the EU are very much under-used, in particular in the case of women. Since 2008, the employment rate gap between third-country nationals and national citizens has widened, especially in medium-skilled and high-skilled categories, noting also that many third-country nationals are over-qualified for the jobs they perform[58].

The *third group* includes all other groups of workers, who had above-average employment rates in 2002, but have not improved since. In almost all cases (the

[58] See 'Special Focus: Labour Market Situation of Migrants' in European Commission (2011b), Supplement 'Recent trends in the geographical mobility of workers in the EU' in European Commission (2014b) and OECD/European Union (2014).

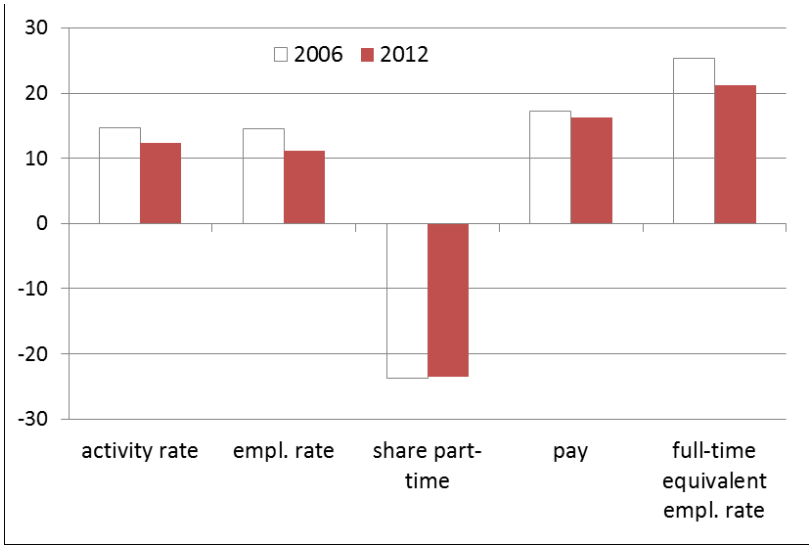
exception being ISCED 3-4) the 2013 employment rate was below its 2002 level, while remaining above the overall average.

For male workers, the above-average decline since 2008 reflects the fact that men are over-represented in sectors such as construction and manufacturing which were particularly hit in the recession.

Gender and labour market participation: fewer and worse jobs for women

While women have historically experienced unfavourable labour market (and social) outcomes compared to men, as reflected in persistent gender gaps on various criteria, women contributed more than two-thirds of the total growth in employment in the EU in the decade before the crisis and, during the crisis, the employment rate of women remained stable while it declined significantly for men[59].

Chart 24: Gender gaps narrowed during the crisis, mainly as men were hit harder



Source: Eurostat, lfsa_argan, lfsa_ergan, fsa_eppgan, lfsa_urgan, earn_gr_gpgr2, lfsa_ewhuna and lfsa_ewhun2
Note: The gap is the figure for males minus the corresponding figure for females
* The pay gap is 2008 and 2011.

The crisis actually resulted in a reduction in the gender gap on various criteria (see Chart 24). However, the underlying gender differences persisted in terms of labour market participation, pay and the risk of poverty. Moreover, since women tend to accumulate fewer total hours over their working lives than men, the total gender employment gap is larger than the simple comparison of employment rates suggests. Moreover, although this gap has narrowed during the crisis years, it is still high and persistent[60].

[59] When leaving out the sectors of agriculture, mining, manufacturing and construction, employment of both genders grew at about the same pace between 2010 and 2013. From 2008 to 2010, employment of women in this aggregate grew 0.8%, while it was stable for men.

[60] See also Chapter 3, 'The gender impact of the crisis and the gap in total hours worked' in European Commission (2014a).

While the lower rates of female labour participation can reflect individual preferences and be associated with some favourable effects, it still leads to diminished career opportunities, lower pay, lower prospective pensions and an underutilisation of human capital, resulting in lower GDP. Many societal or institutional barriers and constraints remain to be tackled in this respect and such structural labour market and social inclusion challenges may harm both the supply and demand side of the EU labour market.

Although Member States perform differently in terms of hours worked by men and women, there are some different patterns: in some cases a high share of women are working but for relatively short hours; in others female participation is lower but, once in employment, women tend to work relatively longer hours. Relatively few Member States succeed in combining high female employment rates with a low gender gap in terms of the total number of hours worked.

Factors that have been identified that allow a combination of high participation and longer hours for women are gender-equal working time, widely available flexible work and employment-friendly, accessible and affordable childcare with longer day-care hours[61].

Older workers: active ageing

Despite the success in raising the employment rate of older workers over the last decade to close to 50%, achieving the target overall employment rate of 75% for workers of all ages by 2020 depends in part on sustained progress in this age group given that the working population in the EU is projected to age significantly in the coming decades which will pose a major challenge to the sustainability of an (un)adjusted European Social Model[62] (Chart 25).

In order to encourage and assist older people to remain active longer, appropriate policy responses or incentives will need to be targeted on both workers and firms, since market forces alone are unlikely to succeed given that the decision on whether to retire or remain in the labour market is a complex one, and not just dependent on financial considerations[63].

Individual and household characteristics will play their part, including the worker's education level[64], the health of both the worker and spouse, and the spouse's activity. Institutional factors include the way older earners are treated in tax-benefit schemes, the retirement eligibility conditions, and the influence of the statutory retirement age.

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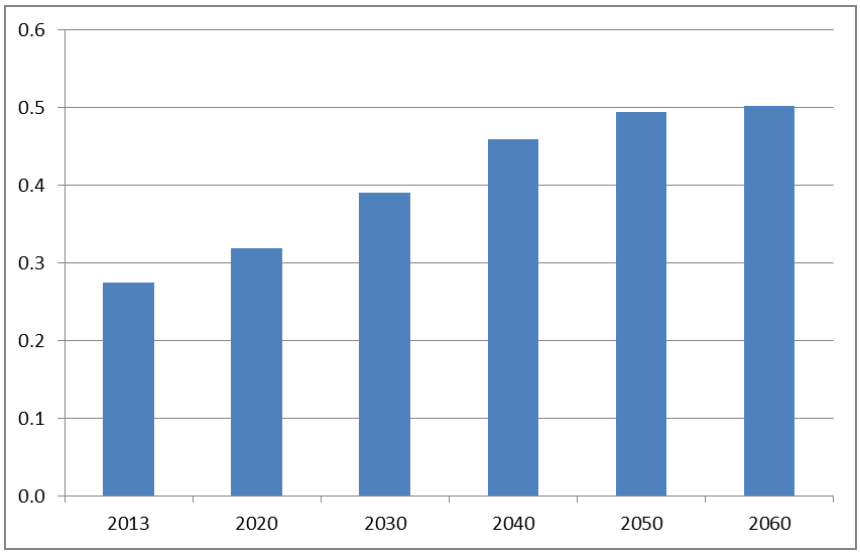
[61] See European social partners' agreement on parental leave http://ec.europa.eu/social/main.jsp?catId=521&langId=en&agreementId=5129, implemented by Council Directive 2010/18/EU.

[62] See also Peschner and Fotakis (2013) and European Commission and the Economic Policy Committee (2012).

[63] See also 'Chapter 5: Active ageing' in European Commission (2011a).

[64] Older workers with higher education levels have higher participation rates.

Chart 25: Old–age dependency ratio in EU-28



Source: DG EMPL calculations on the basis of Eurostat EUROPOP2013 - Population projections
Note: The old-age dependency ratio is the ration between the population aged 65+ and the population aged 16-64

Factors affecting differences in employment rates, including employment protection legislation

Many factors affect the differences in labour market outcomes of different groups with their relative importance being almost always country-specific and including structural issues as labour taxation and benefits (and the associated unemployment and inactivity traps), childcare access, retirement rules, the level of minimum wages, the labour market adequacy of the education system, as well as cyclical issues such as the strength of demand.

