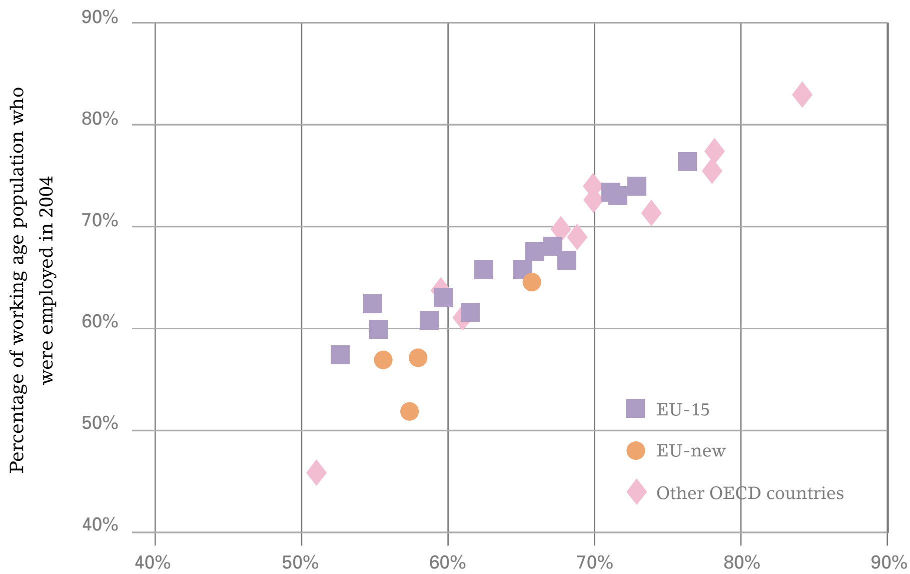
In a world of rapid technological progress and increasing international competition, how can European countries improve their poor employment performance? **Christopher Pissarides** argues that much needs to change in the lower productivity, more labour-intensive service sectors of the economy.

What future for European jobs?

At the Lisbon summit of 2000, the European Union (EU) set an ambitious agenda for making Europe the most competitive economy in the world. Among its many targets were these for employment and growth: by 2010, the EU should have employment rates for the working-age (15-64) population as close as possible to 70%, for women at least 60% and for the 55-64 age group 50%; and as the main driver of growth, spending on research and development (R&D) should be at least 3% of GDP, with two thirds or more done by the private sector.

These targets are unlikely to be achieved. Progress has been slow and a comparison between the EU and other OECD countries shows that although some countries improved their employment performance, in the first five years since Lisbon, no country that was below the

Figure 1:
Employment rates in 1999 and 2004



Percentage of working age population who were employed in 1999
Source: OECD *Employment Outlook*

70% line in 1999 progressed sufficiently far towards the line by 2004 (see Figure 1).

What explains this failure? It seems to me that the central problem is not a lack of knowledge of what policies can work but one of implementation. The European Employment Strategy of 1997 contained several specific measures designed to increase job creation. The OECD has repeatedly emphasised increased flexibility, adaptability, active labour market measures for the unemployed and lower taxes, at least for those at the lower end of the wage distribution. Similar recommendations were made by the European Employment Taskforce, which reported in 2003.

A key part of the problem seems to be that although the types of policies needed are universal (they apply to all countries), the processes needed to implement them are not. The latter must be decided at the national level within the context of the institutions and objectives of the national government, which is much more difficult. And there are likely to be objections from many stakeholders with vested interests in the status quo.

My objective here is not to look at each country's labour market performance and recommend specific measures for reform. Instead, I want to look at policies that can, in principle, be effective in achieving the overall employment targets set at Lisbon.

The novel feature of my approach is that it puts policy in the context of the dynamic evolution of the European economy in a world of rapid technological progress and increasing international competition. We need to understand the underlying causes of low employment in Europe in relation to growth and economic development before a policy prescription can be made.

The connection between jobs and growth

The Lisbon agenda emphasises the 'knowledge economy', which essentially means jobs and growth in high-tech sectors. But much of the job expansion that is needed to satisfy its targets will be in labour-intensive sectors of the economy, which experience low productivity growth. So job creation is not likely to be the main contributor to growth.

