ECONOMIC POLICY COMMITTEE
OF THE EUROPEAN COMMUNITIES

FIRST REPORT
ON THE ACTIVITIES
(1985)

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CONTENTS

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I. Terms of reference of the Committee

1. This is the first report on the activities of the Economic Policy Committee. The Committee was set up under a separate Council Decision in connection with the Council 'convergence-decision' of 18 February 1974. Its task is primarily to help bring about the highest possible degree of convergence in short-term and longer-term economic policy objectives and results in the Community. The Council Decision setting up the Committee expressly mentions the following tasks:

(i) assisting in coordinating general economic policies;

(ii) examining Member States' budgetary policies;

(iii) preparing medium-term economic policy 'action programmes' and monitoring their implementation.

2. In carrying out its tasks, the Committee assists the Council and the Commission in questions relating to general economic policy. For this purpose, it delivers opinions and presents reports at the request of the Council and the Commission, though also on its own initiative. It also performs tasks under specific provisions of Community law.

3. Before 1974, there were three separate Committees, pursuing the same objectives: the Short-term Economic Policy Committee (set up in 1960), the Medium-term Economic Policy Committee (set up in 1964), and the Budgetary Policy Committee (also set up in 1964).

The coexistence of three separate Committees operating in the field of general economic policy led to overlapping and to duplication of work, and there were internal coordination problems between the Committees. To avoid this, the three Comittees were merged in 1974 to form the Economic Policy Committee.

Vestiges of the three former separate Committees are still to be found in the reduced compositions in which the Economic Policy Committee meets. These are the reduced 'medium-term economic policy' and 'budgetary policy' compositions. The reduced 'short-term economic policy' composition does not operate at present, since the Committee's short-term economic policy responsibilities, particularly examination of the Commission's Annual Economic Report, have since 1984 been performed by the Committee itself.

II. Survey of the activities of the Committee and its reduced compositions in 1985

1. The focus of the Committee's work last year was examination of the strategy for more employment-intensive growth. The realization of this goal must be seen in a medium-term

perspective. From this point of view, the Committee completed its analyses of the importance of profitability for investment and economic growth and discussed in depth, as part of a wide-ranging study of the flexibility of markets, the significance of labour markets for employment. In addition to this, it laid down the basic lines for its future work on the flexibility of goods and services markets, on which it will report at an appropriate time. Lastly, it had regular discussions on the development of the economic situation and on current topics in economic policy.

The Committee held five meetings during the year, in February, May, July, October and November. The Committee also met informally in October, where it discussed some aspect of more employment-intensive growth.

2. In 1985 the reduced composition 'medium-term economic policy' began detailed work on the study on improving the operation of the markets for goods and services. The main task here is to describe the macroeconomic importance of greater flexibility in the goods markets. This includes an analysis of the economic benefits to be expected at Community level from the establishment of a uniform internal market. In addition, supplementing and continuing the work of the main Committee and responding to the Annual Economic Report on a cooperative growth strategy for more employment, the reduced composition 'medium-term economic policy' initiated studies on certain technical and quantitative aspects. These concern for instance the relationships between growth and employment (taking account of technological progress and sectoral differences), the relative costs of labour and capital and the scope for capital-labour substitution.

The 'medium-term economic policy' composition held two meetings, one in July and one in October.

3. The reduced composition 'budgetary policy' focused, in line with existing legal provisions, primarily on questions concerning:

(i) budgetary policy in the Member States with a view to the guidelines for public-sector budgets for the following year;

(ii) the three-year financial forecasts for the Community budget;

(iii) the maximum rate for the increase in non-obligatory expenditure of the Community budget of the forthcoming financial year.

It also examined the medium-term trend of the public debt and debt servicing burden in the Member States. It intends to draw economic and budgetary policy conclusions from these analyses which could be taken into account in establishing the budgetary policy guidelines for 1987.

The 'budgetary policy' composition met in April, June, September and December.