In this chapter, some of these factors are discussed when the labour market outcome of a specific group is discussed, others when the general obstacles for job creation are reviewed. Often it is argued that employment protection legislation (EPL) – essentially the set of rules governing hiring and firing[65] of employees - has a strong link to labour market segmentation and hence can be harmful for new entrants.

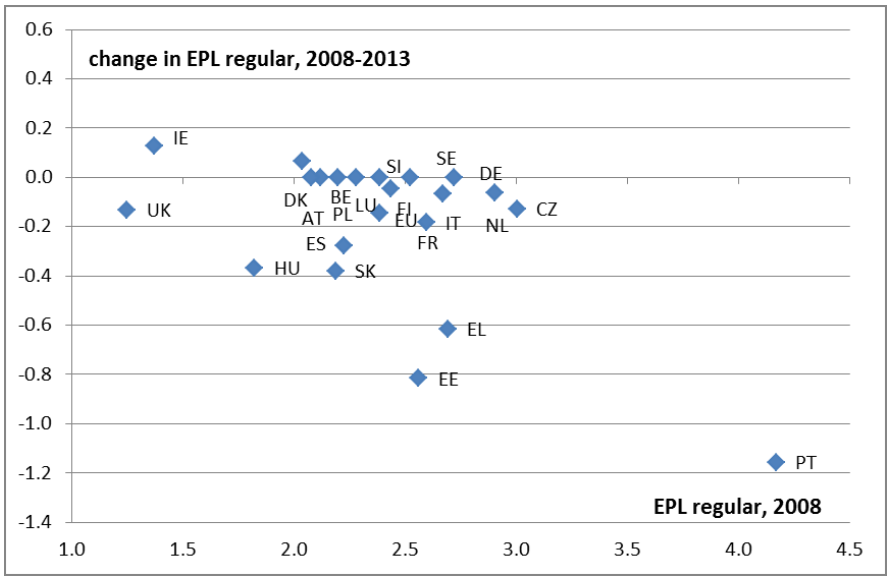
EPL seeks to balance the interests of firms and workers. Firms have to be able to adapt their operations quickly, including adjusting the size and composition of their workforce, while the workers need protection against job loss. There are the publicly borne financial and social costs linked to unemployment. Productive economies also need motivated workers willing to contribute to the success of their company and a certain degree of job protection can encourage such behaviour.

EPL legislation has evolved in recent years with around half of Member States having reduced protection on regular employment with the objective of helping to combat labour market segmentation (Chart 26), although Greece and Spain have also reduced protection of temporary contracts[66].

[65] The hiring rules are the conditions for the use of standard and non-standard labour contracts. The firing rules are the rules on individual and collective dismissals of workers on standard permanent contracts.

[66] Please note that the EPL data are only available for OECD member countries, excluding the other eight EU Member States from the analysis.

Chart 26: Convergence in EPL on regular employment, 2008-13



Source: OECD Employment and Labour Market Statistics, Strictness of employment protection legislation: regular employment, Version 3 (EU = median of available Member States)

Large costs and rights differences between permanent and non-standard work[67] contracts are seen to encourage companies to opt for a prominent use of the latter. As a consequence, these jobs often do not serve as a stepping-stone to more permanent forms of work and rarely provide for sufficient access to lifelong learning, social protection (including pension rights) and monetary protection in the case of termination without fault. This is one aspect of labour market segmentation, with protected insiders on permanent contracts versus outsiders on fixed-term contracts, often young people, who run a high risk of in-work poverty[68].

Temporary contracts are not necessarily problematic if they serve a positive purpose, as for example when they combine work and the acquirement of specific skills through training and learning by doing which could, for example, allow young workers to move from a temporary contract to a more stable employment relationship. Indeed, Chapter 1 documents huge country differences not only in the share of temporary contracts but also in positive transitions.

Chart 27 shows that a high level of employment protection for regular employment, as measured by the OECD indicator, helps to explain the share of temporary jobs. Nevertheless, attempts to assess the effect of EPL reforms on labour market outcomes are made difficult by timing issues (lags), methodological issues and the problem of attempting to do so in a period when the level of labour demand in many countries remains very low (see also Turrini et al., 2014).

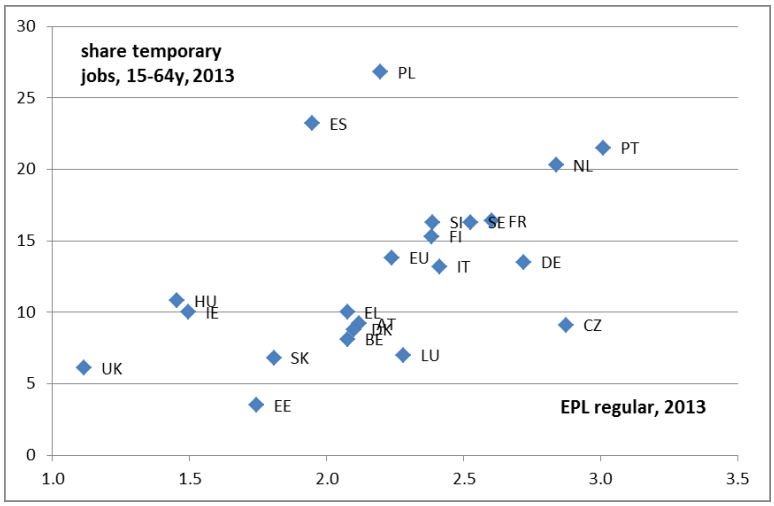
Moreover, there is evidence that, in some of the most resilient Member States, their relatively high level of EPL is not necessarily damaging to well-functioning labour markets, while Member States with relatively low levels of EPL do not necessarily create

[67] Such as fixed-term contracts, temporary agency work, part-time work and independent contract work.

[68] See also "Segmentation of the EU labour markets" in European Commission (2012b).

more jobs. All this evidence suggests the need to take a broader approach to the assessment of the impact of EPL within different labour market and social protection systems.

Chart 27: EPL on regular employment and the share of temporary employment



Source: OECD Employment and Labour Market Statistics, Strictness of employment protection legislation (EU = median of available Member States), Version 3 and Eurostat, lfsa_etpgan

The evidence suggests that the main benefits of reforms designed to reduce labour market segmentation tend to be in terms of providing better opportunities to find jobs that match available skills and thereby improve longer-term career prospects[69]. This suggests that, in order to improve their effectiveness, changes in employment protection should be supported by a range of policies such as activation and training, employment services, lifelong learning and adequate social security systems[70], as well as possible fiscal policy changes[71].

More generally, while reforming EPL may be relevant in terms of reducing segmentation, it is far from being the only way forward, with others actions – such as encouraging employers to use internal flexibility for established workers and work-training combinations for new or re-entrants - also being potentially positive options.

[69] See Chapter 2 "Reducing labour market segmentation by supporting transitions: towards a new momentum for flexicurity" in European Commission Policy Review, 'New skills and jobs in Europe: Pathways towards full employment', Publications Office of the European Union, Luxembourg, 2012. http://ec.europa.eu/research/social-sciences/pdf/new-skils-and-jobs-in-europe_en.pdf

[70] Notably reforms in social protection that are adequate to deal with the challenges created by an increased job turnover as a result of lesser job protection.

[71] Notably, assessing the tax wedge on low-paid workers.

