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Iwona Mertin[*]*, Ognian N. Hishow*

Analysis of the success and failure in the labour market in selected EU member states – macroeconomic aspects

[*]*Aalborg University, Denmark, and The University of Economics Poznan, Poland*

Ludwigkirchplatz 3–4
10719 Berlin
Phone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org

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Summary

The article points out particular economic factors and policies which influence the level of employment/unemployment in selected Western and Eastern European EU member countries against the background of their respective growth performance in the last decade. It tries to shed light on some myths related to the labour market success and failure by looking at the specific conditions in the investigated countries. Through the analysis of indicators related to employment, unemployment and macroeconomy, we explain characteristic features which have been crucial for the labour market performance across Europe.

Key words

Economic growth, macroeconomic policy, ageing society, taxation, active labour market policy

Introduction

The European Union is the leading economic entity in the world: in terms of overall GDP, Europe of the 27 is ahead of the USA, and much bigger than China and Japan. But the EU has not succeeded yet to become a worldwide pacemaker regarding growth, innovation and employment. The opposite applies: the EU is more often perceived as a reaction to globalisation (Giddens 1999: 124), and, worryingly, only as a slow and hesitant one. According to the Lisbon Strategy the EU - facing the increasing competition from the USA and Asia side (European Commission High Level Group 2004) – has agreed *to become the most competitive and dynamic knowledge-based economy in the world, capable of sustainable economic growth with more and better jobs and greater social cohesion* (Lisbon European Council 2000). Although the European Union is lately experiencing relative economic stability as a result of coherent monetary policy, there still exist issues of great concern. The structural problems, lower economic growth and high level of unemployment, especially after the enlargement in 2004, affect the EU ability to cope with forthcoming challenges. The European societies seem to feel fear for the globalisation and perceive it as a reason for higher unemployment, deindustrialization, wage decrease etc. Hence, in an effort to cope, the implementation of the Lisbon Strategy was put forward as the EU plans inter alia to reach the level of full employment, what will help to gain on competitiveness[1]. This is not an utopia: some of the EU member

[1] European Employment Strategy, until 2010, Total employment rate - Employed persons

states have been successful in the field of labour market policy since longer time. Conversely, some have not found their way to reach equlibrium yet.

But which policy is sustainable? Both the politicians and people often see only one side of the problem and try to decrease unemployment rate to minimum level at any price in order to avoid social unrest. However, this short sighted approach might have negative impact on the economic condition of a country. There are some issues that often mislead. First of all, there is no universal model of industrial or social relations, application of which could assure the success in the labour market. Second of all, there is no correlation between the size of the country and its employment situation. Finally, high social protection expenditures are not the explanation of high inactivity rate and they are not the cause of unemployment. To stress it, better situation in labour market is not dependent on the higher level of social protection.

The solution to reach stable equlibrium in the labour area is the subtle combination of labour market policy, macroeconomic policy and social dialogue. Each of the countries investigated here has its characteristic features, that push it towards success or failure. In order to present these characteristic features, but to avoid blurring them, some selection has been made. As a result we have group of 12 countries:

- Nordic countries (Denmark, Sweden),
- Anglo-Saxon countries (Ireland and the UK)
- Continental countries (France, Germany and the Netherlands)
- South-European countries (Portugal)

as a representatives of different social models (Sapir 2006: 376) in Europe and additionally

- Central and Eastern European countries (the Czech Republic, the Slovak Republic, Hungary and Poland).

On the one hand, there is Denmark, a small and open economy that has relative advantage when high-share of part-time job or high level of employment among young people is considered. On the other hand, there are representatives of Central-Eastern Europe, like Slovakia and Poland. The latter has not only poor social protection and low level of development of active labour market measures, but is also facing the highest level of unemployment rate in the whole European Union. Similarly, Germany and France – known for their etatistic stance, and the UK, more liberal, perform – despite they all are big member nations - differently too.

aged 15-64 as a share of the total population of the same age group = 70%; Employment rate - females - Employed women aged 15-64 as a share of the total female population of the same age group = 60%; Total employment rate of older workers - Employed persons aged 55-64 as a share of the total population of the same age group = 50%; regards the EU15.

1. Labour market in Europe - employment, unemployment and inactivity measures

1.1 Employment situation in general and by gender

The situation among selected countries and within entire EU25 is diversified. Taking a look at total employment, it is noticed that different groupings can be made. First of all, when EU25 average is considered, there are two groups of countries. One, represented by Poland, Hungary, Slovakia and France, where employment rates are below the average EU25, and another with rates above the average, consisting of the Czech Republic, Denmark, Germany, Ireland, the Netherlands, Portugal, Sweden and the United Kingdom. For the time being, only four of the researched countries (Denmark, the Netherlands, Sweden and the United Kingdom) already fulfil the goals of the European Employment Strategy for 2010 with regards to total employment. Close to the envisaged level of 70% is Portugal and Ireland.

Crucial to mention is the tendency among the member states. There are three countries where downward tendency is visible: the Czech Republic, Slovakia and Poland, which has also experienced the highest decrease of employment rate since 1998. The highest growth in amount of 7 percentage points took place in Ireland (see table 1.1). Between years 1998 and 2005 rank orders have not changed significantly. In the first place there is Denmark, in the last Poland (the latter has replaced Hungary). The greatest progress has been made by the Netherlands (1998- 4th rank, 2005- 2nd) and Ireland (1998- 8th, 2005- 5th). When the growth rate of this indicator is considered, first impression is that the poorest results have the Central Eastern European countries.

Table 1.1. Employment rate - Employed persons aged 15-64 as a share of the total population of the same age group

	1998	2005	Change	1998	2005	Change	1998	2005	Change
	Total			Women			Men		
EU25	61,2	63,8	2,6	51,8	56,3	4,5	70,6	71,3	0,7
Czech Republic	67,3	64,8	-2,5	58,7	56,3	-2,4	76,0	73,3	-2,7
Denmark	75,1	75,9	0,8	70,2	71,9	1,7	79,9	79,8	-0,1
Germany	63,9	65,4	1,5	55,8	59,6	3,8	71,9	71,2	-0,7
Hungary	53,7	56,9	3,2	47,2	51,0	3,8	60,5	63,1	2,6
France	60,2	63,1	2,9	53,1	57,6	4,5	67,4	68,8	1,4
Ireland	60,6	67,6	7,0	49,0	58,3	9,3	72,1	76,9	4,8
Netherlands	70,2	73,2	3,0	60,1	66,4	6,3	80,2	79,9	-0,3
Poland	59,0	52,8	-6,2	51,7	46,8	-4,9	66,5	58,9	-7,6
Portugal	66,8	67,5	0,7	58,2	61,7	3,5	75,9	73,4	-2,5
Slovakia	60,6	57,7	-2,9	53,5	50,9	-2,6	67,8	64,6	-3,2
Sweden	70,3	72,5	2,2	67,9	70,4	2,5	72,8	74,4	1,6
United Kingdom	70,5	71,7	1,2	63,6	65,9	2,3	77,3	77,6	0,3

Source: Eurostat

The division into gender in two points of time, namely in 1998 and in 2005 reveals that the highest growth rate of employment among both women and men has had Ireland. Moreover, it is coresponding with the highest growth rate of total employment.

