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CONCEPTUALIZING THE DETERMINANTS OF LABOUR MARKET FLEXIBILITY: THE EU PERSPECTIVE

Abstract

Labour market deregulation and flexibility are regarded as key determinants of national competitiveness and successful corporate performance. On the one hand, the use of flexible work practices can result in savings on wage costs. Firstly, work may be hired and paid for only if there is work to be done (for example, during temporary production peaks). And secondly because 'flexible' workers on average earn less than comparable tenured workers and are not entitled to the benefits tenured workers receive.

In this paper, the structural study of labour market flexibility is methodologically based on the **pyramid of competitiveness**, proposed by the European Commission in 1997, where employment rate and productivity are interrelated dimensions in guaranteeing the standard of living in a country. The factor of employment rate is further elaborated with additional determinants and dimensions, which shape a proposed in-depth model for labour market flexibility analysis, e.g. the criteria are grouped into the following sub-dimensions:

- 1) supply-side vs. demand-side of labour market;
- 2) micro-level vs. macro-level of labour market, which was inspired by the proposed concept of **labour market flexibility** by Paas et al. (2002a, 2002b, 2003).

Keywords: labour market flexibility, conceptualization, determinants, the EU, CEEC.

The performance of the labour market is also central to the well being of both the economy and society. A flexible and efficient labour market, combined with a stable macroeconomic environment, implies an economy that is fairer, more competitive and more productive. It also means an economy that is better able to respond to economic change.
(HM Treasury, 2003, p.7)

Introduction

Although unemployment fell across most of the European Union countries in the second half of the 1980s, in 1990 it started to rise again. In the following two years, unemployment reached new heights and had taken a central place on policy makers' agenda. Individual governments developed their own responses. Also, unemployment reduction and employment promotion took on a new importance for the European Union, as stressed by Casey (2002).

The European Union accords a great role to governments in guiding markets and overcoming market failures. Hence, the EU would tend to advocate a welfare state as a productive factor that, by increasing security, encourages the acceptance of change and so enhances growth. The European Union developed its welfare strategy in the form of

recommendations. The aim of this paper is to present an overview of how the European governments meet the EU recommendations when implementing a welfare state that intervenes to moderate negative effects of market relationships on the one hand, and to enhance the efficiency of market performance on the other hand.

The roots of the European Union strategy have been tracked back at least to the publication of a **new strategy of cooperation for growth and employment** in mid 1992, a document that inspired the **Delors growth initiative** at the Edinburgh Summit of 1992 and the subsequent White Paper on **Growth, Competitiveness and Employment**. The Essen Summit of end 1994 issued a series of employment recommendations, but the strategy was crystallized in the Amsterdam Treaty of 1997. This gave the Council competence to set out recommendations upon which Member States were required to act, whilst a special jobs summit in Luxembourg at the end 1997 developed the first set of employment guidelines. In each succeeding year, the end of year summit has added to or amended these.

The nature of the recommendations made was predicated upon the diagnosis of the problem. The EU was conscious not only that unemployment, but also structural unemployment, was high. This was symptomatic of an insufficient ability to adapt to change. Moreover, although an employment strategy implies a focus upon policies concerned with labour, the EU recognized that the achievement of flexibility had been hindered by the instability of the macro-economic environment and inappropriate macroeconomic policies. Indeed, the conclusions of the Luxembourg jobs summit stated, before laying out the details of any “employment guidelines”, that with regard to the macroeconomic context, it is essential for the Union to pursue a policy of growth geared to stability, sound public finance and structural reform.

Turning from the macro-economic environment to the labour market itself, for enhancing labour market adaptability, the EU requires member states to examine proposals for new provisions and incentives to make sure they will contribute to reducing barriers to employment.

Moreover, tax and social security system, and namely unemployment and related compensation system, may generate disincentives to work. Given that, the EU guidelines ask to make social protection systems more “employment friendly”. Member States are asked to review and, where appropriate, reform their benefit and tax system to reduce poverty traps, and provide incentives for unemployed or inactive people to seek and take up work or measures to enhance their employability and for employers to create new jobs. However, the EU recognizes that benefit cuts cannot be pursued without limit, since there is some level of “poverty” below which people cannot be allowed to fall (Casey, 2002).