4. JOB CREATION WITH PRODUCTIVITY GROWTH

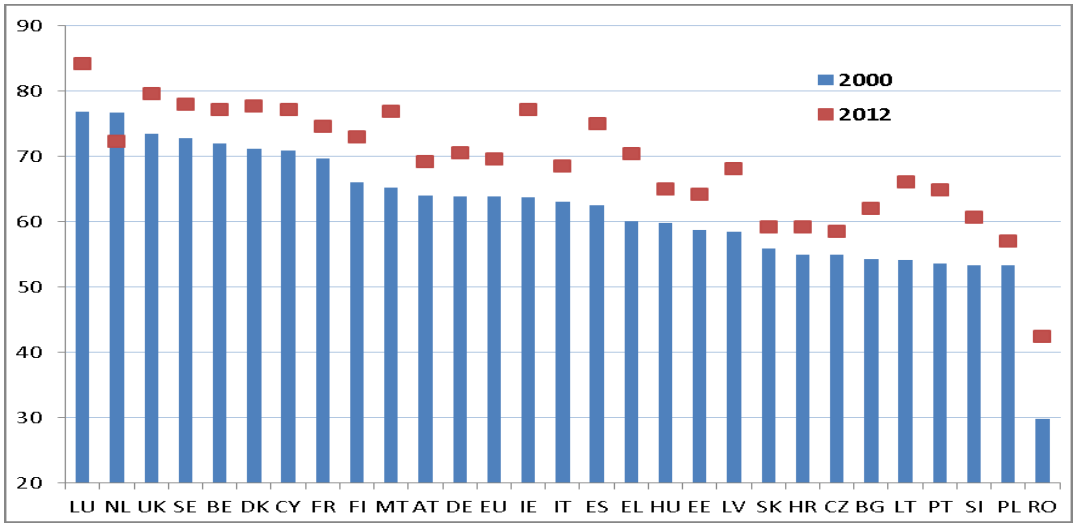
4.1. What sort of jobs will be created?

Technological progress, especially in key enabling technologies[72] and information and communication technologies (ICT), in combination with the forces of globalisation, are widely seen as the basis for the creation of new higher quality jobs, which the EU could exploit to its comparative advantage while enabling it to speed up productivity gains in order to offset the likely impact of a declining working-age population.

At the same time, demographic trends characterised by ageing populations and changing family structures are expected to create new jobs in the health and care sectors, while the 'greening' of the economy and a more intensive use of ICT could result in profound changes in the skill profiles that employers want, and employees need[73].

Nevertheless, there are limits to this positive outlook in that the benefits of these transformations can only be sustained by a virtuous circle of continuous innovation, supporting strong knowledge-intensive and technology-intensive enterprise sectors backed by expanding international trade and appropriate human capital investment. Moreover, work organisation that supports the adaptability of firms to these transformations is seen to be required (see Chapter 3 of this ESDE report).

Chart 28: Share of technology- and knowledge-intensive jobs in total service sector employment



Source: Eurostat, Science and technology, htec_emp_nat and htec_emp_nat2.
Note: 2000 and 2012 data are not fully comparable because of change-over in NACE code. Data are for 2011 instead of 2012 for UK and EU; 2002 and 2004 instead of 2000 for Croatia and Poland respectively.

At the same time it has to be recognised that, along the way, many existing jobs will inevitably be destroyed and there is no automatic guarantee concerning the impact of

[72] Key enabling technologies (KETs) enable the development of new goods and services and the restructuring of industrial processes needed to modernise EU industry and make the transition to a knowledge-based and low-carbon resource-efficient economy (European Commission, 2012a).

[73] See also Chapter 1, 'EU employment in a global context: where will new jobs come from and what will they look like?' in European Commission (2014a) and Chapter 3, 'The Future of Work in Europe: Job Quality and Work Organization for a Smart, Sustainable and Inclusive Growth', of this issue.

such changes on overall job quality. Skill mismatches[74], gaps and shortages are liable to be issues in this respect, with the risk of a potential worsening of the existing labour market polarisation which would further inhibit the realisation of the EU's employment goals in 2020 and beyond.

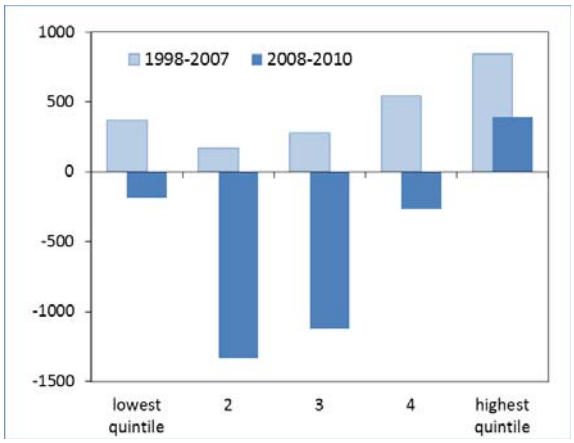
4.2. Job and wage polarisation: a pre-crisis trend that has continued

Even before the crisis there was evidence of an increasing polarisation in the labour market, with new jobs being concentrated at the high and low ends of the skill and income scale, notably in the expanding service sectors, with a predominance of better-paid jobs.

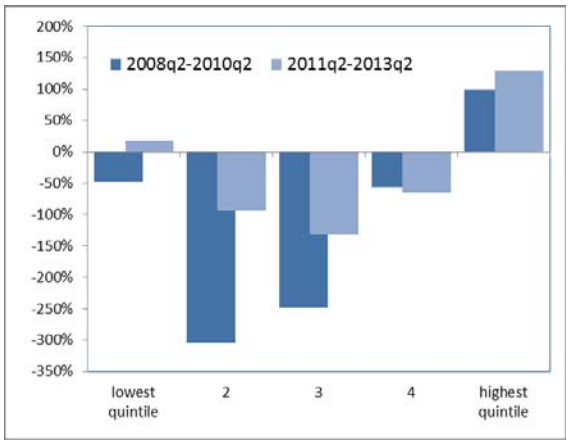
The intensity of the 2008 recession and the consequent job reallocations destroyed many medium-paid jobs in manufacturing and construction (Chart 29) while, at the same time, the educational and skills profiles in the new service-based jobs structures have tended to be more demanding, limiting the chances of re-employment for those who had lost their jobs during the recession.

This experience highlights the importance of addressing wage-related issues in terms of factors such as wage-setting mechanisms and the income security implications of low wages; and the need for up-skilling and re-skilling of the workforce at all levels[75].

Chart 29: Polarisation of jobs in the EU, 1998-2010, and 2008-2012



Source: European Commission (2011a)
Note: The chart shows the annual average change in absolute employment by wage quintile, in thousands.



Source: Eurofound (2014), *Drivers of recent job polarisation and upgrading in Europe: European Jobs Monitor 2014*, Publications Office of the European Union, Luxembourg

From an individual perspective, choosing which specific skills to acquire in addition to crucial transversal competences is an important factor for a successful working life. Likewise, from the perspective of the economy, it is necessary to improve the ability to

[74] See also Section 2.2.

[75] See Chapter 1, 'Shifts in the job structure in Europe during the recession' in European Commission (2011a) and Box 3, 'Employment polarisation in the crisis', in European Commission (2013d).

forecast future skills demand, ensure effective labour market matching, promote the adaptability of enterprises and workers to change and develop new sectors with sustainable job-creation potential.