Indeed, the link runs the other way: more growth will bring job creation. There is evidence, for example, that increasing the growth rate of labour productivity increases the demand for labour, reduces unemployment and increases participation. My research (Pissarides and Vallanti, 2004) finds that increasing productivity growth by 1 percentage point reduces unemployment by about 1.3 percentage points. Such changes in the growth rate in Europe are feasible given the low starting points.

Of course, high growth is not spread uniformly across the economy. Some sectors will inevitably grow faster than others. And high growth usually does not create many jobs in the sectors that experience it: rather, it creates wealth, which in turn creates demand for services elsewhere.

The jobs growth that comes with productivity growth is more widespread across the economy than the productivity growth itself, and usually more heavily concentrated in low productivity sectors such as retail trade and medical care. The people who take these jobs need to be compensated sufficiently to give them the incentives to enter employment. High compensation in the low-growth sectors is achieved through high prices for their final products, not through more productive use of resources. This is why we experience more price inflation and more job creation in low-productivity service sectors.

The European jobs deficit

How do we know that most jobs will be created in low-productivity sectors? First, in recent European history, employment has been moving out of agriculture and into the low-productivity service sectors, with manufacturing showing either a small fall or no change. In countries that completed the transition out of agriculture early, such as the UK and the United States, the subsequent transition was mainly out of manufacturing and again into services.

Importantly, however, although average hours of work decline with economic development, there is also pressure in these countries for an increase in the participation rates of working-age women, especially those aged 15-50. So historically, European countries should expect that given their small agricultural sectors, there will be pressures on their manufacturing sectors to contract, as well as pressures for an increase in women's employment rates.

The pressures on manufacturing to contract are likely to intensify with the emergence of large Asian manufacturing producers. Trade and export-led growth can provide a cushion for manufacturing, as happened in Japan and Germany in the last 30 years, but it is not likely to continue in the future. Europe has to face the reality of the dynamics of the 21st century: most employment growth is likely to come to service sectors that do not rely on high-tech knowledge or trade.

In some ways, this is good news for the Lisbon employment targets. Economic forces in Europe should be creating demand for job creation in sectors of the

Europe's jobs deficit is in sectors that are labour-intensive with low productivity growth economy that can easily be met with the existing stock of human capital. But creating demand is not equivalent to creating jobs.

The United States is the most advanced country in this dynamic economic process. Its manufacturing sector is shrinking and service employment is rising; women's labour market participation is also rising. As a result, the main gaps in employment now between Europe and the United States are in service employment. Production industries and agriculture occupy more or less the same fraction of people. Can Europe expect a similar dynamic evolution as the one experienced by the United States and if so, can it sit back and wait for natural economic forces to satisfy the Lisbon targets?

This is a difficult question, but given the different performance of countries within Europe, despite their similar level of economic development, the answer is probably no, at least in the foreseeable future. Big gaps remain in employment between Europe and the United States, and within Europe, mainly between the north and the south. These gaps are mainly in business services (such as finance, retail and transport) and community services (mainly in health and education).

Figure 2 shows the gaps in the two types of services. The main gaps are in business services, with only the UK surpassing the United States because of its large financial sector. But there are also substantial gaps in community services, with the exception of the Scandinavian countries (Sweden and Denmark), which have many community services supported mostly by the state.