In order to overcome the negative implications of an approach that is based upon reducing benefits, the EU gives a role to **active labour market policies**. For the European Union, it makes clear that increasing the employment rate can help ensure the sustainability of social protection. The European strategy makes repeated reference to battles against exclusion and the importance of bringing groups, on the margin of the labour force or even outside the labour force, back to work. Therefore, under guidelines to increase employability, it concerns itself explicitly with elder people and first-time job seekers.

The structural study of LMM is methodologically based on the **pyramid of competitiveness**, proposed by the European Commission in 1997, where employment rate and productivity are interrelated dimensions in guaranteeing the standard of living in a country. The factor of employment rate is further elaborated with additional determinants and dimensions, which shape a proposed in-depth model for LMM analysis, e.g. the criteria are grouped into the following sub-dimensions:

- a) supply-side vs. demand-side of labour market;
- b) micro-level vs. macro-level of labour market, which was inspired by the proposed

concept of **labour market flexibility** by Paas e al. (2002a, 2002b, 2003).

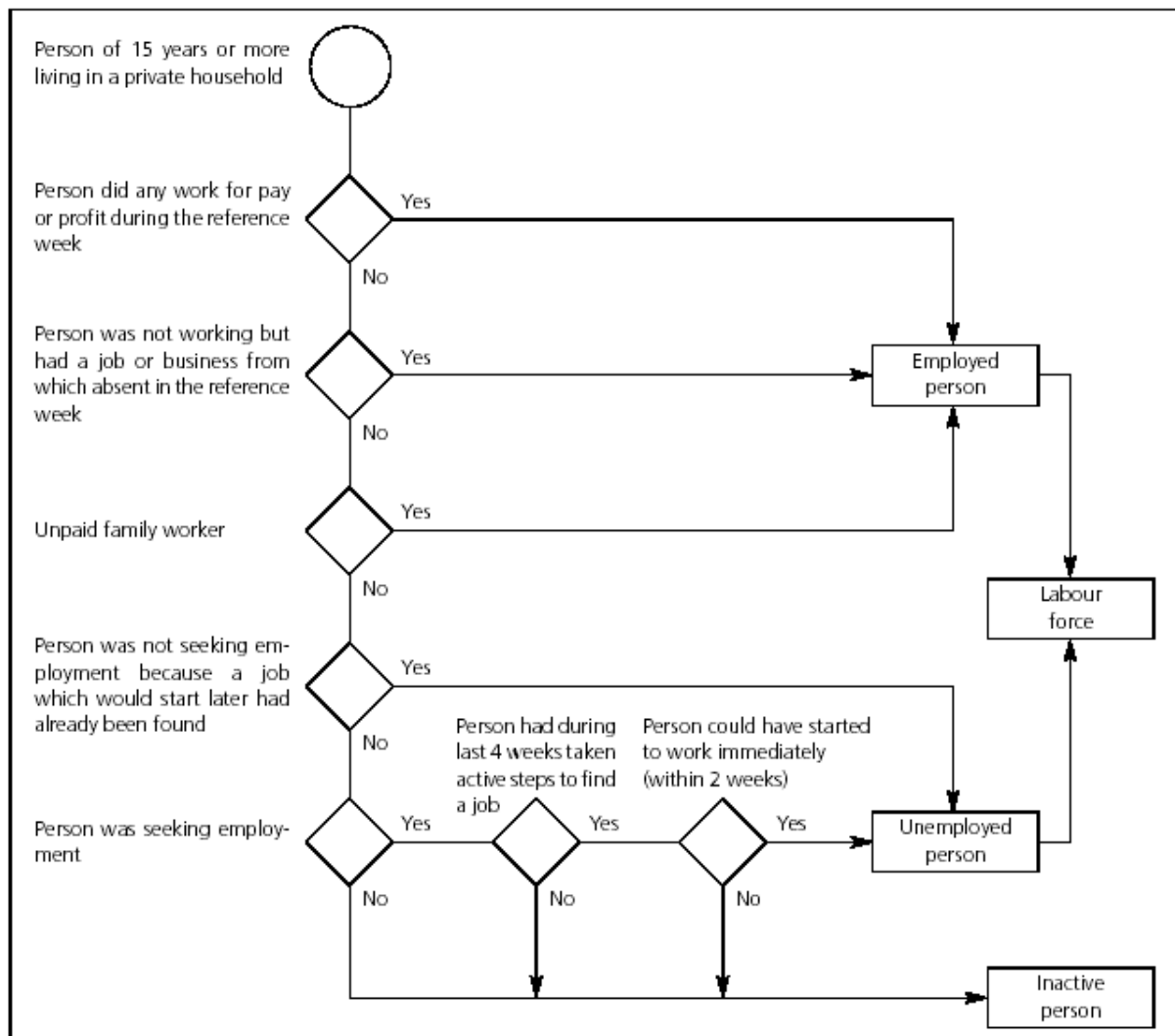
Labour force classification in the EU and terminology explained