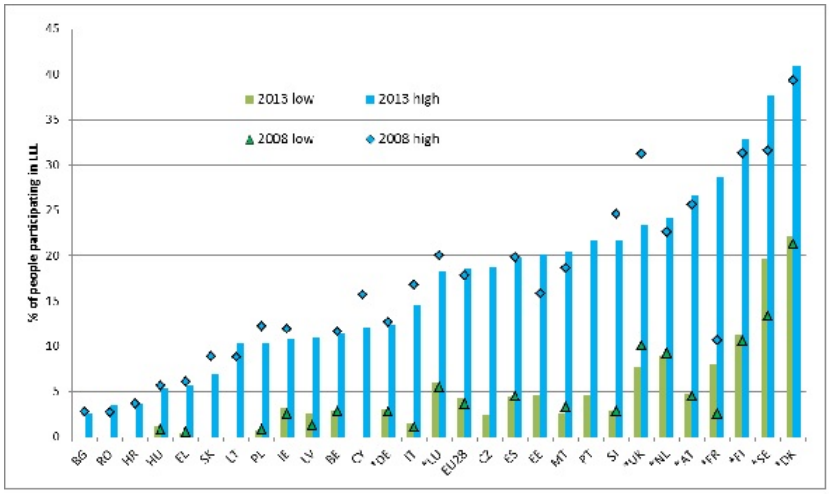
Many low-skilled jobs will continue to exist but will nevertheless require greater literacy, numeracy and other basic skills. Equally, the availability of more high-skilled jobs will not guarantee that all graduates find appropriate work unless the content of tertiary education is aligned with new needs.

4.3. A major role for lifelong learning

To ensure a virtuous circle of continuous innovation supporting a strong knowledge-intensive and technology-intensive enterprise sector, a strong and continuous investment in human capital is clearly necessary. This means not only investing in initial education and training systems, but also ensuring that the skills people acquire are used and maintained over their life course. In this respect, all stakeholders have an important role to play[76].

Concerning public policies, it is encouraging that participation in lifelong learning (LLL)[77] was higher in 2013 than it had been before the recession (albeit with a slight dip in 2011[78]). However, Member States where LLL was already the highest in 2008 have seen the most progress, specifically for the low-skilled, where progress has been lacking in some Member States (Chart 30).

Chart 30: Participation in lifelong learning by education (%)



Source: Eurostat, trng_lfse_03, 25-64 years old, Member States indicated by * are among the top 25 most competitive countries in the world in 2013, according to the 'IMD World Competitiveness Yearbook 2013', International Institute for Management Development.

[76] For example, social partners identify skills gaps and need, develop joint curricula, and provide training through paritarian funds.

[77] Lifelong learning is measured through the participation rate in training and education in the last four weeks.

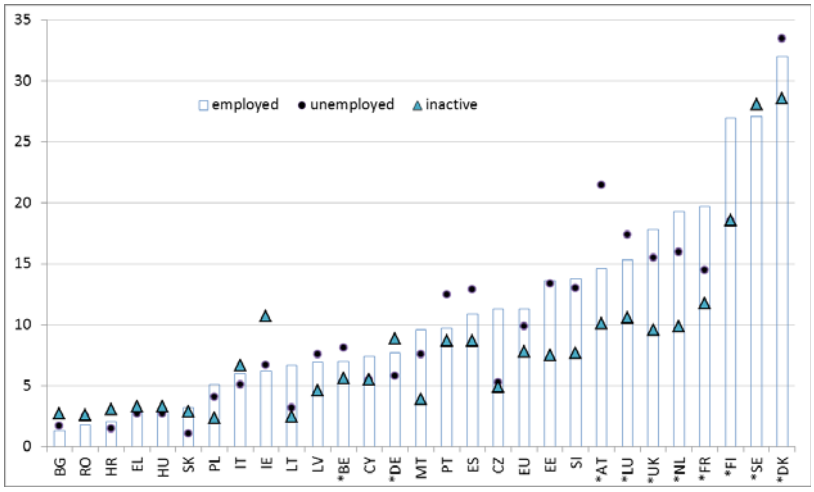
[78] Please note that comparisons over time are hampered by breaks in series, for example for France and the EU in 2013.

Note: ISCED97 classification used: low education level corresponds to pre-primary, primary and lower secondary education (levels 0-2) and high education level corresponds to first and second stage of tertiary education (levels 5-6). Due to breaks in series instead of 2008 values 2009 value used for LU and 2010 value for NL. Due to breaks in series no value for 2008 for CZ and PT, nor for 2008 'high' for LV. No 'low' shown for BG, RO, HR, SK, LT, CY and (2008 only) EE, due to low reliability.

Member States with the higher levels of participation in lifelong learning for both the employed and the unemployed (Chart 31) also have the highest labour market performance in terms of having the highest transition rates out of unemployment and lowest transition rates from employment to unemployment (see Section 3.1). This has positive implications for the prevention of long-term unemployment and exit rates out of unemployment.

However, Chart 31 shows that in seven Member States, only around 5% of workers participate in lifelong learning and less than 10% in a further nine. Moreover, only in a few countries is the participation of the unemployed in LLL higher than for workers although public policy might have been expected to be focused on encouraging the use of periods of unemployment to improve competencies and skills.

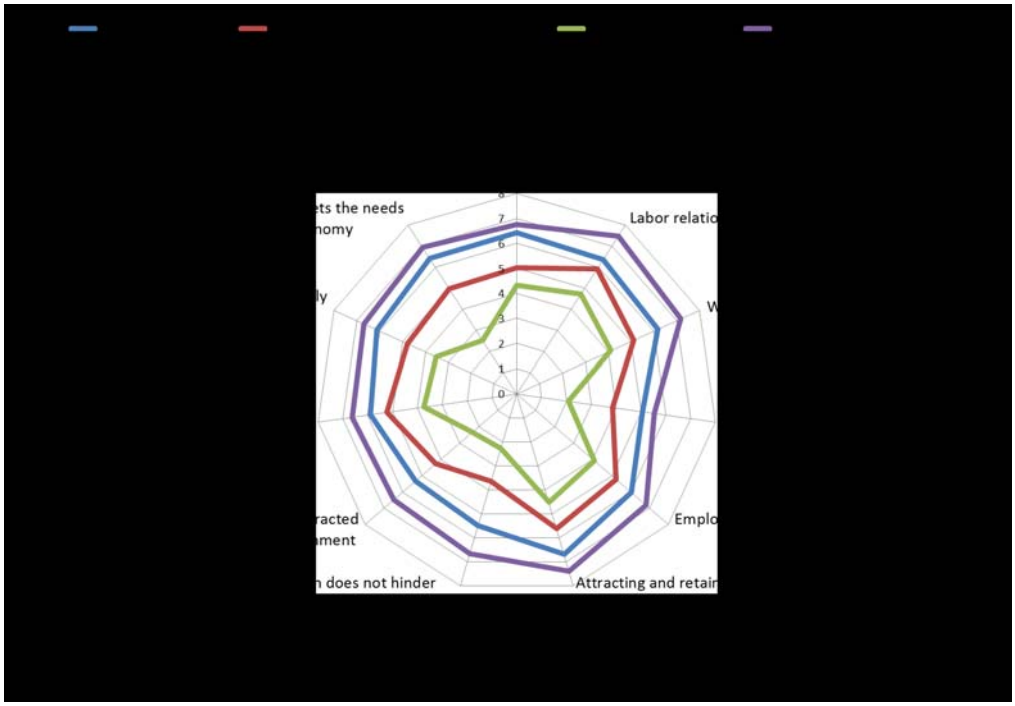
Chart 31: Participation in lifelong learning by labour status (%), 2013



Source: Eurostat, trng_lfse_02, 25-64 years old, Member States indicated by * are among the top-25 most competitive countries in the world in 2013, according to the 'IMD World Competitiveness Yearbook 2013', International Institute for Management Development.
Note: Values for unemployed: CY 5.5; FI 15.5

Business surveys show big differences in the way companies and workers see the quality of managers and in-firm training. They also show that the most competitive and resilient countries are those where companies and entrepreneurs value and invest most in skills (Chart 32). In this context, however, huge challenges clearly remain in a number of countries notably in Central and Eastern Europe and in some Southern European countries

Chart 32: Higher levels of business values and investment in skills are associated with higher competitiveness



Source: DG EMPL calculations on the basis of Business Survey results from the 'IMD World Competitiveness Yearbook 2014', International Institute for Management Development.
Note: Index values (0-10 index points) for respective statements. Median values taken by group. EU best performers include SE, DE, DK, LU, NL, IE, UK and FI, which were ranked among top 20 competitive countries (out of 61) in 2014.