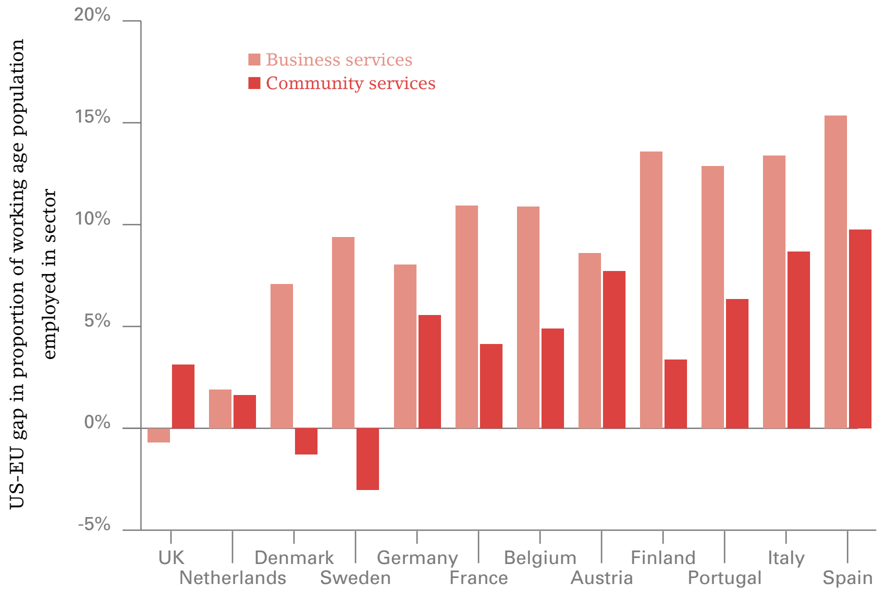
Figure 3 breaks down the employment gaps in the business sector. Here the biggest gaps are in retail and wholesale trade. The gaps in transport and communication are relatively small. There are also gaps in financial services, mainly in business services connected with real estate and in the provision of a variety of other services to employers.The biggest gaps in financial services are in the southern European countries.

Figure 4 shows employment growth in the business services sector. Over the last 30 years, European countries have been achieving good rates of growth in finance, real estate and insurance services, which include high-tech computing services. But they have not been able to match the US rate of growth in the retail and wholesale trade sector, which is the one of this group characterised by lower productivity growth.

It is clear that the jobs deficit in Europe is in sectors that are labour-intensive with low productivity growth. Europe has been creating jobs in the knowledge economy at a comparable scale to the United States, although it has not substantially closed the gap yet. But the low-growth sectors in the United States attract big numbers of workers, especially women, which are not matched in Europe.

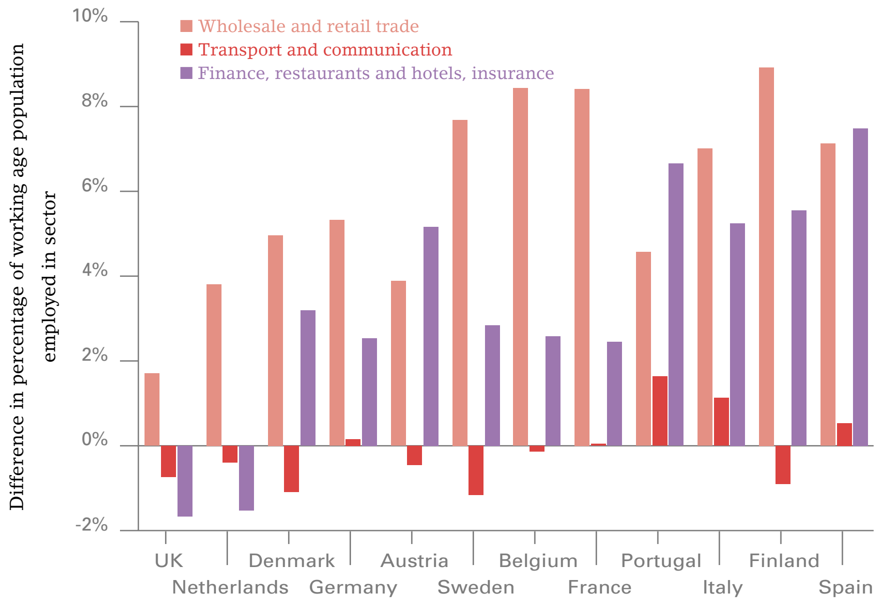
Compensation in these jobs is good in the United States because the prices of their final products are relatively high. The fact that consumers can afford to pay the high prices is itself the result of more

Figure 2:
The employment gap in business and community services between the United States and EU countries



Source: OECD *STAN* database (online)