III. The main fields of action of the Committee

1. As already mentioned, the question of more employment-creating growth was the central theme of the Committee's work this year. The results of its work were partly incorporated into the Commission's Annual Economic Report 1985-86, which puts forward a medium-term strategy for more employment-creating growth. The aim of the strategy is, through balanced contributions from employers and unions, the governments of the Member States and the Community, to achieve stronger and more employment-creating growth in the medium term.

The cornerstones of this cooperative strategy are:

(i) a moderate increase in real wages, so as further to improve the return to physical capital, and to shift the relative rewards to capital and labour towards a greater increase in employment;

(ii) a use of available margins for flanking measures to support demand, insofar as this is necessary to secure a favourable investment climate;

(iii) at the microeconomic level, an improvement in market flexibility.

The Committee delivered an opinion on the draft Annual Economic Report which its Chairman presented to the Council on Economic and Financial Affairs in October (see Annex VI).

2. With a view to the achievement of stronger and more employment-creating growth, the Committee dealt in depth with the role of the profitability of fixed capital (point 7) and of labour-market flexibility (point 8), and transmitted to the Council and the Commission reports on these issues.

3. In its report 'Profitability and rate of return in the Community', (see Annex I) the Committee drew particular attention to the more pronounced decline in the return on capital in the Community than in the United States and to its repercussions for the Community economies. Although this decline appeared to have been arrested, the rate of return was still low compared with previous years and probably insufficient. In the Community the decline of return on capital was accompanied by a growing trend towards greater capital intensity and lower capital productivity. The report looked at the numerous reasons for these unfavourable developments and the economic policy measures that could rectify the situation.

4. In its progress report on 'Labour markets and employment' (see Annex II) the Committee pointed out that its work in this field should be seen in the broader context of the efforts to foster the necessary structural change in the Community by making markets more adaptable. This meant greater flexibility not only of labour markets but also of product markets. A balanced approach in these areas would help in establishing the Community's internal market. More specifically, the progress report discussed the macroeconomic reasons for, and benefits of, improved labour-market flexibility and listed the main areas of action and guidelines.

The Committee wanted to make it clear that its thinking on labour-market flexibility should not be regarded as an isolated recommendation. Therefore it drew up a comprehensive programme of work on the flexibility of product markets, and the first studies were started in the year under review.

5. On a number of occasions, the Committee considered the economic situation in the Community and the budgetary developments in the Member States. As preparation for the Council meeting in March 1985 on the adjustment of economic policy guidelines for the current year, it delivered an opinion in which it drew particular attention to the progress made towards economic policy convergence and to the reduction in imbalances in Member States (see Annex V).

With regard to the Council meeting in July 1985 the Committee discussed Member States' budgetary policy and its role in economic policy as a whole. At this, its second quarterly examination of the economic situation, the Council each year sets the first quantitative guidelines for the central government budgets in the year ahead. The purpose of this procedure is for the Community's views to be given early consideration during the preparation of the central government budgets in the Member States. In its discussions, the Committee made a particular point of supporting the continuation of the policy to eliminate internal and external imbalances. It felt that in general there was still very limited scope for budgets to support economic activity.

6. In autumn 1985, the Committee delivered an opinion on the three-year financial forecasts 1986-88 for the Community budget in which it underscored the importance of financial forecasts for the Commission's medium-term strategy and for the Council's deliberations on the budget for the coming year. It also suggested a number of methodological improvements (see Annex III). It discussed its proposals on this with the relevant Commission departments towards the end of the year. Agreement was reached on a number of important changes that should make for a noticeable improvement in the content, transparency and significance of the forecasts.

7. The Committee was consulted, as it is every year, concerning the determination of the maximum rate for the increase in non-obligatory expenditure[1] in the Community budget for the year ahead (see Annex IV concerning the maximum rate for 1986).

After the European Council's adoption of the texts on 'Budgetary discipline' on 4 December 1984, the determination becomes more important than hitherto, starting with the 1986 budget. In particular, it is the opinion of the Council[2] that in future the increase in non-obligatory expenditure should no longer exceed the 'maximum rate'.