To mitigate the risk of accelerating labour market polarisation, a return to growth combined with adequate policy responses is needed. These responses include stronger synergies between education/training systems and the needs of enterprises, as well as a greater involvement of companies in the use and development of skills. Unless the worst performing countries make substantial improvements in in-firm training, and this requires a big change of attitude by companies, skills and productivity will continue to languish.

5. WHO WILL BENEFIT FROM INCOME GROWTH?

5.1. Household incomes declined in the crisis but have started to recover

After nearly four years of continuous declines, gross disposable household income in the EU[79] increased in real terms in the last quarter of 2013, as result of the general economic recovery and the associated improvements in labour market conditions. The overall decline in household incomes had mainly been driven by job losses, reduced working hours and wage compression in some Member States.

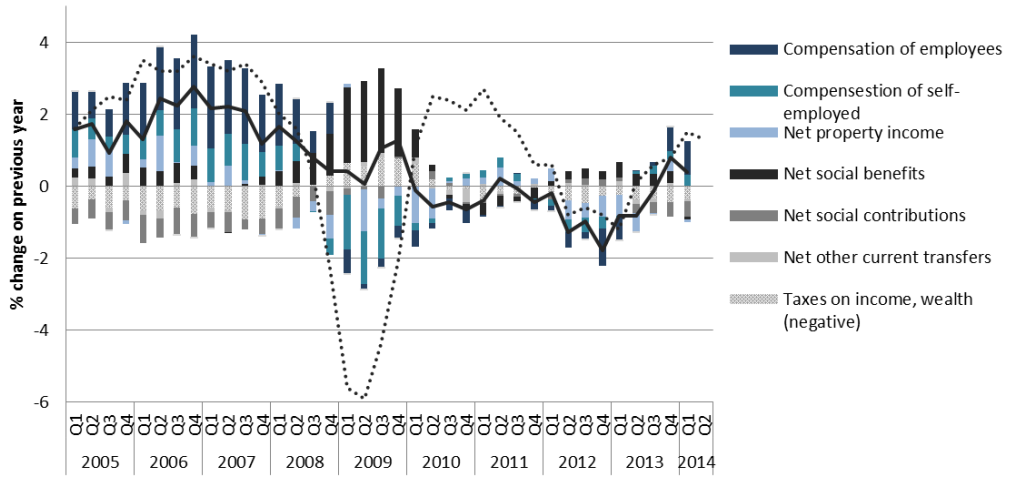
In the first years of the crisis, unemployment benefit systems played an important role in stabilising income, while other items of social expenditure (notably pensions and health) also helped maintain aggregate demand (see Chart 33). Since 2011, however, the

[79] Estimate based on data for 20 Member States.

stabilisation impact of tax and benefit systems has weakened over the prolonged recession. This was due to various factors including the increasing number of long-term unemployed losing their entitlements, the partial phasing-out of the stimulus measures taken to counter the crisis, and cuts in social expenditure under pressure of budgetary consolidation. According to a recent EUROMOD analysis[80], between 2008 and 2013 the total impact of changes in the tax and benefit systems on household disposable income was particularly strong in Ireland (-17 pps), Greece (-14 pps), Portugal, Spain and Lithuania.

It is to be expected that the redistributive impact of taxes and transfers increases with unchanged policy settings when unemployment increases significantly. However, policy changes implemented during the crisis also had an impact on the income distribution. The analysis based on EUROMOD[81] shows that, in many countries, the measures taken during the crisis had either neutral or progressive impacts on income distribution, with a few notable exceptions (Germany, Estonia and Lithuania). It also shows that similar types of tools can have different distributional impacts depending on their design, and independent of the size of the adjustments.

Chart 33: Real change in Gross Disposable Household Income by component in the EU (year on year; 2005Q1 – 2014Q2)



Source: Eurostat, National Accounts, data non-seasonally adjusted [namq_gdp_k, nasq_nf_tr and namq_fcs_p] (DG EMPL calculations)
Note: GDHI EU aggregate for Member States for which data are available, GDP for EU28.

5.2. Rising poverty mainly affects the working-age population and children

As could be expected, poverty and social exclusion in the EU worsened during the crisis and has shown little sign of improvement up to 2013, especially in Member States where economic conditions continue to worsen. The deterioration of labour market conditions has significantly increased the number of people on low income or living in jobless

[80] De Agostini P., Paulus A., Sutherland H. and Tasseva I. (2014), 'The effect of tax-benefit changes on income distribution in EU countries since the beginning of the economic crisis', EUROMOD Working Paper Series EM9/14 - 02 May 2014.

[81] De Agostini P., Paulus A., Sutherland H. and Tasseva I. (2014), 'The effect of tax-benefit changes on income distribution in EU countries since the beginning of the economic crisis', EUROMOD Working Paper Series EM9/14 - 02 May 2014.

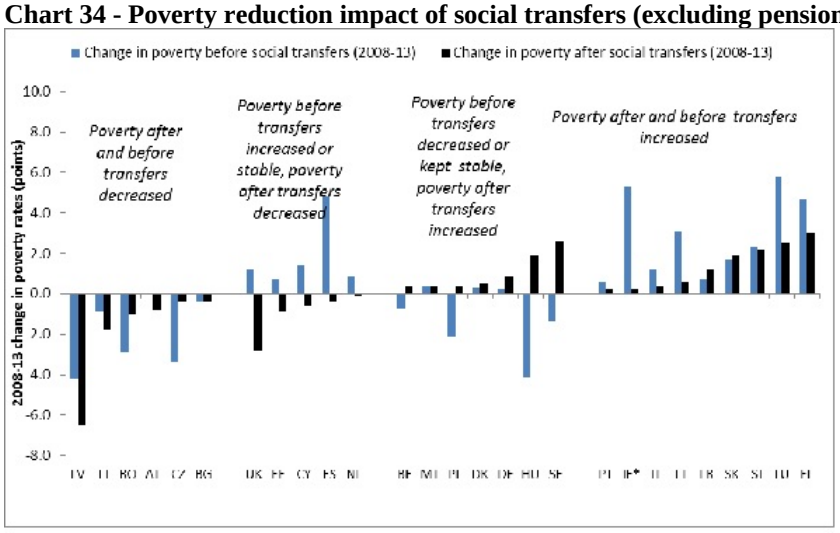
households, with the overall reduction in household incomes resulting in increased hardship among the poorest segments of the population, resulting in a rise in material deprivation.

The working-age population has been most affected, mainly due to rising levels of jobless or low work-intensity households and increased in-work poverty. In more than 20 Member States, the risk of poverty or social exclusion for children has risen since 2008, along with a worsening situation for their (mostly working-age) parents, with single-parent households facing the highest risks. Older people (65+) have been relatively sheltered as pensions have remained largely unaffected, while income levels for the working-age population have stagnated or fallen. In most countries, women are still more affected by old-age poverty than men.

The likelihood of entering into and exiting from poverty varies greatly across Member States and between population groups[82]. In some countries a significant proportion of the population is trapped in persistent poverty, while in others they may exit poverty for a time but nevertheless return. The key risk factors include lack of strong labour market attachment, being young or old and being in particular family circumstances, including those caused by care obligations; as well as other individual characteristics, such as disability, being a migrant or coming from a minority background.

In the crisis all these factors have been reinforced by increased long-term unemployment, labour market segmentation and wage polarisation (see Section 4.2). The weakening of the poverty reduction impact of social transfers also played a role in a number of countries (see Chart 34), as measures taken to restore the financial sustainability of welfare systems included reductions in the level or duration of benefits, or tightened eligibility rules to increase incentives to seek work, and may have led to excluding beneficiaries from certain schemes. Restoring the effectiveness of such schemes and adapting them better to the economic cycle would be important.