Data show also that the countries try to expand the access of women to the labour market, what is a result of following the early implemented guidelines for national employment policy (Action Programmes against Unemployment 1993) . All countries, except Poland, Slovakia and the Czech Republic, have increased the share of female labour force in the market. The most difficult situation have Polish women, who have experienced the highest decline in employment of 4,9 percentage points. The leaders are Denmark, Sweden (around 70%), the Netherlands and the UK. Ireland has made the biggest progress, while Hungary has been replaced by Poland in the last rank. The male share of the labour market goes lately through more dramatic changes. Except Ireland, also France, Sweden, Hungary and the UK have noticed an increase in men employment. In the other countries this indicator has fallen down, the most remarkably in Poland (7,6 percentage points), in Slovakia (3,2), in the Czech Republic (2,7) and in Portugal (2,5).

1.2 Unemployment among selected countries

While in the EU25 the unemployment rate has declined from 9,4% in 1998 to 8,8% in 2005, some of the countries were not able to follow this path. There has been significant increase of unemployment in the Slovak Republic (3,7 percentage points) and Poland (7,5 percentage points). The negative tendency has also appeared in Germany, the Netherlands, the Czech Republic and Portugal.

Ireland seem to be on a winning position in this aspect with its decrease of unemployment rate by 3,2 percentage points (see table 1.2). The rest of the countries have observed also slight declines in unemployment rates, among which are both Nordic countries, France, the UK and Hungary. Changes within this indicator seem to point out the weakest parts of Europe, which are the South and the East. What is here worth highlighting however, is the fact that, although Swedish unemployment rate is around 8%, the unofficial one is said to be even around 20% (Larson 2006: 3).

Taking the unemployment rate itself into consideration, the highest is in Poland (over 17 %). This country has been suffering not only from the highest growth of unemployment rate but also from the highest amount of unemployed. The lowest unemployment level have: Ireland, Denmark, the UK and the Netherlands. All these countries – except the latter – have lately managed to decrease their unemployment. From the Western European countries, in the worst position is France alongside Germany. In both countries the level of unemployment is near 10 percent, while in Germany barely falling. In 1998, the Netherlands had the lowest unemployment rate and Slovakia the highest one. After seven years, rank orders have changed significantly. There is Ireland, which has made great progress moving from 6th into the 1st place. Countries like Denmark, the Netherlands, the UK and Portugal have changed their places within 2nd and 4th rank. The rest has made modest changes when their unemployment rate is considered. The last rank in 2005 belongs to Poland, preceded by Slovakia.

Table 1.2. Unemployment rate - Unemployed persons aged 15-64 as a share of the total active population

	1998	2005	Change	1998	2005	Change	1998	2005	Change
	Total			Women			Men		
EU25	9,4	8,8	-0,6	11,2	9,9	-1,3	8,0	7,9	-0,1
Czech Republic	6,4	7,9	1,5	8,1	9,8	1,7	5,0	6,5	1,5
Denmark	4,9	4,8	-0,1	6,0	5,3	-0,7	3,9	4,4	0,5
Germany	8,8	9,5	0,7	11,1	10,3	-0,8	7,1	8,9	1,8
Hungary	8,4	7,2	-1,2	7,8	7,4	-0,4	9,0	7,0	-2,0
France	11,1	9,7	-1,4	12,9	10,8	-2,1	9,5	8,8	-0,7
Ireland	7,5	4,3	-3,2	7,3	4,0	-3,3	7,7	4,6	-3,1
Netherlands	3,8	4,7	0,9	5,0	5,1	0,1	3,0	4,4	1,4
Poland	10,2	17,7	7,5	12,2	19,1	6,9	8,5	16,6	8,1
Portugal	5,1	7,6	2,5	6,3	8,7	2,4	4,1	6,7	2,6
Slovakia	12,6	16,3	3,7	13,1	17,2	4,1	12,2	15,5	3,3
Sweden	8,2	7,8	-0,4	8,0	7,7	-0,3	8,4	7,9	-0,5
United Kingdom	6,1	4,7	-1,4	5,3	4,3	-1,0	6,8	5,1	-1,7

Source: Eurostat

The division into males and females reflects once more that the worse labour market condition has Poland. Between 1998 and 2005 the female unemployment has risen about 7 percentage points and male unemployment– 8 percentage points. The best performance represents Ireland and the Netherlands that especially in 1998 has reached optimistic results, but in 2005 still was remaining in a good shape.

1.3 Inactivity rates in working societies

The next indicator that needs analyzing is inactivity rate. The inactivity rate is defined as the percentage of the population that is neither working nor seeking work, so it is not in the labour force (International Labour Office). It shows what part of working force remains outside of labour market and because of what reasons. The availability of data forced us to choose some of the latest, in order to present changes in reliable way.

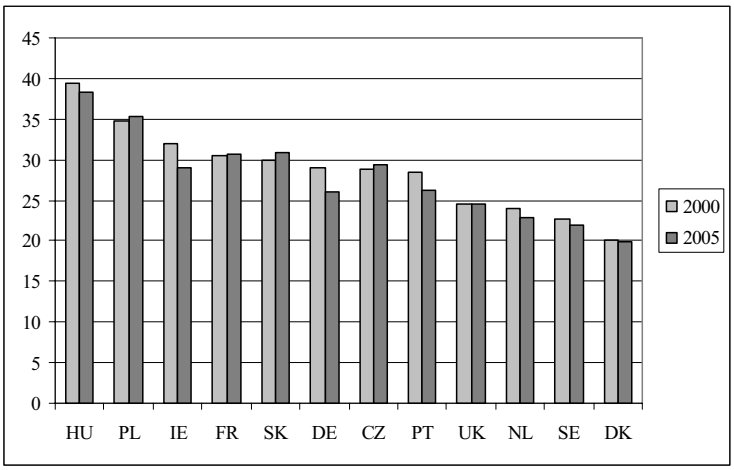
Since 2000, the level of inactivity was the lowest in countries from the Northern group[2] and the Netherlands. While Denmark seem to have

[2] Denmark, Sweden

advantage regarding the lowest inactivity rate in whole population and among women, the Netherlands is especially successful when the inactivity rate of men is considered, though with a negative trend of this rate. The greatest winner in this case is again Ireland, which has already gained a lot from joining the EU.

At the end of rank is Hungary where not only the inactivity rate for the whole population but also sepearately measured for women and men belongs to the highest among investigated countries.