The central distinction in any Labour Force Survey (LFS) is the classification of persons aged 15 years or more by their labour status (EEO, 2005, p.10):

Employed are those who, during the reference week (*Figure 1*):

- did any work for pay or profit, or
- were not working but had jobs from which they were temporarily absent.

Figure 1. Labour force classification in the European Union LFS



Source: EC, 2003, p.10.

Family workers are included.

Unemployed are those who (*Figure 1*):

- had no employment during the reference week, and
- had actively sought employment during the previous four weeks, and
- were available to start work within the next two weeks.

Persons who have already found a job, which was to start later, are also classified as unemployed.

Inactive are all those who are not classified as either employed or unemployed.

Figure 1 shows a flowchart for the classification of the population according to these definitions as prescribed up to the year 2000. In this context, persons temporarily absent from work present certain difficulties. The accepted criterion for their classification as employed is a formal attachment to their job, which in turn is defined by:

- the continued receipt of pay,
- the assurance of return to work, or
- the elapsed duration of absence.

For the 2001 LFS, the definition of the labour status has been further specified in a number of points (EC, 2003, p.11):

- Persons who work on their own small agricultural farm, but produce only for their own consumption, should be considered as employed only if this production is included in national accounts.
- Conscripts who performed some work for pay or profit during the reference week should not be considered as employed.
- Persons on maternity leave should always be considered as employed.
- Others not at work during the reference week (seasonal workers during the off-season, persons on parental leave, unpaid family workers, lay-offs and persons on long-term absence except due to illness) should be considered as employed only if they have an assurance to return to work within a period of three months or continue to receive 50% or more of their salary.
- Persons who were not employed during the reference week but already had found a job starting later should be considered as unemployed only if the starting date for that job was within a period of at most three months and as inactive otherwise.

Another problem is the classification of unemployed by LFS as opposed to the registration in public employment offices. Due to differences in the criteria used, the respective figures for a given country can differ considerably, and while the definition applied to all CEECs' LFSs is the same, the figures on registered unemployment are rarely comparable between countries due to different national regulations.

Based on age and labour status, a number of groups and rates are derived (EC, 2003, p.11):

- **Working-age population:** 15–64.
- **Youth dependency rate:** under 15/15–64.
- **Old age dependency rate:** 65+/15–64.
- **Effective dependency rate:** not working 15+/employed.
- **Labour force:** employed + unemployed.
- **Activity rate:** labour force 15–64/working-age population.
- **Employment rate:** employed 15–64/working-age population.

Unemployment rate: unemployed/labour force.

In addition, there are a number of concepts relating to specific conditions of employment, unemployment, or inactivity:

The permanency of a job only refers to employees. Temporary employment, work contracts of limited duration or fixed-term contracts are characterized by the agreement between employer and employee on objective conditions under which a job ends, such as a specific date, the completion of a task or the return of another employee who has been temporarily replaced. In particular, this applies to (EC, 2003, p.11):

- persons with seasonal employment,
- persons engaged by an agency or employment exchange and hired to a third party to perform a specific task (unless there is a written contract of unlimited duration with

- the agency or employment exchange),
- persons with specific training contracts.