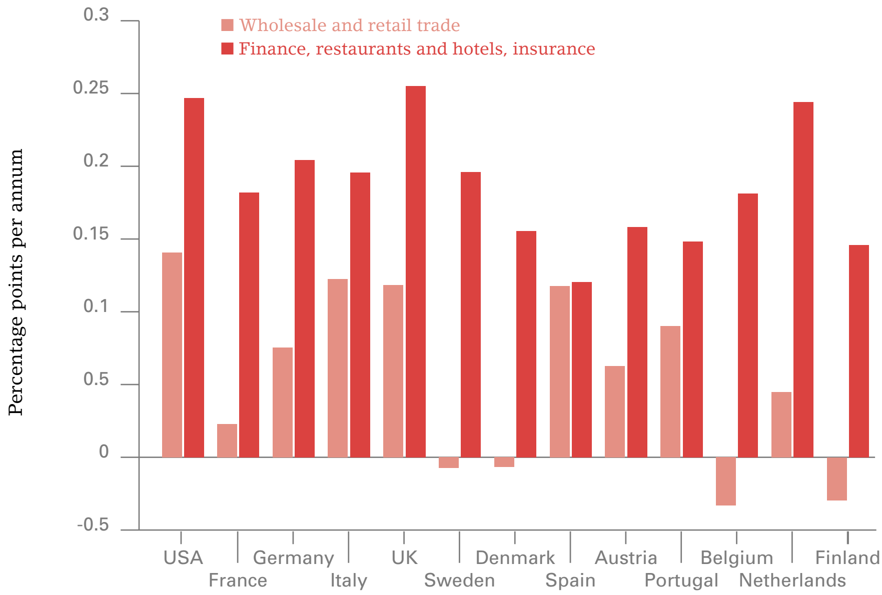
Figure 3:
The employment gap in business services sectors between the United States and EU countries



Source: OECD *STAN* database (online)

Figure 4:

Average annual change in employment rate in business services sectors, 1970-2004



Source: OECD *STAN* database (online)

employment. When women leave the home to take employment, they create demand for market services such as cleaning, food preparation and childcare, which creates more jobs for others.

Why are European economies not creating so many jobs?

The same pressures for an increase in the consumption of business and community services are present in Europe. Europe has more or less caught up with the United States in productivity per hour, but because Americans work more hours, income per head is higher.

But do Americans really work more hours than Europeans? Americans work more hours in the market and so create more jobs, but they work fewer hours at home. Recent research (Freeman and Schettkat, 2005) on the hours worked by Americans and Europeans concludes that they work approximately the same number of hours, but Europeans work much more in the home than Americans (see Table 1). The difference between market and home allocation is particularly marked for women.

European women work on average 8 hours less than American women in the market, but they work 10 hours more in the home. They do more house maintenance, they cook more at home and they look after relatives. They are engaged in 'home production', something Americans do much less.

The Lisbon targets imply that Europeans should move to the market by 'marketising' their home production. It is, of course, debatable whether this is a good policy to encourage, but how could it be done?

The natural conclusion is that to increase employment in Europe, we need to make the market more accessible to women, who now shy away from market work, and we need to create good jobs in labour-intensive sectors of the economy. It is interesting, and encouraging for Europe, that the sectors that lag behind the United States in job creation are women-friendly sectors: retailing, restaurants and hotels, and community services such as childcare and nursing care. Men need not be displaced from their current jobs to make room for women.

An explanation why the market pressures that have given rise to more employment in the United States have not had the same impact in Europe runs as follows. Consumers work out the relative cost of buying some services in the market versus providing them at home. When the price of market goods relative to per capita incomes is lower, more households will choose to use the market for services that have close substitutes in the home. So to understand why Europeans use the market less than Americans, we need to look at the factors that influence the relative costs of buying in the market versus producing at home.

There cannot be large differences in the cost of producing services at home in Europe and the United States. Consumer durables are widely available and homes are as well equipped in Europe as they are in the United States. The factors that can explain the differences in employment patterns in Europe and the United States must therefore be in the returns to market work and in the cost of buying services from the market. The interpretation of these costs must be general, to include convenience factors and not only prices and wages.

Several factors are contributing to making the products of market work in Europe too expensive for consumers and market work itself unattractive for workers. And the two issues are, of course, interconnected: if there are features that make market work unattractive, they could be offset by higher prices for the final product; but higher prices would then choke off demand and so reduce employment.

Table 1:

Weekly hours of work of men and women aged 25-54 in the United States and Europe in the early 1990s

	Men			Women		
	Market	Home	Total	Market	Home	Total
United States	44.1	16.1	60.2	28.7	30.1	58.8
European Union	43.4	13.6	57.0	20.7	40.5	61.2

Source: Freeman and Schettkat (2005)

What can make market work more attractive?