Figure 1.1. Inactive population aged 15-64 as a percentage of the total population (4th quartal data)



Source: Eurostat

2. Linkage between macroeconomy and labour market

2.1 Economic growth vs. employment

The growth theories attribute output growth to the input mainly of three factors[3]:

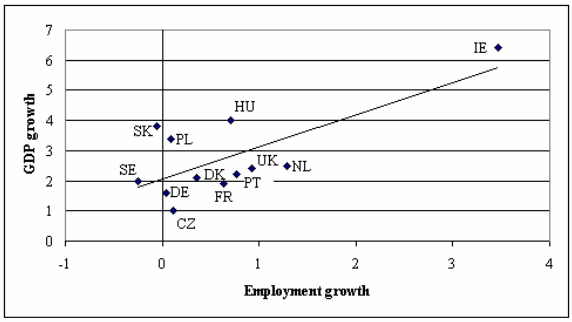
- labour growth multiplied by the share of this input in income,
- capital growth multiplied by the share of this input in income,
- technical progress/growth of total factor productivity[4].

[3] According to the *growth accounting equation:* $\Delta Y/Y=[(1-\alpha)\Delta N/N] + (\alpha\Delta K/K) + \Delta A/A$, where *Y* is an output, *A* is level of technology/productivity, *K* is capital, *N* is labour, *(1-α)* and *α* are weights equal to labour's and capital's share of income.

[4] The amount by which output would increase as a result of improvements in methods of

With reference to the above mentioned factors, let us have a more detailed look at them. One could say, that the more people in labour force, the more goods and services is provided. However, since the II WW the employment growth has been losing on importance in productivity's advantage. The increasing role of innovation and improving qualifications among employees are lately the steering factors of economic growth. There is growing need of human capital development what directly affects the labour productivity. Next, the labour productivity is the main factor of output growth, being at the same time the basis for growth of society's welfare.

Figure 2.1. Relation between employment growth and GDP growth– annual average growth rates (1990-2005)[5]



Source: Eurostat, DG ECFIN, European Economy, Spring 2004, OECD Productivity Database, September 2006

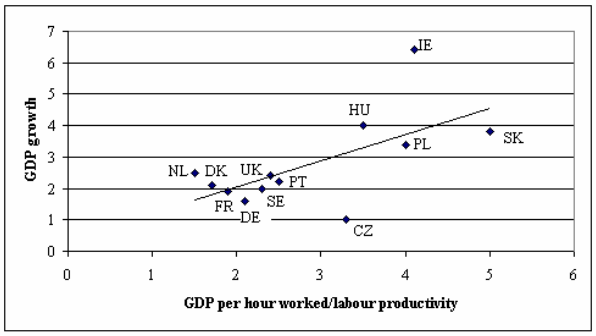
In Ireland the high GDP average annual growth rate in years 1990-2005 have corresponded both with high productivity and employment growth (see figure 2.1, 2.2). The Netherlands has also followed this approach, although not reaching such astonishing effects regarding GDP growth as Irish economy. Other countries represented far modest employment growth rates, rather basing their growth on increasing productivity[6].

production, with all inputs unchanged (Solow 1957: 312-320).

[5] For employment growth data from 1991-2005 (IE 1991-2005; DK, DE, FR, NL, SE 1992-2005; UK 1993-2005; CZ, SK 1995-2005; PL, HU 1996-2005; PT 1999-2005), GDP growth 1990-2004 (for HU and SK 1995-2004).

[6] Sweden between 1992-2005 and Slovakia between 1995-2005 have even noticed declines within annual unweighted average employment growth.

Figure 2.2. Relation between GDP growth per hour worked/labour productivity growth[7] and GDP growth – annual average growth rates (1990-2005)[8]



Source: Eurostat, DG ECFIN, European Economy, Spring 2004, OECD Productivity Database, September 2006

When comparing the indicators from 2005, it can be noticed there are two patterns of economic growth. One that has its roots in increasing productivity and another that is basing on higher job creation. According to the data, two countries' divisions can be introduced:

- predominantly employment-driven economic growth: Ireland
- predominantly productivity-driven economic growth: Germany, France, the Netherlands, Sweden, Portugal, Poland, the Czech Republic, Slovakia and Hungary
- in between: Denmark and the UK have similar results for both factors, so they are moving towards the economic growth both through productivity and employment growth.

Some countries have increased their levels of productivity per hour as the consequence of the reduction of average working time (CZ, FR, PL and SE). Moreover, in case of the Czech Republic the labour productivity growth is in general focused on industry, transport and public services (Podkaminer, Stehrer 2006: 140).

Regarding the economic growth one more thing can be noticed. Predominantly, countries from the Eastern Europe have higher GDP per capita growth than the Western countries. This difference is estimated at the level of 1,8% to 2% per year and will be maintained at least until 2015 (for more see Maddison 2002, Podkaminer and Hunya 2005).

2.2 Population growth and ageing society phenomenon

The output growth depends on labour growth, capital growth and on the

[7] It grows as a result of technical progress and because of the accumulation of capital per worker.

[8] Productivity: for CZ, HU and SK data from period 1995-2004, for PL 2000-2005. GDP growth 1990-2004 (for HU and SK 1995-2004).

speed of technical progress. Looking at the issue from per capita dimension, in order to maintain the equilibrium of production function, income per capita and capital per capita have to be constant, what means both income and capital has to grow at the same rate as population.

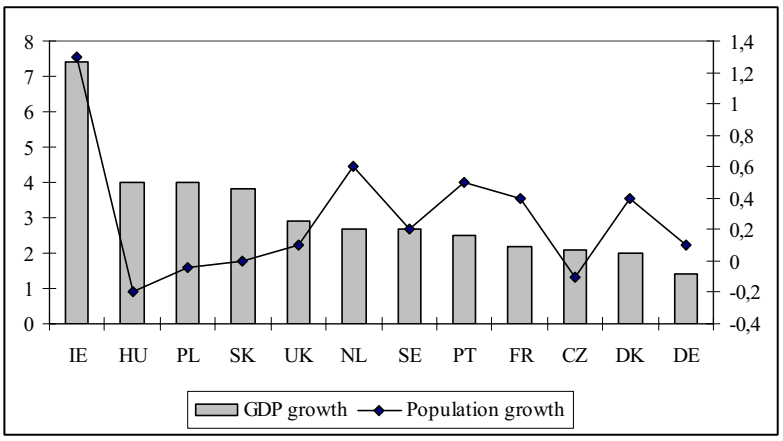
In steady-state the investments which are required to assure capital for new workers and to replace already used machines are equal to savings provided by economy. The level of capital per worker depends on investment and the investment level depends on population growth and depreciation rate. If there is a population growth, the capital per head and output per head decrease, when investment is unchanged, though the aggregate output increases (Solow 1956: 65-94)[9].

So far the theory shows that population growth could have a negative impact on the per capita income, as the case of Germany's unification shows. Especially, that it affected negatively the output per capita, the most reliable indicator of the economic wealth. However, the example of Ireland shows that population growth and its appropriate structure is fruitful. According to macroeconomic models, to maximize the long term economic growth per capita there has to be population growth of 1-2% per year, savings rate 2-4% and discount rate below 4% (Simon 1977). Abstracting from other conditions, none of the countries, except Ireland, fulfils the proper requirement of population growth (see figure 2.3).