If there are no objective criteria for the end of a job or work contract, then this is considered as permanent or of unlimited duration.

The distinction between full-time and part-time work is based on the subjective declaration of the respondent. A more precise, objective definition is not possible since working hours differ from country to country and from one branch of activity to the next.

The number of hours usually worked per week in the LFS only refers to the usual number of hours *in the main job*, including paid or unpaid overtime, but excluding travelling time between home and workplace or time for the main meal break. Apprentices or trainees should exclude any time spent at college or in other special training centres. Persons unable to provide a figure for their usual working hours may replace it by the average number of hours actually worked per week over the past four weeks. Some persons, particularly self-employed and family workers may not have a usual timetable because their working hours vary widely from one week or month to the next.

The duration of unemployment is operationally defined by the shorter of the following two periods:

- the duration of search for work, or
- the length of time since last employment.

Youth unemployment refers to the unemployment of persons aged 15–24.

Long-term unemployment is defined by duration of 1 year or more.

Proposed Methodological Framework for Labour Market Flexibility

The pyramid of competitiveness

In 1997, the European Commission proposed the so-called „**pyramid of competitiveness**”¹. This pyramid is used to develop various models of competitiveness on the macro- and micro-economic levels.

The competitiveness pyramid presents a set of factors, which determine competitiveness. The most important factor – **standard of living** – is placed at the top of the pyramid. Standard of living is considered to be a synthetic competitiveness indicator for any given economy (GDP per capita). This indicator is influenced by two factors: **the employment rate** and **productivity**. They are further broken down into individual factors determining both values (*Figure 2*).

Employment rate is influenced by the ratio of professional activity, creation of new jobs, labour market, demographic aspects of the society and intangible investments, defined as investment into human resources (increase of qualifications).

Productivity is influenced primarily by innovations, research and development outlays, investments in fixed assets and the financial situation (investment financing, taxes).