Chart 34 - Poverty reduction impact of social transfers (excluding pensions), 2008-2013



Source: Eurostat EU-SILC

[82] See Chapter 2 in ESDE 2012, Chapters 3 and 4 in ESDE 2011

While the deterioration of labour market conditions was a strong driver of the rise in working-age poverty, past experience has shown that improvements in the labour market do not necessarily lead to a reduction in poverty. This implies that, independent of any improvement in the economic and employment outlook, a combination of effective policy interventions is likely to be required in order to support returns to work and ensure that jobs enable workers and their families to stay out of poverty. This is especially the case for workers who have been out of work for some time or have weak ties to the labour market.

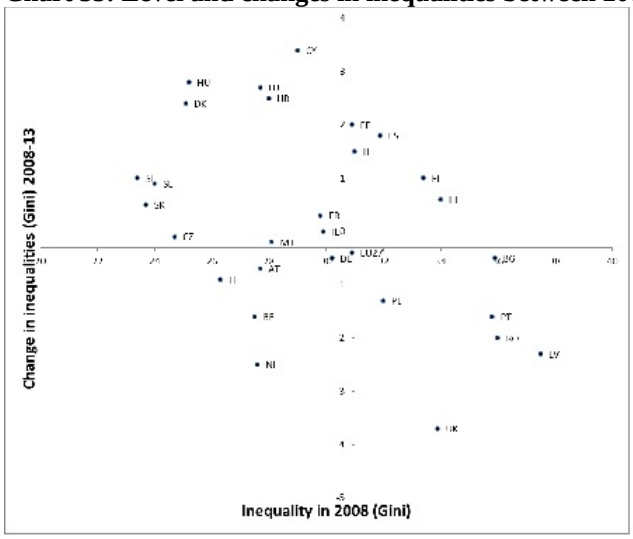
Analysis[83] shows that income support (unemployment and social assistance) can support returns to employment if linked with activation and well designed (see also Section 3.2). Income support also allows people both to maintain a decent standard of living and devote time to job search. Enabling services such as training, Public Employment Services, childcare or housing support the employability and active participation of people in society. At the same time, the likelihood to escape poverty on a lasting basis when moving into employment depends on the quality of jobs, including decent pay and sufficient working hours to earn a living, but also on measures supporting households willing to increase their level of labour market participation (taxation for the second earner, childcare and other reconciliation measures).

Policies to address and prevent poverty and long-term exclusion need both to prevent people from falling into persistent poverty and to reach the most excluded.

5.3. Mitigating rising inequalities requires training and quality jobs for all and improving the effectiveness of social policies

Since the beginning of the crisis, income inequalities are converging across the EU (Chart 35). They increased in the countries with lower levels of inequality (DK, HR, LU, HU, SI, SK, SE), while they decreased in a number of countries with initially high levels (BG, LV, PT, RO). Greece, Lithuania and Spain are exceptions in so far as inequalities increased from their already high levels.

Chart 35: Level and changes in inequalities between 2008 and 2013. Gini Index

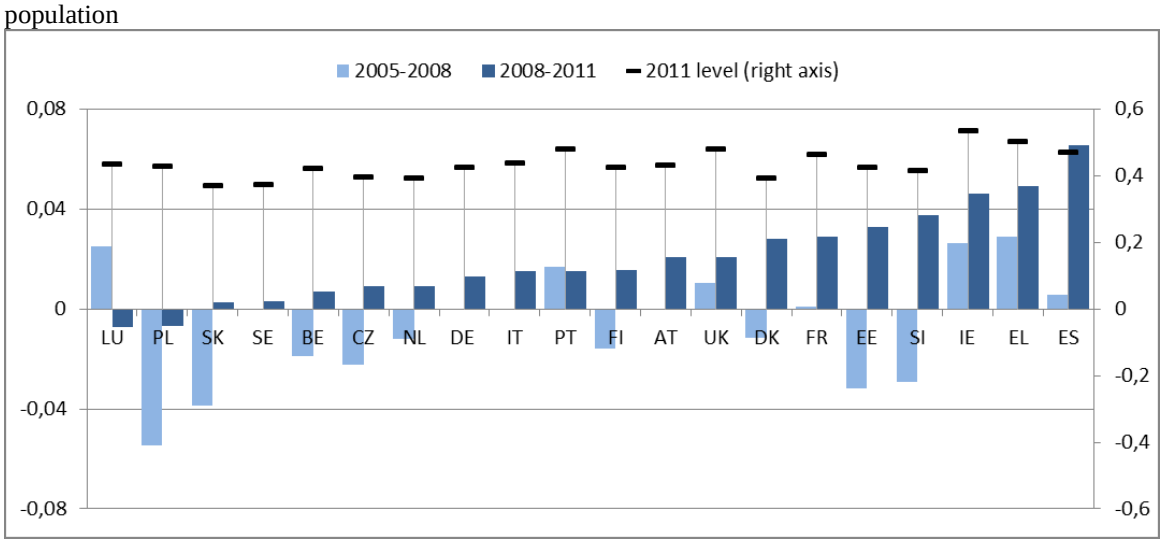


[83] See Chapter 2 in ESDE 2012, Chapters 3 and 4 in ESDE 2011

Source: Eurostat, Gini coefficient of equivalised disposable income (source: SILC) (ilc_di12)

Income inequalities are primarily formed on the labour market reflecting both labour market exclusion and a polarisation of earnings of those in work. Market income inequalities (i.e. referring to the distribution of incomes before taxes and transfers) among the working-age population[84] have increased in at least 15 Member States (Chart 36) with the largest increases in those countries hit hardest by the crisis notably Ireland, Greece, Spain and Estonia, but also Denmark, Slovenia, Germany, France, Austria and Italy.

Chart 36: Trends in market income inequalities between 2005 and 2011, Gini coefficient, 18-65 population

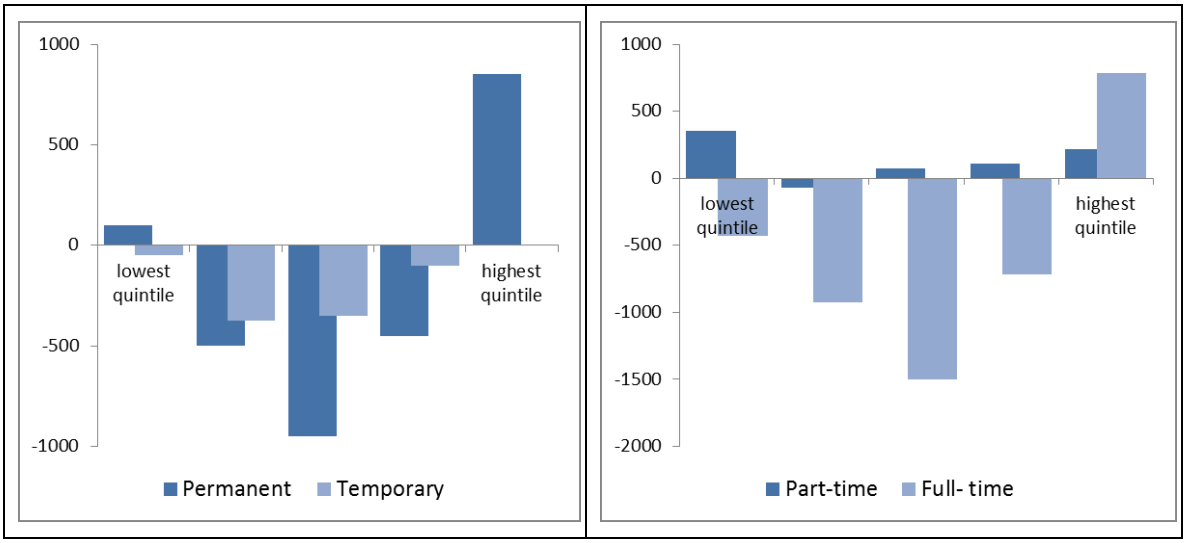


Source: OECD, Income distribution database, own's calculations.
Note: No data for HU, HR, MT, CY, LT, LV ; no data for 2005 for SE, DE, IT; 2011 data not available for BE (2010) and NL (2012).