Does this mean, then, with respect to the theory, that in the shrinking societies the standard of living will rise? In theory, yes, only when the share of the active population remains unchanged. However, in reality the answer is no, since almost the entire EU population is an ageing society and until 2020 the share of population aged 65 and more is forecasted to increase in all analyzed countries. Only Ireland with the highest population growth rates and total fertility rates is beyond this frame. Such internal condition of Ireland is positively perceived by its young society who in the future will be better prepared to care burden of pensions and extensive health care. Research results indicate also that population of Slovakia, Hungary and the Czech Republic will remain constant.

[9] The linkage is as follows: $sy^{*}=sf(k^{*})=(n+d)k$, where *s* is saving, *sy* is saving per capita, *k* is capital, *n* is a constant rate of population growth, *d* is depreciation.

Figure 2.3. GDP growth and population growth – annual average growth rates (1995-2004)[10]



Source: Eurostat, EC, OECD Productivity Database, September 2006

Therefore, in the case of almost all industrialized countries the issue of concern is not the population decline itself but the age structure of society. An ageing society is already a problem, because with the growing number of older people, the economic efficiency will decrease. In other words employment level will not increase, because of too few people in labour force. Following, it will cause decline in output per capita. Situation in Sweden reflects the core of this problem. Until 2050 it will increase its old age dependency ratio[11] from the level of 29% (in 2000) to 45% and total dependency ratio[12] from 71% to 85%. Such changes will cause serious tensions within the Swedish society, because of appearing inequities. Moreover, except social aspect, there is much more important financial one: the ageing population causes significant financial implications (higher savings, higher taxes, higher contributions).

When it comes to pension burden, some of the countries have decided to tighten the relation of contributions and benefits. Slovakia and Hungary have decided to delegate a part of social security pension into schemes funded from private resources. France and Portugal have increased the dependency of pension from contribution of years, rather than from the age of person. Additionaly, France has increased the level of contibution years for a full pension with reference to growing life expectancy. Both these countries offer their citizens to be retired earlier or later, however with changes in the size of pension. In the same field, Poland and Sweden have implemented the direct linkage between contributions paid during

[10] Population growth: for Poland data from 2005.

[11] Ratio of the population aged 65 and over to the population aged 20-64 (Eurostat, National projections, UN, World Population Prospects 1950-2050).

[12] Ratio of the sum of the population aged less than 20 and the population aged more than 65 to the population aged 20-64 (Eurostat, National projections, UN, World Population Prospects 1950-2050).

working life, life expectancy of the person and pension benefit; and Germany conducts the indexation of its public pension scheme which is dependent from the relation between number of employees and retirees (European Commission 2006).

Table 2.1. Total fertility rates

	2000	2005
Czech Republic	1,14	1,28
Denmark	1,77	1,80
Germany	1,38	1,36
Hungary	1,32	1,32
France	1,88	1,94
Ireland	1,90	1,99
Netherlands	1,72	1,73
Poland	1,34	1,24
Portugal	1,55	1,40
Slovakia	1,30	1,25
Sweden	1,54	1,77
United Kingdom	1,64	1,80

Source: OECD Country Statistical Profiles, Eurostat

Another issue that awakes lately a lot of concern is low fertility rate. The worse situation in the labour market, the lower fertility rate. Such linkage is a result of psychological fear, which is related with feel of insecurity. This relation is noticed in Slovakia, Poland and Portugal, but also in Germany. Changes in fertility rates are the results of internal situation of the country but also of social mentality. It is possible to stimulate the fertility rate through appropriate policy. An example of Sweden shows that in the beginning of 1980s the fertility rate has risen (from 1,6 in 1984 to 2,1 in 1991) as the result of implemented social reforms. However, because of economic recession in the beginning of 1990s it has declined to level of 1,6 in 2001 (OECD 2003: 23).

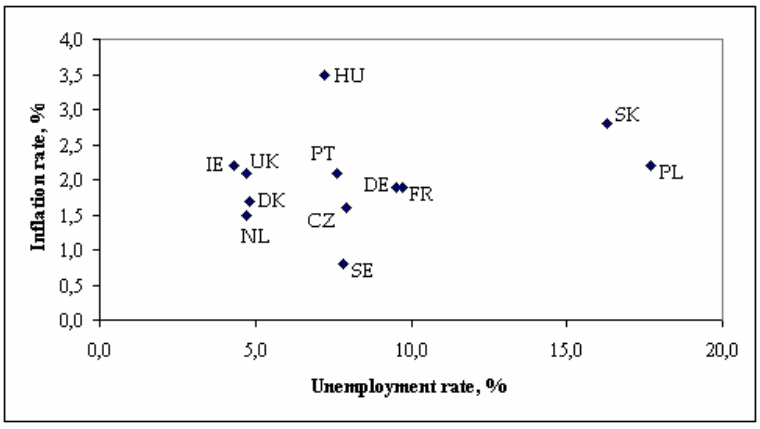
2.3 The EMU – monetary policy and employment

With membership in the Economic and Monetary Union some of the investigated countries have lost the flexibility of exchange rates, so they cannot use the currency devaluation to improve their competitiveness. As a result, another tools for adjustment has to be identified and used in case of economic fluctuations. It means that within the labour market more space for adjustments has to be provided (for more see De Grauwe 2006: 711-730). However, if the EMU has or will have a healing influence on performance of labour markets still remains an open question. Among theoreticians are both the supporters and opponents of statement that with the EMU the employment situation of a country improves (for more see Belke and Gros 2001: 231-264). One say that changes within flexible

exchange rates are an obstacle for investment and employment development so the EMU implementation affects positively the economy and labour market (Mundell 1973), while the others claim that the increase of price stability through the EMU will be occupied by *greater volatility of output* (Begg 2002: 6). The crucial is the rank of goals. In this case the European Central Bank pursues a goal of price stability as it is its constitutional duty, however in some particular circumstances one should decide which goal should be given a greater priority: price stability or loss-reduction in output and employment (for more see the US Federal Reserve).

The tight monetary policy focused on price stability has to be adjusted by wage policy. Following this way of thinking, such wage policy can lead to the recovery of labour markets (Auer 2000: 42). According to the figure below it can be noticed that in 2005 almost all of the countries (less Hungary and Slovakia) have decreased or maintained their inflation rates on very low level (around 2%), so the goal of price stability has been in general fulfilled. Theoretically, in the short run, all countries having low inflation, at the same time have higher unemployment rates. Explanation's attempts of the real relation in the EU by employing the shape of the Phillips curve (the lower inflation, the higher unemployment in the short run) fail, as the case of Ireland, Denmark, the Netherlands and the UK proves. These countries have found the "panacea" close to the ideal combining relative low unemployment rate with prices under control (see figure 2.4). The others stay far behind with respect to their unemployment rates. F.i. in Poland it is a result of incoherent goals: while the National Bank of Poland looks after low inflation and stable currency, having the economic growth of lower importance, the fiscal policy focuses on high GDP and low unemployment. It suggests us that critical for the overall result is the level and ability for coordination.