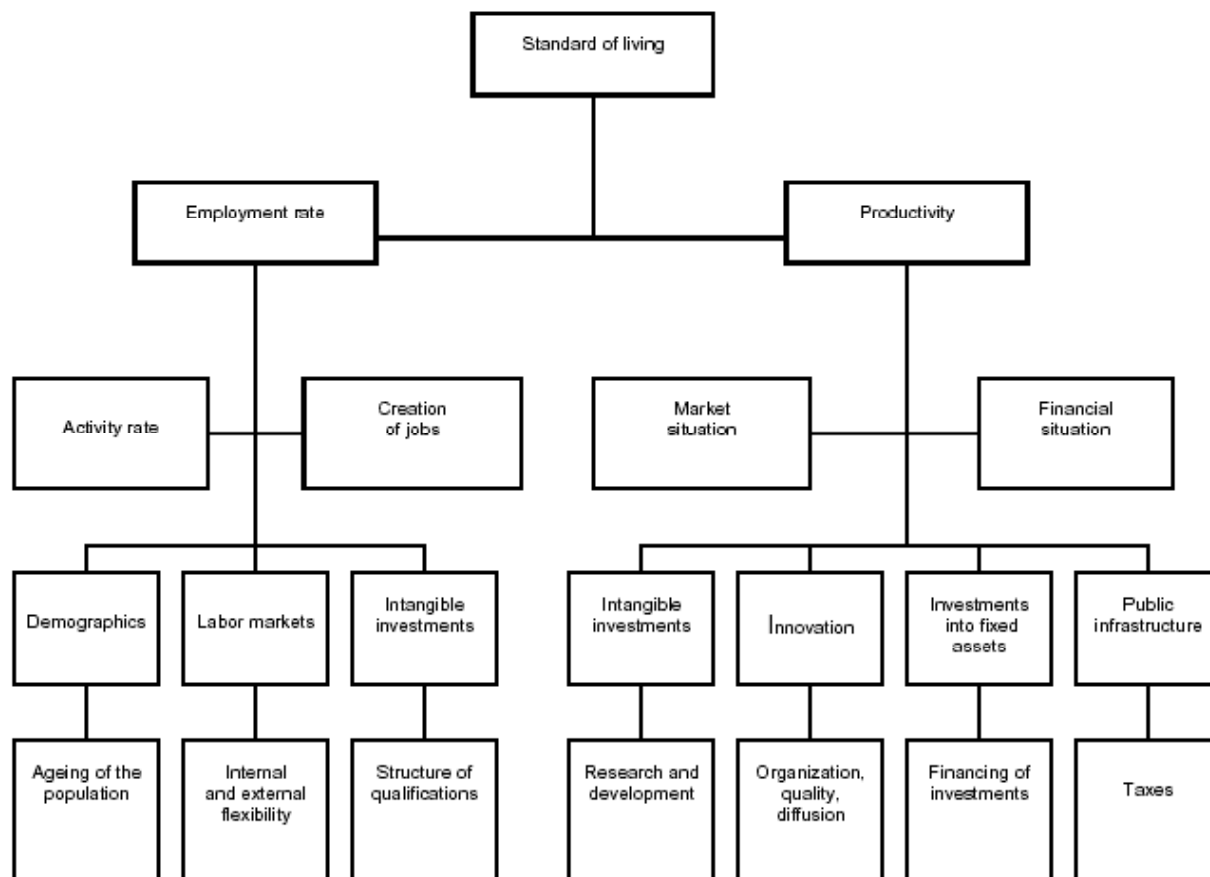
The logic of the current study

The focus of the current study is the **employment rate dimension** (*Figure 3*) in the pyramid of competitiveness, acknowledging that there are direct ties with productivity dimension, e.g. the issue of wages is directly connected with the factor of taxes (on the productivity dimension). The proposed model of research incorporates **supply-side of labour**

¹ Source: Benchmarking the competitiveness of the European industry, COM (96) 463 final, Brussels, 9.10.1996, in: A. Hildebrandt, Competitiveness – attempts to define and measure the event, the European Communities, No. 3 (126) 2002, page 69.

market (demographics, ageing of the population, activity rate and rate of passive population) and **demand-side of labour market** (general indicators and structure of employment; intangible investments; structure of qualifications).