While rising unemployment obviously increases the income gap between those in and out of work, the crisis has also led to a further widening of labour market inequalities among those in work. This is because well paid, full-time jobs remained relatively well protected, while lower-paid workers often ended up with fewer hours worked and less take-home pay. In fact, in the years 2011-12 most of the new permanent jobs and full-time jobs were high-paid jobs while the new low-paid jobs were increasingly part-time and temporary (see Chart 37). Likewise, job losses tended to be concentrated in low- to middle-income households, while richer households were relatively spared and more often combine two full-time jobs (see Chapter 1).

[84] Inequalities are measured based on the Gini coefficient in this Chapter - OECD, Income Inequality Update 2014.

Chart 37: Employment change by job-wage quintile and full-time or part-time status (a) and temporary versus permanent (b), EU, 2011 Q2 to 2013 Q2
In thousands



Source: European Job Monitor 2014, based on Eurostat, EU-LFS and SES (Eurofound calculations)
Note: Data for 26 Member States; Germany and the Netherlands excluded due to data breaks.

Mitigating rising inequalities therefore requires actions to address the forces driving labour market (earnings) inequality, preventing and tackling long-term unemployment and improving the effectiveness and efficiency of social protection systems.

Mitigating rising labour market inequalities

Over the long term, the main drivers of overall earnings inequalities are skills bias, technological change and policy interventions that may affect employment and earnings distribution differently, resulting in a complex impact on inequalities as analysed by the OECD in their latest report on inequalities[85].

As illustrated in Section 3.2, participation in training protects workers from unemployment and increases the chances of the short-term unemployed going back to work. At the same time, investing in skills may help more people into employment but may increase dispersion in hourly wages. Great attention has to be paid to these interactions when designing policy interventions.

Tackling labour market segmentation, improving the quality of jobs (notably by ensuring access to adequate working hours and working conditions for all workers) and tackling underemployment (e.g. involuntary part-time) can also mitigate earning inequalities and improve the overall use of human capital. This may require considering adaptations to wage-setting mechanisms, increased income security for the low waged and the up- and re-skilling of the workforce at all levels[86].

Measures to facilitate the entry of low-skilled workers into the labour market may contribute to increasing the dispersion of hours worked and wages, while narrowing the total earnings dispersion by reducing the number of individuals who are not working.

[85] OECD (2013).

[86] See Chapter 1, 'Shifts in the job structure in Europe during the recession' in European Commission (2011a) and Box 3, 'Employment polarisation in the crisis' in European Commission (2013d).

Preventing and tackling long-term unemployment through activation, training and income support can also mitigate labour market inequalities. However, when faced with a prolonged recession and the increase in long-term unemployment, most welfare systems came under pressure, and there is now a need to restore their effectiveness.

Improving the effectiveness and efficiency of social spending

Tax-benefit systems helped to maintain gross household disposable income in all Member States in the first phase of the crisis. However, this also represented a further challenge to government financing as tax revenues declined in line with falling GDP, while expenditure levels did not.

While the intensity of fiscal consolidation has differed across countries, Member States used markedly different economic and social approaches and achieved somewhat different outcomes in terms of income smoothing and poverty and inequality reduction despite similar levels of spending.

The allocation of welfare expenditure to different social functions has strong implications for the overall efficiency and effectiveness of social protection[87]. In 2010, EU Member States had different welfare expenditure patterns. For instance, Member States such as Italy or Poland have a strong orientation towards pension expenditure, associated with relatively strong pension adequacy, but also with a low level of labour market attachment among older workers. In such cases, there may be scope to improve the efficiency of old-age spending and shift the spending towards other functions that support those of working age.

As analysed in Chapter 1 of this review, countries that have directed their social investment expenditure efforts to helping people return to work, through active labour market policies combined with widely available and well-designed unemployment benefits, have shown better signs of resilience in the recession. However, most welfare systems were not designed for a prolonged crisis and recent reforms of unemployment benefits systems did not introduce measures to improve the reactivity of the systems to the economic cycle (e.g. automatic triggers) in case of future recessions.

Furthermore, while the strictness of employment protection legislation has been further reduced in most countries, the coverage and adequacy of benefits did not improve, the financing of active labour market policies has declined slightly and participation in training and lifelong learning has fallen slightly, although it did recover slightly in 2013. Hence renewed attention needs to be paid to the orientation of social expenditure and the interaction of income support schemes with labour market regulations.

During the recession social investment in children and families (notably through early childhood education and care) continued to strengthen[88], but there have been signs of a weakening investment in education and the unemployed in some Member States. Table 3 summarises the evolution of the social investment orientation of social spending. It

[87] As analysed in ESDE 2013, efficiency gains can be obtained by shifting expenditure from functions in which high levels of spending are associated with comparatively low economic or social outcomes, towards functions where relatively low spending levels may explain their below EU average outcomes.

[88] A recent report of the OECD analyses in detail the "relative efficiency of cash versus in-kind family benefits". See OECD (October 2014). It provides insight on the potential efficiency gains of several combination of cash and in-kind benefits for different levels of spending and policy goals.

shows that while a number of Member States seem to be moving towards a social investment model, others seem to be departing from it.

Table 3: Evolution of the social investment orientation of social spending in EU Member States

Investments in 2007		Between 2007 and 2011		
		Decreased	**Stable**	**Increased**
Overall level of spending oriented towards social investment	**High**	DK	FI	SE
	Medium	EL, ES, IT, HU, PT, RO, SI, UK		AT, BE, DE, FR, LU, LV, (NL)
	Low	BG, CZ, IE, CY, LT, PL	EE	MT, SK

Source: ESDE 2014 Chapter 1

Notes: MS in Group 1 have high expenditure in 2007, Group 2 medium and Group 3 low. Levels refer to expenditure in child day care per relevant child population, education expenditure per relevant young population and mostly active unemployment expenditure per unemployed in 2007. In the columns MS are grouped according to the real evolution of expenditure between 2007 and 2011. Stable real growth is defined for changes between 1.5% and -1.5% for education expenditure, -4% and +4% for unemployment and family, and, -5% and +5% for active unemployment. The level of overall expenditure in 2007 is based on the social investment score, which assigns an equal weight to the three areas. Overall trend is based on the average growth in the three areas. For NL the social investment score is based only on education and child day care expenditure as data for mostly active unemployment measures are not reliable in ESSPROS.

The crisis has also shown that Member States with better coverage and more adequate unemployment benefits achieved better automatic stabilisation. However, while these systems proved adequate in the first phase of the crisis in sustaining household income, they were not designed for a prolonged crisis. Faced with a prolonged recession and the increase in long-term unemployment most countries did not, or could not, strengthen the automatic stabilisation dimension of their welfare systems, thus undermining the effectiveness of social protection.

Analysis presented in chapter 1 of this review shows that the responsiveness of unemployment benefits to the economic cycle can be increased by allowing a temporary increase in the duration of benefits and a relaxation of the eligibility criteria during recessions. Other measures, such as minimum income schemes linked to activation and a more responsive indexation of family benefits and pensions can also play a role.

Overall the evidence indicates that adequate levels of social investment, investment in lifelong learning, social expenditure that are more responsive to the economic cycle and integrated welfare reforms supported by well-functioning labour markets all help mitigate excessive inequalities.