Figure 2.4. Relation between the UR and inflation rate (2005)



Source: Eurostat

The source of the success of investigated countries within labour market performance is not the EMU membership itself as table 2.2 shows.

Table 2.2. EMU membership and labour market result

	EMU member	Non-EMU member
Success	IE, NL, PT	DK, SE, UK
Failure	DE, FR	CZ, SK, HU, PL

So what kind of other factors regarding macroeconomic policy affects the employment results of these countries?

As it was above highlighten, in the case of the EMU membership, the labour market starts to fulfil important role of adjustment tool, f.i. with reference to labour mobility or wage setting (CEC 2002: 11). It looks that France and Germany are not able to provide enough flexibility within their labour markets and the same they are not able to cope with economic fluctuations. Let us have a look at labour mobility and the case of Germany first. The German government has provided to its citizens high level of unemployment benefits, what make them reluctant to join labour force. As the artificially increased level of wages was higher than the acceptable wages in the UK or Portugal, the result was increasing inflow of British and Portuguese workers into Germany, while the level of unemployment among German workers has increased - the case of German construction industry (for more see the European Industrial Relations Observatory - EIRO and International Labour Office - ILO).

When wage setting is considered, the nominal wage flexibilty is crucial substitute of monetary policy in case of absence of the latter on national level[13]. However, important is the level where wage bargaining is taking place. Within the investigated countries the process of wage setting has become more centralised in Portugal (Visser 2004: 42-43), while the other countries move towards increasing decentralisation. Wage bargaining remains on a sectoral level in Sweden, Denmark, the Netherlands, Germany and Slovakia. In the United Kingdom, the Czech Republic, Poland, Hungary and France dominates the company level, however in the case of the latter it is an alternating issue. Ireland has preserved a system of wage bargaining at the intersectoral level (Schulten 2005: table 4). The research results indicate that pattern of decentralisation will become common within the whole European Union. And here appears a conflict, because in order to be able to use flexible wages as a automatic stabilizer of economic situation, the EMU will be imposing greater pressure on national coordination of wage bargaining instead of the decentralisation of this process, as it will be then easier to coordinate and at the same time more adjustable to the external shocks.

If the wage flexibility is so important for the EMU membership, it can

[13] The case of EMU members.

impose enormous challenge to the new member states (NMS). Characteristic feature of the CEE countries is the fact that their nominal wages are rather inflexible. However, research results indicate that detrimental for adjustment in case of these countries is fast productivity growth and unit labour cost variability. That is why we can divide the CEEC into two groups. The first one, consisting of the Czech Republic and Hungary, where the labour markets are inflexible, and the another represented by Slovakia and Poland. In case of the Czech Republic, the past experience of crisis indicates that, except the wage rigidity, the serious problem for the Czech labour market will be stickness and upward tendency of unit labour costs. In Poland and Slovakia the rigidity of wages may be overcome because changes within unemployment are well followed by the changes in unit labour costs, despite that the channels of adjustment are different. While the first has linked its flexibility with productivity growth, the latter has focused more on inflation (Radziwiłł, Walewski 2006).

Additonal problem regards wages, except the need of bargaining at the national level and preferred flexibility, is the fact that infrastructure and framework for social and macroeconomic dialogue has to be developed enough to allow for wage changes in both directions (up and down) and to cope efficiently with asymmetric shocks. As it can be noticed, the most successful countries in the labour market have already long tradition of social dialogue and mutual cooperation between different levels of governance. Here the Netherlands stands out. Its *Wassenaar Agreement* (1982) as a social pact and *the Dutch Economic and Social Council (SER)* and *the Labour Foundation (STAR)* as institutions do support tripartism and provide social partnership. In *Ireland,* the *Programme for National Recovery* (1987) supported by *the Irish National Economic and Social Council (NESC)* and *The Central Review Commitee (CRC)* plays similar role.

2.4 Fiscal policy and taxation

In whole period 1996-2005 only four of the 12 analyzed countries have met the convergence criteria regarding the general government debt (the Czech Republic, Slovakia, Poland and the UK). In the same time span, eight other countries had differentiated their levels of government debt. While for some of the countries having the debt higher than 60% of GDP belongs to the past (DK, IE, NL, SE, HU), for such countries like France and very lately Portugal, it is a current issue of concern. In this aspect, Germany's deteriorating debt position is a permanent problem that has been overcome only twice in investigated period (in 1996 and 2001). Regarding the requirement of the government deficit, in the last 10 years only Sweden, Ireland and Denmark were able to stay below the level of 3% of GDP.

Despite the restrictions imposed by the Growth and Stability Pact, a helpful – however limited - space to manoeuvre have been left to deal with asymmetric shocks (The Brussels-Frankfurt Consensus), stimulate growth and activity of labour markets. The labour market revival or recession can be affected by properly implemented endogenous fiscal policy.

This relation is explained by the aggregate demand, which consists of consumption, investment, government expenditures and net exports[14]. In the beginning of 1990s, the Danish government has used this instrument in the form of higher government spending and tax cut to get out of recession. Through the higher consumer spending, the aggregate demand has increased. To face the growing consumption, the business' representatives had to increase the level of investment, what further has required the employment increase. It is common practice to conduct looser fiscal policy during recession in order to maintain the demand. However, it can not be forgotten that in such situation the inflation threat exists.

Through the changes in size or structure of expenditures, a particular country may stimulate the labour market. In this case a good example is Denmark, Ireland and the UK, which want to increase the productivity and employability of their labour force through increase of government expenditure on education. The public finance need to be reformed especially in case of Poland, where the unfavourable structure of expenditures and revenues is perceived as a restraining force for job creation and economic growth. Moreover, the result of irrational pension system (f.i. the KRUS[15] existence, the differentiated pension systems for particular groups) is burden in form of 17% of GDP spent on social protection.

While fiscal spending is related to the demand side of the economy, taxation is related to the supply side and is of great importance too.

In order to stimulate the economy, the reforms in following fields of taxation should be implemented:

- decrease of high marginal tax rates on labour, production and investment,
- decline the existing level of distortions within the tax system.

However, one should bear in mind that lower taxes can become a danger. First of all, because of the threat of tax competition, next that the role of welfare systems might be endangered and finally, despite the decreasing taxes, the public goods and social protection have to be financed anyway. That is why, plausible shift of tax burden to labour[16] may occur - risk of overtaxation of labour and undertaxation of capital (CEPII April 2001: 16).

According to the research basing on the Marmotte macroeconometric model (CEPII April 2001), the cuts within particular taxes (social security contributions, personal income tax and corporate tax), affect the economic situation of the country differently depending on the size of the country, EMU membership and other factors:

- any cut within above mentioned taxes leads to higher output in the country conducting reforms; however, it can not be forgotten there exists a risk of fiscal deficit, so finally these cuts have to be

[14] Net export=Export-Import

[15] KRUS (pol. Kasa Rolniczego Ubezpieczenia Spolecznego) – complex system of social security for farmers, including f.i. pension schemes financed in the biggest share from government resources.