Figure 2. The pyramid of competitiveness

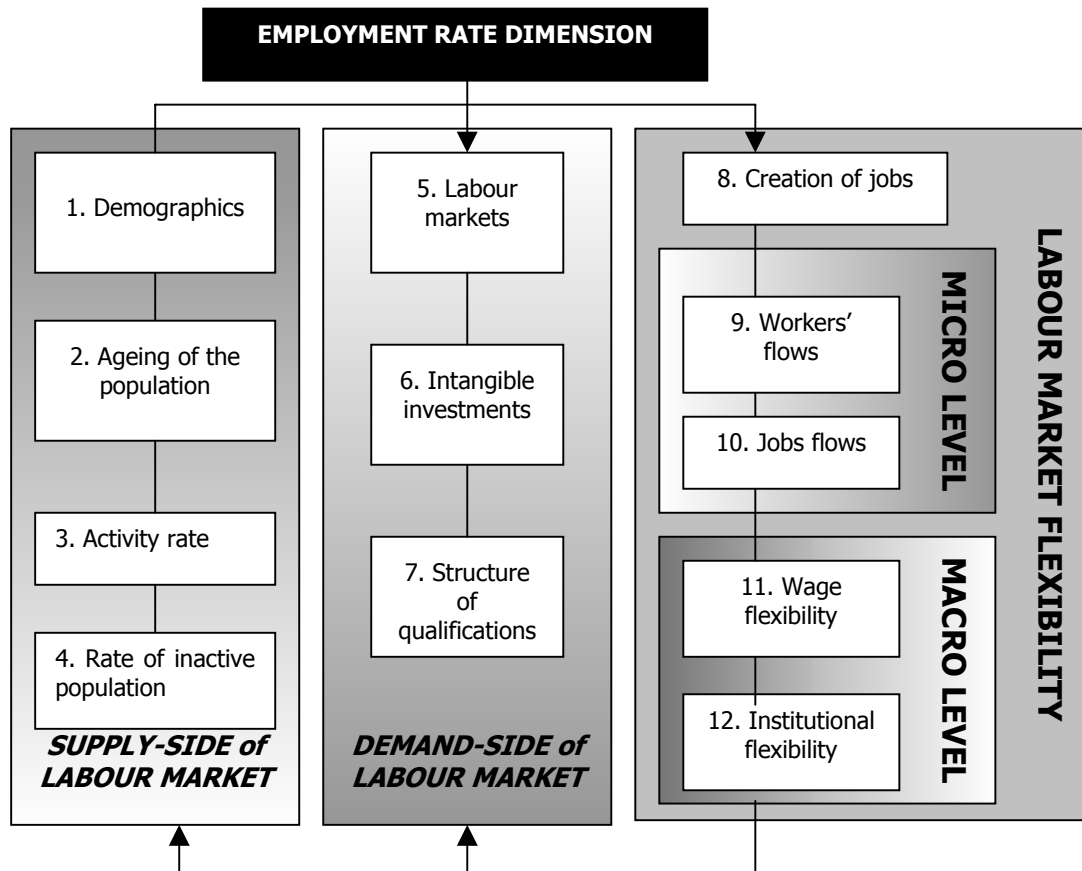


Source: *Benchmarking the competitiveness of the European industry*, COM (96) 463 final, Brussels, 9.10.1996, in: A Hildebrandt, *Competitiveness – attempts to define and measure the event*, the European Communities, No. 3 (126) 2002, page 69.

Besides, the factor of **job creation** has been viewed according to the concept of **labour market flexibility** (Paas et al., 2002a and 2002b; Paas et al., 2003; Cazes and Nesporova, 2004). They argue that labour market flexibility should be measured at two distinct levels: **the micro level** and **the macro level**. The latter can be further divided into institutional and wage flexibility.

The institutional flexibility of a labour market denotes to what extent state institutions and trade unions are involved in the regulation of the labour market. **Wage flexibility** shows how responsive wages are to market fluctuations. **Micro level flexibility** relates to labour market flow analyses. A labour market can be characterized by various flows of transitions to and from employment, unemployment and non-participation, as well as flows of job creation and creative job destruction.

Figure 3. The proposed employment rate dimension for the current study (in the pyramid of competitiveness)



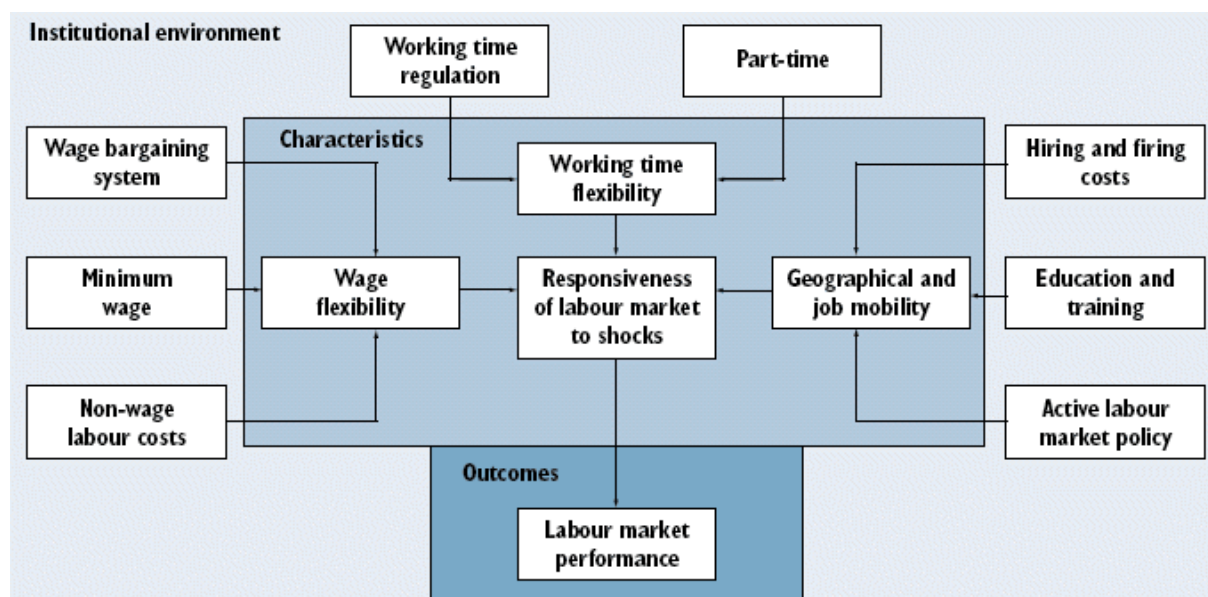
In practice, different aspects of flexibility are interrelated, presumably in a hierarchical way. If institutional involvement is very high, workers' transition rates are likely to be low. If trade unions are weak, then wages are more flexible. Thus, macro level flexibility can partly be measured via the indicators of micro level flexibility. While it is generally difficult to quantitatively measure institutional involvement (although quite a few indexes have been constructed), it is much easier to measure workers' flows, job creation and creative job destruction.