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[1] Non-obligatory expenditure is 'expenditure other than that necessarily resulting from the Treaty or from acts adopted in accordance therewith'. The maximum rate is determined on the basis of the evolution of the gross domestic product and of central government expenditure in the individual Member States.

[2] However, neither Parliament nor the Commission consider themselves bound by the texts on 'Budgetary discipline'.

List of members of the Economic Policy Committee

Chairman

I.C.R. Byatt	Deputy Chief Economic Adviser, HM Treasury (London)

Vice-Chairmen

J.K.T. Postma	Directeur-generaal, Ministerie van Financiën (The Hague)
H. Prévot (until 23 May 1985)	Commissaire, ministère du Plan (Paris)
H. Guillaume *(since 23 May 1985)*	Commissaire, ministère du Plan (Paris)

Members

R. Bausch	Conseiller, ministère des Finances (Luxembourg)
S. Bertholomé	Conseiller, Banque Nationale de Belgique (Brussels)
J. Børglum-Jensen	Deputy Permanent Secretary, Det Økonomiske Sekretariat (Copenhagen)
H.J. Brouwer	Directeur-generaal, Ministerie van Sociale Zaken en Werkgelegenheid (The Hague)
N. Bub	Leiter der Hauptabteilung Volkswirtschaft, Deutsche Bundesbank (Frankfurt-am-Main)
E.A. Clarke	Assistant Secretary, Department of Finance (Dublin)
M. Emerson	Directeur à la direction générale des Affaires économiques et financières, Commission des Communautés européennes (Brussels)
A. Fazio	Vicedirettore generale, Banca d'Italia (Rome)
M. Gabriele	Direttore generale, Ministero del bilancio e della programmazione economica (Rome)
N. Garganas	Counsellor, Bank of Greece (Athens)
L. Heltberg	Director, Det Økonomiske Sekretariat (Copenhagen)
R. Hullebroeck	Directeur général, ministère des Finances (Brussels)
J.H. Kjaer	Director, Danmarks Nationalbank (Copenhagen)
R. Maldague	Commissaire, Bureau du Plan (Brussels)
H. Matthes	Deputy Director-General in the Directorate for Economic and Financial Affairs, Commission of the European Communities (Brussels)
J.C. Milleron	Directeur de la Prévision, ministère de l'Économie (Paris)
B. Molitor	Ministerialdirektor, Bundesministerium für Wirtschaft (Bonn)

J. Odling-Smee	Under Secretary, HM Treasury (London)
M. O'Connell	Assistant Secretary, Department of Finance (Dublin)
J. O'Leary (until 31 April 1985)	Manager, Central Bank of Ireland (Dublin)
G.A. Posthumus	Thesaurier-generaal, Ministerie van Financiën (The Hague)
P. Ranuzzi	Direttore generale del debito pubblico, Ministero di Tesoro (Rome)
V. Rapanos	Secretary to the Minister, Ministry of National Economy (Athens)
N. Tatsos (until 31 December 1985)	Counsellor, Ministry of Finance (Athens)
C.T. Taylor	Head of Economic Division, Bank of England (London)
L. Tybjerg	Director, Finansministeriet (Copenhagen)
P. Van den Bempt	Director in the Directorate for Economic and Financial Affairs, Commission of the European Communities (Brussels)
J. Waringo	Inspecteur des Finances, ministère des Finances (Luxembourg)
R. Weides	Conseiller économique au Statec (Luxembourg)
G. Zalm	Directorate general, Ministerie van Economische Zaken (The Hague)

Secretariat

A. Kees	Director of the Secretariat (Brussels)
R. Malbois	
H. Gerner	

Report to the Council and the Commission on profitability and rates of return in the Community (24 May 1985)

I. Cover note by the Chairman

Following a request by ECO/FIN, I attach a Report by the Economic Policy Committee (EPC) on relative profitability in the Community and the United States and its relationship to economic prospects.