[16] The least mobile tax bases.

replaced by tax raises or expenditures cuts
- tax cut in large country, affects negatively the economy of partner countries
- the level of impact on neighbouring economies depends on the membership of reforming country to the EMU[17]
- large countries are less sensitive for tax cuts, while the smaller/peripherial EU members might be seriously influenced by tax changes in large and central ones
- small countries are more eager to cut taxes to the higher extent than the large countries[18]
- small countries gain more from the tax cut conducted alone, then together with other countries[19].

So in the case of tax cuts, detrimental is not only the level of cut, but also which country and when is conducting particular reforms. Moreover, taking all these mentioned aspects into consideration, it can be noticed why the tax harmonisation is an issue of such great concern. It is obvious, that because the large countries are more indifferent on tax cuts in other countries and because the small countries gain less when they implement reforms at the same time as large countries, then there is unanimous interest of the member states in the issue of harmonisation.

However, as examples of some big Eastern and Western European, not enough open EU member states like Poland as well as France show, not implementing reforms within taxes causes serious implications for economy as a whole, because of suffering from tax reforms conducted by other large countries (f.i. by Germany).

To give some explanation, but to retain the clear view of the topic, we will present countries of our focus in two dimensions of taxation: pro-labour and pro-investment tax cuts.

2.4.1 Pro-labour tax cuts

As we have already mentioned, one welcome solution within a favourable taxation that can push the economy towards pro-growth performance is the decline of marginal tax rates. This, if conducted, will stimulate investment and entrepreneurship in society. The issue of marginal tax rates is tightly related with tax wedge.

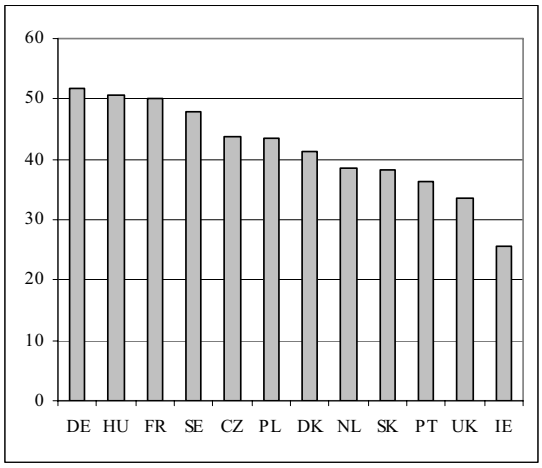
Tax wedge on labour and social security contributions

Taxing wages report by OECD shows that such countries like Ireland, the UK, Portugal and the Netherlands, which have employment rates higher than

[17] If the reforming country is a member of EMU, *the adjustment of the real exchange rate falls on prices* (CEPII April 2001: 7). In case of non-EMU member country, there is depreciation of nominal exchange rate relative to non-reforming countries.
[18] All Eastern European countries, except Poland.
[19] Especially with the big ones like France or Germany.

67%, at the same time have relatively low total tax wedge[20], what makes their citizens work-eager (OECD 29.03.2006: table I.2). Sweden with higher (but already decreased) total tax wedge of 47,9% (see figure 2.5) can bring this linkage into doubt. In the beginning of 1990s, Sweden has conducted a tax reform. The result was the marginal tax rates reduction what is perceived as a positive incentive and it may help to avoid the development of poverty traps.[21] However, in this case, the high employment rate in the last 15 years is a result of overwhelmingly high employment in public sector what corresponds with low input efficiency of this sector[22]. Exception here is Slovakia, where despite relatively low total tax wedge, the level of unemployment remains very high.

Figure 2.5. Total tax wedge (as percent of labour costs)



Source: OECD, Economic Outlook No 77, June 2005

Except Sweden, a decrease of total tax wedge in the period 2000-2004 was also noticed in Denmark, Ireland, the Netherlands, Germany, Portugal and the Slovak Republic. F.i. the Dutch government has agreed on lowering the tax wedge by 1,1%. In 2006, it has reduced the level of social transfers (decline of duration of unemployment benefits), what provided the space for reductions in the labour income tax. Next, Slovakia has decreased its tax wedge by significant level of 4,1 percentage point as a result of employers' part decline in social security contributions and Hungary has conducted labour cost reduction on low-wage earners what also caused the total tax wedge decline.[23]

Let us have a look now at social security contributions cuts. Reducing the level of social security contributions should be profitable both for employees (because the real wage inclines) and employers (because the real

[20] Respectively: 25,7%; 33,5%; 36,2%; 38,6%.

[21] It refers especially to unemployed or people whose main source of income are benefits. The higher marginal tax rate, the lower additional income from work.

[22] Lower than the UK, DE, FR and DK (European Central Bank).

[23] OECD, Progress in responding to the 2005 policy priorities: country notes.

labour cost declines), so the result ought to be the growth within employment. Empirical evidence is highlighting the fact, that with the increase of production, *firms need to create new production units by investing more in the short run* (CEPII April 2001: 24) and these particular cuts support more labour intensive technology, so the new production units are more labour than capital intensive. That is why the use of the SSC cut as a tool to stimulate employment growth is more efficient than cuts in corporate income tax.

According to the implemented and ongoing reforms most of the investigated countries has reduced their social security contributions what should have had healing influence on labour market. Indeed, this is the case of Ireland, the Netherlands or Sweden. However, the cuts there referred only to particular labour groups like low-wage earners and self-employed. Germany has in last years not only reduced the levels of social security contributions, but also of personal income tax and corporate tax. All these changes within taxes should give similar results for the German economy – increase of labour supply and labour demand, followed by employment rate and production growth. However, the increase of employment rate between 1998 and 2005 was only 1,5 percentage point, what was mostly related with increase of female employment occupied by decline in male employment. Additionaly, the significantly large tax wedge (see figure 2.5) makes people to avoid work through running into unemployment or inactivity. Similarly the tax wedge obstacle is perceived in Hungary and France. What are the other factors explaining the high unemployment rate f.i. in case of Germany except the highest among selected countries tax wedge? One of the reasons for poor economic and employment performance is preservation of old structures, old-fashioned labour law, high increase of wages and at the same time low wage differentiation. The important obstacle for development is also insufficient fiscal policy (just as in case of Poland), that is unable to cope with external shocks. Moreover, the crucial in the case of Germany is its reunification. East Germany suffers from weaknesses of the GDR economy. The difficulties in adjustment of the East Germany are also the result of too fast shift into the West-German conditions regarding wage, income level, social transfers and labour market regulations (Walwei 2004).

When it comes to France, is the poor performance regarding growth and employment the result of being a neighbour of Germany? If macroeconometric models assume that the large country like France is not sensitive on tax cuts of small countries, is it experiencing the asymmetric shocks as a result of relevant interdependence with Germany? The answer can be the fact that France is the biggest trade partner of Germany, both when export and import is considered[24] (Federal Statistical Office, Germany) and its bilateral openness rate as percentage of GDP towards Germany belongs to the highest[25]. One could put this statement in doubt because while the

[24] In 2005, import in amount of 54627,2 mil euro and export 79871,1 mil euro.