Detailed determinants for labour market flexibility: the institutional perspective

This study employs an organising framework for the analysis which highlights three facets of labour market flexibility – **characteristics**, **outcomes** and **the institutional environment** – which are illustrated in *Figure 4*. This study defines a flexible labour market as one that has the ability to adjust to changing economic conditions in a way that keeps employment high, unemployment and inflation low, and ensures continued growth in real incomes (HM Treasury, 2003, p.10).

As it is indicated in *Figure 4*, Labour market flexibility can be looked at, primarily, as the speed with which the labour market adjusts to **shocks**, which cause disequilibrium. Such disequilibrium can be caused to a large extent by structural changes in the economy. Therefore, three *major characteristics* of responsiveness of labour market to shocks can be observed, namely:

Figure 4. Detailed determinants of labour market flexibility: the institutional perspective



Source: HM Treasury (2003), p. 11.

- 1) *working time flexibility*, pertaining working time regulations and a possibility of working part-time;
- 2) *wage flexibility*, which incorporates wage bargaining system, minimum wage and non-wage labour costs;
- 3) *geographical and job mobility*, consolidating hiring and firing costs, education and training, active labour market policy.

From the **macroeconomic perspective** a flexible labor market gives rise to full utilization and efficient allocation of labor resources. This entails high labor force participation, low unemployment, and labor mobility resulting in an efficient structure (industrial, occupational, regional, etc.) of employment. The prerequisite of the latter is a process known as “creative destruction”, that is reallocation of jobs from the declining firms and industries to the expanding ones.

From the **worker perspective** a flexible labor market means an ease in finding a gainful employment. This entails availability of information on job opportunities, low mobility costs (including regional mobility and the acquisition of new skills necessary for occupational mobility), and a short duration of job search resulting in a satisfactory worker-job match. Although in a flexible labor market the probability of job loss is relatively high, the costs of joblessness are relatively low, as unemployment spells tend to be of short duration and there are high chances of finding a new job.

From the **employer perspective**, a flexible labor market does not unduly constrain the employer’s ability to adjust the size and the composition of their workforce as well as wages to changes in product demand.

At the **firm level** there are three principal means of securing flexibility (Michie and Sheehan, 2001, 2003): numerical, functional, and wage or reward flexibility. *Numerical flexibility* is the ability of firms to vary the amount of labour employed, by making use of part-time, temporary and seasonal employees, short fixed-term contracts, agency labour, freelance work, and homework or outwork. The use of this type of labour is also commonly referred to as ‘flexible employment contracts’ or contingent labour. *Functional flexibility* is the ability of firms to vary the amount and type of labour they use without resorting to the

external labour market, and is accomplished primarily by having a labour force that is able to carry out a wide range of tasks – that is, the ability to move workers from one task to another. *Wage or reward flexibility* is having payment systems in place that encourage and reward improved performance (for example, performance related pay). Since functional and reward flexibility are subsumed in human resource policies and practices, the effects of using contingent labour, or flexible employment contracts, is the focus of our flexibility analysis.