So the key question is what can make market work more attractive, especially to women? First, there are various restrictions on market work, which, although individually seemingly unimportant, when aggregated they add up to a lot. These include flexibility in market work hours, flexibility in shop opening times, and the availability of inexpensive childcare services (see Freeman and Schettkat, 2005). These types of facilities make it easier for women with children, and for those without children who have a household to run, to enter employment.

Examples of European countries that have liberalised restrictions and succeeded in increasing women's employment to the Lisbon targets, include the Netherlands and the UK. Both countries have very large numbers of part-time jobs and, in the UK at least, evenings and weekends are the busiest times in the shops. The Scandinavian countries have also succeeded in raising women's employment. A factor here is not just widely available childcare, but also the fact that many of the community services marketised in the United States are provided by the state, which employs large numbers of women.

Another important factor in the employment of women is education. Employment differentials across countries are lower at higher educational attainments. Women with university degrees have similar rates of employment everywhere. Of course, it would take a long time for substantially more women to acquire university degrees and gain employment. But the impact of higher education on women's employment is not one-for-one. When more women acquire education and gain employment, they create demand for the services of other women with less education. There is a 'multiplier' effect of education, which brings to the market a larger number of women than the ones leaving college with higher qualifications.

The initiative to increase education in Europe comes from the state. But for it to be effective, two pre-conditions need to be satisfied. First, women need to know that jobs will be available and that they would be compensated as well as men's jobs. There is EU legislation against discrimination, but it is not always effectively implemented (see Boeri et al, 2005). Increasing the effectiveness of legislation and making working conditions good for women will certainly improve the chances of satisfying the Lisbon targets. In the United States, there has been high-profile anti-discrimination legislation since the early 1970s and it has contributed to the expansion of women's employment.

> Effective labour market reforms include more flexible employment and lower taxation of low-wage jobs

The second pre-condition is that highly qualified women need to know that there will be less qualified people around, mainly women, prepared to do the tasks normally done in the home. This is where childcare services are vital, but equally important (because they affect larger numbers of women) is the availability of people prepared to work as cleaners and in restaurants and laundries.

To achieve this, the EU needs to think seriously about unskilled migration and its potential contribution to the Lisbon agenda. In Cyprus, for example, employment levels are within the Lisbon targets. Educational levels and women's employment rates are unusually high for a Mediterranean country. These rates are supported by large numbers of unskilled immigrants on regulated fixed-term contracts, working in business and community services, mostly domestic service, nursing and retailing.

Making it easier for employers

Job creation needs to be attractive to potential employers too. An obvious policy reform here is that labour markets should be liberalised, especially at the lower end of the skills distribution. This is not new: it has been emphasised in numerous writings by the OECD and the European Commission. But reforms have not been forthcoming.

The administrative burden on companies, especially new, smaller companies, certainly explains some of the gaps in service jobs. Jobs in business and community services are frequently performed within small companies or by individuals working on their own account. If these individuals are to be attracted to the market, it is important that setting up a small company and running it should be easy and inexpensive.

For example, there should be one window for completing all the necessary administrative work for a new company, setting it up should be completed within a week and the company should not be required to report detailed accounts and register for VAT if turnover is expected to be below a certain (generous) limit. Direct assistance from the state for new entrepreneurs is also important.

A study of the French retail sector (Bertrand and Kramarz, 2002) finds that barriers to the setting up of supermarkets have a negative impact on the local labour market. And other studies find that unimpeded entrepreneurship helps in both the diffusion of new technologies and the adaptation of businesses to new challenges. Diffusion and adaptability are important for Europe in a world with the twin challenges of technological catch-up with the United States and globalisation. Indeed, with these two challenges, adaptability is more important than R&D geared to new discoveries.

Another obvious factor in the attractiveness of job creation that has attracted a lot of attention recently is taxation, which can discourage both employers and employees. This follows Edward Prescott's claim that the entire gap between European and American hours of work can be explained by taxation, which makes work in the home relatively more attractive because it is not taxed.