6. SOCIAL AND LABOUR MARKET IMBALANCES IMPACT GDP GROWTH

6.1. How unemployment, poverty and inequality might affect GDP growth, also across national borders

While GDP growth is the central pillar of economic performance, it is important to recognise that growth alone is not enough to bring jobs (see Section 2), that employment growth does not necessarily bring sufficient earnings growth (see Section 5.1), and that tax-benefit systems do not necessarily ensure adequate redistribution (see Section 5.3).

It is also necessary to consider the interactions from the opposite direction: how do labour market conditions and levels of inequality and poverty affect GDP growth? All three possible causalities come with a time dimension:

- In the short term, higher unemployment, inequality and poverty are expected to curb GDP growth through constraints on demand[89].

- In the medium term, the associated lack of available financial resources can lead to the build-up of unsustainable household debt levels, which potentially endangers future GDP growth (via increased financial risks).

- In the long term, higher inequality and poverty can affect potential GDP, through reduced access for many households to education and health services, affecting human capital.

Higher unemployment can, over the medium term, affect GDP growth through diminished human capital, through skills loss of the (long-term) unemployed and young workers, whose access to the labour market is blocked. Higher unemployment, inequality and poverty can, rather quickly, bring the risk of social unrest and a lack of support for government, both of which might endanger the implementation of necessary reforms. In turn, this lack of reform can restrain future GDP growth.

Given that lower growth tends to impair public debt sustainability, policymakers have to weigh the direct (cost) effect of social welfare on public finances against its indirect (beneficial) effect via economic growth.

Moreover, these effects do not stop at national borders. The effects spill over to other countries, both directly through the intensive intra-EU trade and indirectly through the effect on the confidence in the common European project[90], contributing to the divergence in the EU.

6.2. The impact of inequality on GDP growth: theory and recent evidence

Theoretically the effect of inequality on GDP growth is ambiguous[91]. While inequality may promote growth through higher incentives for innovation and entrepreneurship, and in so far as the rich save and invest a higher share of their income, it may equally reduce the ability of the poor to accumulate human capital (education and skills) for themselves and their children.

More generally, inequality might generate social and political instability, which harms investment and growth and may harm consensus on necessary reforms, restraining future growth. Moreover, the large increases in borrowing in a number of Member States prior to the crisis might have been related to high and rising levels of inequality, implying that this partly contributed to the build-up of today's problems (Darvas and Wolff, 2014).

[89] This goes via disposable income, domestic demand and foreign demand (cross-border spill-overs). The higher propensity to consume of households with low income is a vital factor in this process.

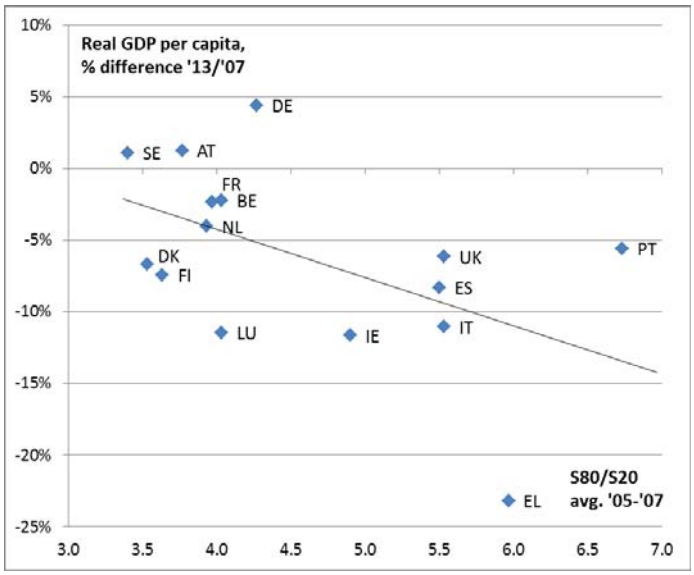
[90] See also Chapter 4 of this issue.

[91] See also Cingano (2014).

In terms of empirical analysis on the growth impact of inequality, three recent studies stand out. Ostry et al. (2014) found that lower net inequality (after taxes and benefits) is robustly correlated with faster and more durable growth for a given level of redistribution. Redistribution appears generally benign in terms of its impact on growth; only in extreme cases is there evidence that it may have direct negative effects on growth. Thus the combined direct and indirect effects of redistribution - including the growth effect of the resultant lower inequality - are on average pro-growth.

Econometric analysis by Cingano (2014) on data covering OECD countries over the past thirty years suggests that income inequality has a sizeable and statistically significant negative impact on growth, and that redistributive policies achieving greater equality in disposable income have no adverse growth consequences. Causa et al. (2014, *forthcoming*) also find evidence that, in OECD countries, higher levels of inequality can reduce GDP per capita[92].

Chart 38: Inequality and resilience since 2008



Source: Eurostat, ilc_di11 and AMECO, HVGTP.

Note: S80/S20: (Income quintile share ratio: the ratio of total income received by the 20% of the population with the highest income to that received by the 20% of the population with the lowest income.

Chart 38 suggests that, in the EU, more equal societies withstood the recent crisis better than less equal ones. This relationship holds well for Member States who were in the EU before 2004. When all Member States are considered, the picture is blurred by developments in four catching-up Member States with a high level of inequality whose real GDP per capita in 2013 was at least 10% higher than it had been in 2007 (Bulgaria, Lithuania, Poland and Romania).

It can also be noted that in the present 'secular stagnation' debate on lower long-term growth perspectives for the US economy, several authors mention inequality as one of the contributing factors (see Teulings and Baldwin, 2014 and S&P Capital IQ, 2014).

[92] Moreover, the results are invariant to whether the rise in inequality takes place mainly in the upper or lower half of the distribution.

6.3. Lessons from the different interactions between GDP growth and labour market and social developments

Some overall conclusions could be drawn from the literature and the analysis presented in this chapter (with cross-references to other chapters).

Firstly, more equal societies appear to do better in terms of growth and employment resilience. This is linked to differences in the propensity to spend (short-term growth) and differences in access to education and health services (affecting human capital and long-term growth).

Secondly, high-employment societies show higher resilience, pointing to the added value of well-designed combinations of social protection and activation. Some of these societies did so, while having relatively strict employment protection legislation. At the same time less resilient societies have loosened EPL in recent years and may need to address other policy challenges.

Thirdly, societies that invest more in human capital and share human capital more equally also show higher resilience. This is linked to the impact that productivity has on growth, which is likely to increase over time, given the likely reduction in the size of the working-age population due to ageing.

These conclusions suggest that the EU should try to develop its comparative advantage on issues such as apprenticeship, enterprise training, internal flexibility, workers' involvement and participation, ensuring that opportunities are widely shared and that access to the labour market at all levels is not decided simply by market forces.

They also imply that the EU would benefit by restoring the sustainability and effectiveness of its social model, notably by improving its design (e.g. combining protection and activation) and by the orientation of its expenditure towards greater social investment.

Such developments will need significant reforms and investments (specifically in education, training, ALMPs and health). Such reforms and investments require a stronger growth environment, as structural reforms need stronger aggregate demand (and vice versa) and investments need to be paid for.

Among these reforms, tax shifts away from labour could have a vital role to play by reducing labour costs for the low-skilled and the young, where such reductions can have a strong impact and are most needed. This makes handling the distributional implications of such shifts even more important.

Stronger aggregate demand can come either from the public or private sector, but it is important that it occurs in a way that does not weaken the structural improvements in budgets - hence an EU-led public investment initiative is such an attractive idea since it paves the way for more productivity in the months and years to come.

As ECB President Draghi concluded: 'the way back to higher employment… is a policy mix that combines monetary, fiscal and structural measures at the union level and at the

national level. This will allow each member of our union to achieve a sustainably high level of employment'[93].

[93] Draghi (2014).

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