Employers and workers would probably agree whether or not the labor market is flexible, but they could disagree on the assessment of labor market flexibility. While employers would probably unambiguously prefer more flexible labor markets, some workers – especially the insiders, i.e., those with secure jobs – may prefer higher degree of employment protection. However, those workers who are unemployed – the outsiders – could prefer to look for jobs in a dynamic labor market, where their chances of finding work are better, and unemployment spells are shorter.

From the view point of macroeconomic performance flexible labor markets tend deliver better outcomes. This point was forcefully made in the influential OECD Jobs Study (1994), and since then has been further supported by additional empirical evidence. For example, Boeri et al. (2000) found that countries with tight employment protection legislation tend to have lower employment rates. Garibaldi and Mauro (1999) provide evidence that flexible employment protection legislation is associated with high job creation. Di Tella and McCulloch (1998) show, based on the assessment of labor market flexibility by employers, that a more flexible labor market leads to lower unemployment rates and to a lower proportion of long-term unemployed in the unemployment pool.

Moreover, rigid labor markets produce “jobless recoveries,” introduce unemployment persistence, and reduce the country’s vulnerability to external shocks. Recent work by Blanchard (2000) and Bertola et al. (2001) provides further theoretical and empirical support to the proposition that flexible labor market institutions reduce unemployment, particularly of long-term nature. This is thanks to greater wage flexibility and higher labor turnover associated with less regulated labor markets. Accordingly, it is real and relative wages, rather than employment, that bear the brunt of adjustment to adverse shocks. In addition, high labor turnover decreases the average time a worker spends in unemployment. Thus, flexible labor-market institutions positively influence the speed at which an economy can return to its equilibrium rate of unemployment following a negative shock. By contrast, it takes a regulated labor market much longer to get back to its equilibrium unemployment rate after a shock.

Measuring labor market flexibility is not easy for three reasons. First, there is no single indicator that would capture all dimensions of flexibility. As a result, different measures of flexibility usually produce different and sometimes inconsistent results, which may create ambiguity and in some cases makes a definite assessment of labor market flexibility difficult. Second, existing partial indicators (such as various indices of the strictness of employment protection legislation) are imperfect proxies for the phenomena they intend to measure. This implies that the assessment of flexibility is of an approximate character and can be inaccurate. Third, quality of data used to construct an indicator can be poor. For example, job turnover can be deemed a good indicator of labor market dynamics, however available data sets tend to be flawed and not comparable across countries. This means that there is no reliable yardstick and the measures of flexibility are subject to a possibly wide margin of error.

Problem areas in LFS data: the CEEC perspective

Problem areas in CEECs’ LFS data occur due to the fact that the EU LFS standards, concepts and definitions are not yet fully implemented in the national surveys, and major

steps in that direction only were taken in the 2002 LFSs.

PROBLEM AREA 1. A first problem area is the *survey coverage*. In some countries the LFS still excludes the population under 15 so that the necessary figures for computations involving the whole population have to be derived from other sources. Several countries also included persons living in collective households through their private household of origin but cannot identify them as such due to the lack of corresponding questions or response categories. In some CEECs persons in compulsory military or community service, who should be omitted from LFS results, are excluded from the national LFS from the very outset, in others they were included, but not identifiable.

PROBLEM AREA 2. A second problem area has been *missing items or responses*. Up to now the CEECs did not cover all EU items in their national LFSs. Such gaps exist, among others, with regard to persons in education or training, the full-time/part-time distinction, the permanency of jobs, the number of usual hours, or atypical work. But it also happens that responses are missing even though an item is included in the questionnaire, because some persons simply are not asked that question due to the filter applied to it.

PROBLEM AREA 3. Another area of concern is the basic classification of respondents by their *labour status*. There are considerable differences from country to country in terms of the type and number of questions as well as the criteria used to determine this status.

PROBLEM AREA 4. General methodological discrepancies also occurred with respect to the *professional status* (e.g. the classification of members of co-operatives) or the *methods used to find work* (i.e., the number of possible responses).

In sum, it should be reiterated, however, that despite all of these reservations the CEECs' LFSs still provide the most consistent and comparable set of statistical data for the analysis of employment and the labour market – if properly treated with the necessary caution.

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