Econometric evidence has so far failed to find a large impact of taxation on employment, and Prescott's work has been criticised for failing to distinguish between different types of taxation and the uses to which the tax revenue is put, which must influence the impact that taxation has on employment. Nevertheless, taxation clearly has a bigger impact on economic activity at the lower end of the productivity distribution. Profit margins and net gains from employment are smaller when productivity is lower so a given tax takes a bigger proportional slice of net gain.

It is now widely accepted that capital should not be taxed much because it is mobile: if one country taxes it, capital will flee to another. The experience with home and market work in Europe shows that low-wage labour is also mobile, between the home and the market. Based on the same principle, low-wage market work should not be taxed much either. Otherwise, it will flee to the home.

What can the European Commission do?

The most important reforms needed to achieve the Lisbon targets are at the national level. Not all EU countries need the same reforms and it is up to individual governments to decide what is most urgent for their situation. But can the Commission help in any way other than giving advice and exerting moral pressure?

The answer is yes – and although much has been done, much remains to do. The report of Wim Kok's group (European Commission, 2004) highlights five areas of policy that require urgent action. Four of them are firmly in the national domain: encouraging R&D; improving the business climate; improving the performance of the labour market; and ensuring environmental sustainability. But the fifth – the completion of the single market – mainly requires action from European institutions.

Market integration is important because European companies can take advantage of economies of scale. Prices of goods are generally lower in the United States than in Europe and the reason is that US companies have better distribution networks and make better use of diversified locations within the United States. Europe can do the same, but it is not doing it yet.

The main benefits from European integration so far have been the benefits from free trade. The Commission estimates that in the first 10 years of the single market, European GDP gained about 1.5%. This is not very much compared with the annual rate of growth of GDP, corresponding to about a year's growth. There have also been some gains in job creation but with respect to services, the biggest component of GDP, integration has not yet taken place.

The Kok report rightly emphasises that efforts towards completing the single market should be stepped up, especially in the liberalisation of services. Even financial services are not fully integrated, although there is an agreement that they should be. On paper, integration is complete in the goods sector, but the large differences in prices that remain across Europe are evidence that it has not yet fully taken place. The limits here may be due to corporate policies and not a matter of national policies. If that is the case, the Commission can again take action to improve integration.

Beyond this channel, the Commission has mainly emphasised the need for reform and more effort to achieve the Lisbon targets. But it has not taken concrete action. The failure to take the necessary action at the national level is partly the result of countries not doing what they said they would do, and partly not saying or doing what is needed.

The Commission could work out a system or incentives to make countries more willing to take on the necessary measures. For example, it could give some financial compensation for research and other spending that is now financed by national budgets but which contributes to the Lisbon targets. Financial aid or incentives have not been tied closely to the targets. If the Commission wishes to accelerate the reform process, this is one area in which it could contribute a lot.

The central problem is not a lack of knowledge of what policies will create jobs but one of implementation

Conclusions

- The job creation required to achieve the Lisbon targets will be mainly in sectors with low productivity growth: retail trade, a variety of business services and community services.
- European countries have been successful at creating jobs in the 'knowledge sectors', such as financial services, but have been unsuccessful at creating them in the more labour-intensive service sectors.
- Most new employment will come from women now outside the labour force and it will 'marketise' many of the services now done in the home, such as childcare and other personal care, cleaning, shopping, etc.
- To achieve the new job creation, employment needs to be made more women-friendly through more flexibility of working hours, more flexibility in shop opening hours and easier availability of domestic service.
- Education needs to be further advanced and supported by less expensive immigrant labour in the labour-intensive service sectors, including the home.
- Other essential labour market reforms include an increase in the flexibility of employment, less taxation of low-wage jobs and fewer administrative burdens on new entrepreneurs.
- Finally, the failures of the Lisbon agenda are not due to a lack of knowledge of the principles behind the right policies but a lack of urgency in the reform and implementation process needed to put those principles into practice.

This is an edited version of the keynote address by **Christopher Pissarides** delivered at the Austrian Presidency conference on *Innovations in Labour Market Policies: Challenges in Times of Globalisation*, Vienna, 16-17 February 2006. Pissarides is professor of economics at LSE and director of CEP's research programme on macroeconomics.

Further reading

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