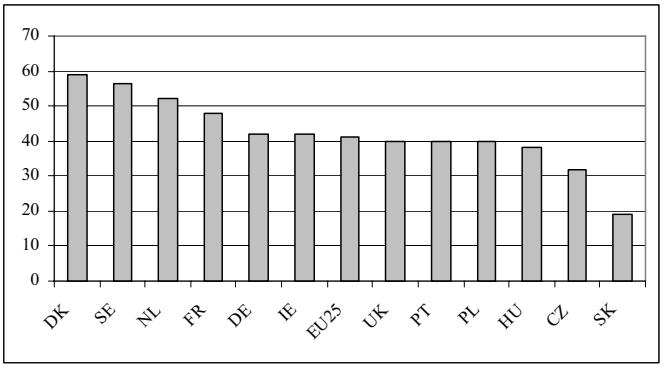
[25] Export of France towards export of Germany as a percentage of GDP of France: 3,1%, source CHELEM-CEPII.

bilateral openness rate for Germany towards France is 2,6% of GDP, the same indicator towards the UK is 2,1% of GDP. Why difficulties and tax cuts in Germany affect more French than British economy? The answer has its roots in EMU membership. When there is flexible exchange rate between reforming country and its partners (as it is in case of the UK), then the exchange rate can be used as an automatic stabilizer of economic situation and help to cope with asymmetric shocks from the outside.

Personal income tax

Another tool that can be significant for pro-growth stimulation is personal income tax. The reduction of PIT is the most favourable issue for employees/workers, because it increases post tax wage rate (CEPII April 2001: 25) and, if conducted, gives similar positive results on employment and output growth as the cut of social security contributions. As it can be noticed in figure 2.6, there is no clear linkage between the level of PIT itself and the labour market performance of a country. However, it partially helps to understand the high level of taxes in such countries like Denmark, Sweden and the Netherlands. The acceptance of the Nordic and the Dutch societies for high tax levels is a result of aware choice, since citizens, who value more public goods and services, prefer an economic system where the level of taxation and public services is higher (Tiebout 1956).

Figure 2.6. Top statutory personal income tax rate in % (2006)



Source: EC Services, Eurostat, DG Taxud

2.4.2 Pro-investment - the corporate income tax and taxation schemes

As we have already mentioned, the growth within investment directly contributes to economic growth. With the cut of CIT the profitabilitity of companies increases, what is mirrored by increase in production and employment[26]. Countries, with high level of corporate tax, are less

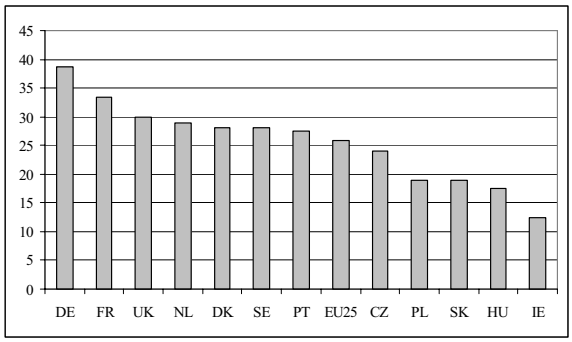
[26] However, the employment growth takes place to a lesser extent than by cut in SSC,

attractive for foreign investors (Djurović-Todorović 2002: 62). It can be noticed that countries like Ireland, Poland, the Czech Republic and Portugal, where the inward of Foreign Direct Investment stocks is higher than outward, have lower rates of corporate tax then the others (see figure 2.7). This would suggest that there has to be some kind of tax competition. The countries who are the EMU members have delegated their monetary policy to the ECB, so they are not able anymore to use monetary policy as a tool of competition. The role of these is partially replaced by competitive tax cuts and this is especially an example of Ireland and Portugal. The Czech Republic, Slovakia, Hungary and Poland are trying to give an incentive to their economies, through the profits flowing from FDI (output growth, employment growth), f.i. Hungary has implemented solutions into tax allowance scheme in fields of R&D as it is more clear now. However, the first three countries are more attractive to foreign investors than Poland. The reason for the latter is poor infrastructure and non entrepreneur-friendly environment, complicated procedures and developed bureaucracy. Crucial for further development of Poland will be better infrastructure, fiscal reform and proceeding privatisation. However, it cannot be forgotten that the CEE countries start to face increasing competition from Romania, Bulgaria, Turkey or China regarding the labour costs, corporate taxes, level of wages, what suggests that another factors have to be identified in order to attract investment (Podkaminer, Stehrer 2006: 136).

Other countries, although not as much successful as countries where there is FDI surplus, do not rest on laurels. To promote investment and stimulate aggregate demand growth, the Netherlands has reduced taxes for companies which decide to invest in fields of R&D. Sweden already in the beginning of 1990s has conducted a tax reduction on investment aiming at higher investment, the higher employment and more economic growth. Moreover, research results point out, that the cut of the capital income tax financed by an increase of the payroll tax will have positive influence on the employment and growth rate (Michaelis, Birk 2004: 3). Since 1983, Denmark has been decreasing the rate of corporate income tax, however the importance of revenues from VAT and payroll tax remained at the same level. Therefore, Denmark pursues entrepreneur-friendly tax policy to stimulate employment and higher budget revenues.

because additional production units are more capital intensive than labour intensive– the result of higher level of investment. The differentiation between the SSC cut and CIT cut is a result of assumption that labour and capital are not complementary.

Figure 2.7. Adjusted top statutory tax rate on corporate income in % (2006)



Source: EC Services, Eurostat, DG Taxud

Success of particular country has its roots also in taxation schemes. The full exemption scheme[27] and partial credit scheme[28] allow corporations to avoid double taxation. In the countries with full exemption schemes[29], the level of tax rate is a strong motivating factor for company, which will gain the more profits, the higher the difference between tax rates of foreign country (lower CIT) and the country of origin (higher CIT). Conversely, this incentive does not have place in case of partial credit scheme implemented in Ireland and the UK. Here, the corporation does not take the CIT into consideration as long as its home country's CIT rates are higher than these of the countries, where it has allocated its investments. In this way the British and the Irishmen have provided their FDI outflows the higher level of resistance on tax levels (CEPII April 2001: 50).

3 Additional factors affecting labour market performance

3.1 Models' relevance

According to Höcker (1998: 191-214) the success of particular country can also depend on:

[27] Mother company gains profits as long as the tax rates of the country where it has allocated its branch are lower than tax rates in its home country. In this case mother company is not obliged to pay corporate income taxes in home country from gains created by its daughter company allocated abroad.
[28] Mother company has to pay home tax rates anyway, so the profits made by daughter company are taxed regarding the rules of country of origin.
[29] Like France, Germany, the Netherlands.

- the structure of labour market administrations,
- the system of industrial relations,
- the general political administrative structures.

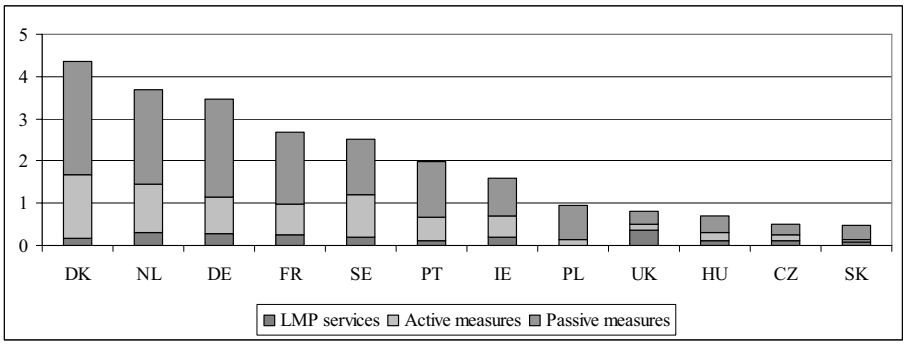
Countries that have decentralized their organization of labour administration perform better than these with centralized structure. Moreover, the model of industrial relations has also an influence on overall labour market results but it is not detrimental. For example, the representatives of Northern corporatism (Sweden, Denmark) or Anglo-Saxon pluralism (Ireland, the UK) reach better results than the countries from Latin confrontation model (France). However, there are always exceptions. There is Portugal which belongs to the latter group but is not as much problematic child as it looks like. There is the Netherlands and Germany that, despite being numbered among the central social partnership models, have far different results in the labour market (Visser 2001). Finally, there are Central and Eastern European countries with the Czech Republic, Slovakia, Hungary and Poland as transition economies, which still combat with relicts from the past in form of inefficient industries and post-socialist mentality. In the case of the latter, the reason for poor performance is negligence of privatisation process, fatal structure of social system and large share of inefficient agriculture.

3.2 Active labour market measures

Another issue that can bring a country closer to the level of full employment is active labour market policy. Although there is no relation between LMP spending as a percentage of GDP and the level of unemployment as the examples of the UK or Germany show (see figure 3.1), the European Commission, basing on data from period 1997-2002, claims that there is a linkage between ALMPs and increase in employment rate (*Employment in Europe 2004*: Chapter 2). The increase of ALMP expenditures intensity[30] is said to be an explanation of employment growth rate in 10 to 20%, however data from period 1998-2004 seem not to confirm this statement (see figure 3.2).

[30] ALMP spending as a percentage of GDP divided by the unemployment rate.

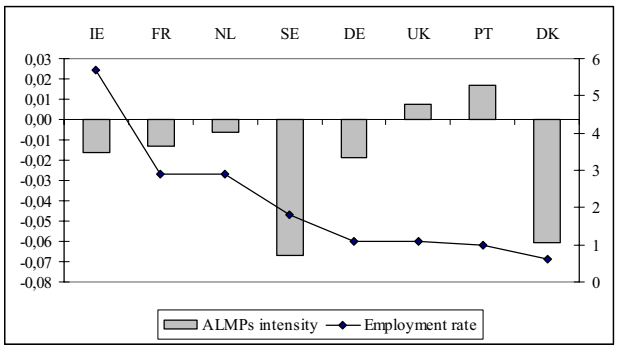
Figure 3.1. Structure of public expenditures on LMP as a percentage of GDP, 2004[31]



Source: Eurostat, OECD

The direct effect of expansion of active labour market programmes is increase of their participants' number, what is followed by unemployment decline. Such gross effect might be reinforced by additional indirect effects and this is the core of success, which further can be supported by proper institutional framework, social dialogue or other factors. However, some doubt in the effectiveness of these active labour market programmes, claiming that they are more sources of employment for their creators than a bridge to employment for participants of these programmes. Though they can be perceived, alongside with long-term sick leave or early retirement, as a roots of hidden unemployment (Karlsson 2006).

Figure 3.2. Change in the intensity of ALMPs spending as a percentage of GDP and in employment rate (1998-2004)[32]



Source: Eurostat, OECD

[31] For Poland – OECD data.

[32] Lack of data for PL, HU, SK and CZ.

3.3 Reforms

Crucial for better performance of labour market are also implemented and ongoing reforms. In order to increase employability of workers, the possibilty of skills and education has to be provided together with flexibility. While these issues are the crucial goals of the British labour market policy, they are the secondary for Germany (Schmid, Roth 2006: 8). This indicates on importance of goals and its meaning for labor market performance. The successful way towards an increasing employability is remarkable in Denmark. The Danish solutions through the active labour market measures (on-the-job training, education) have resulted in high employability. Similarly, the Netherlands has managed to limit the long-term unemployment to 1,9% through the Melkert jobs offered to unemployed longer than 12 months and through the increasing share flexible forms of employment (like part-time or fixed term employment).

However, as the example of Ireland shows there are always country-specific factors of success. Ireland through the conducted economic reforms in the 1990s, limitation of bureaucracy and opening of markets, has managed to transform from the country of famine, intensively exploated by the United Kingdom, into the one of the best performing economies in Europe (for more see O'Connell 1999). However, are the implemented reforms the main factor of success? Probably they are, but an important incentive for further development of this country are repatriants. According to the research of the Economic and Social Research Institute, Dublin, the return of repatriants means the return of high-qualified people who earn 15% more than the Irishmen who have never worked abroad. Moreover, in 2005, 11% of all Irish start-ups with the highest efficiency was founded by repatriants.

How in this European landscape the Central and Eastern European Countries look like? It is visible already at the first glance, that Poland, Slovakia, the Czech Republic and Hungary have to conduct proper reforms in order to narrow the gap between their own and the Western Europe's development. Governments of these countries, however, have to be aware that long-term vision is needed to help their countries get out of recession and not to fall into trap of low economic growth and declining employability. As the example of Poland shows this aspect is often forgotten. This country was able to implement reform regarding pension system scheme which allowed to decrease the forecasted level of public expenditures on pensions (the EC forecast 2004-2050). However, the positive results of this reform are constantly undermined by existence of KRUS or earlier retirement system for miners.

4. Conclusions

Although it is impossible to give one and clear set of rules that could be helpful for improving the labour market performance of a country, we have come up to following conclusions. First of all, predominantly, smaller countries deal better with the problems and reach better results then the larger ones when the labour market outcomes are considered. Because they are more dependent on surroundings and external environment, they have to act in advance and to the higher extent. Second conclusion we have drawn is the fact that an Achilles' heel of Europe are the Central and Eastern European countries, with Poland and Slovakia in the front. The gap between the NMS and the EU15 is going to deepen, if the NMS do not conduct efficient reforms within their fiscal policies, taxation systems, education system etc. For the CEEC is also crucial to complete the privatisation process and to implement entrepreneur-friendly environment, because the low unit labour costs will loose on importance soon as a decisive factor for foreign investors. Finally, to increase the employability, one has to bear in mind that to assure long-term sustainable prospects of growth, the country should treat the best practices of other countries regarding labour market perfomance only as a benchmark. It means that instead of copying the solutions of other countries, the particular country ought to look for solutions that will suit its internal condition.

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