1. The results of the EPC work are set out in the attached report. Despite the difficulties in measuring the return on capital, in particular of comparing profit levels in different economies, EPC has concluded that there has been a greater decline in the rate of profit in the Community than in the United States and that this has indeed contributed to the problems of the European economy. This decline appears to have been arrested but, by comparison with the past and with the United States, profitability is still low, and probably inadequate. Profitability has recovered more strongly in the United States, which helps to explain why investment has grown more rapidly than in the Community, despite high interest rates.

2. Unlike experience in the United States, the fall in the rate of return on capital in the EC has been associated with a rise in the stock of capital required to produce a given output. Also in contrast to the United States where the ratio of capital to labour has changed only slightly, there has been a rise in the volume of capital used per employee in virtually all EC Member States. This suggests a secular decline in the efficiency of investment in the Community.

3. There are many reasons for these unfavourable trends and it is scarcely possible to disentangle their relative importance. Two oil price shocks, together with an increase in world commodity prices raised business costs. Economic policies designed to combat inflation squeezed cash flow and profits. The rise in real interest rates, arising in part from increased government borrowing, reduced, and in some cases eliminated, the differential between the return on physical assets and the cost of capital. Real wages did not adjust quickly to a changed economic environment. Real wage pressures were intensified by higher taxation. Technological factors may also have been important.

4. Achieved profits are not a 'free standing' variable. They depend on a host of factors, including the level of aggregate real demand. The Community also needs to increase its rate of profit for a given level of demand.

5. Improved expectations about future profitability would encourage more investment; currently there is little spare capacity in the European economy although unemployment remains high. But while more investment is necessary for more jobs, the extent to which it will achieve this aim depends on the degree of labour intensity involved. In the past high

real wages, and high non-wage labour costs coupled with generous incentives to investment may have encouraged excessive capital intensity.

6. What can be done to improve matters? EPC suggests that the policy strategy should aim to:

(a) establish a macroeconomic strategy which will:
 (i) help to ensure a stable economic environment;
 (ii) provide a clear framework within which wage negotiations can take place;

(b) ensure a modest evolution of wages. In present circumstances real wages should, for some years, increase somewhat less rapidly than productivity;

(c) ensure that any increase in the burden of tax and social security contributions on companies is modest, and where possible to reduce it, provided that this does not increase the budgetary burden. This involves close control over social security expenditure;

(d) maintain, or where appropriate, achieve a tax system which is broadly neutral as between factors of production. The danger of specific investment incentives is that they encourage capital intensive investment which provides few extra jobs.

II. Introduction to the Report

1. The Economic Policy Committee in the autumn of 1983 was invited by the ECO/FIN Council to consider current problems of profitability in the European economy and to report back on its findings. The Committee has in the meantime had a number of discussions on the basis of material submitted by Member States and analyses prepared by the services of the Commission.

2. The paper starts with a short review in Section III, of factors affecting the longer run trends on profitability, productivity and factor rewards. Section IV attempts to provide an assessment of the more immediate situation and prospects for profitability. This leads to a consideration in section V of whether in the light of the current recovery, there is a profitability problem now. A final conclusions section VI presents what are perceived to be the major policy issues which emerge.

Various tables and charts which are referred to in the text appear at the end of the paper.

III. Trends over the last two decades

3. The profits performance of an economy is the outcome of numerous factors. Whilst one can debate the extent of poor profitability in the European Community there can be no reasonable doubt that the trend decline is one of considerable significance. However, the precise causes and channels of influence remain somewhat imperfectly understood.

4. The two oil shocks together with the increase in world commodity prices raised business costs. Since real wages did not adjust appropriately, both company cash flows and

profits were squeezed. Given the background of more restrictive national policies, especially after the second oil price shock, higher energy costs coupled with energy/capital complementarity led to a fall in the return on capital. This further depressed both productivity and profits in the enterprise sector. It is important to recognize also that the more general inflationary environment helped to create a climate of uncertainty which reduced profit expectations. To this extent, the effects were self-reinforcing since firms became more reluctant to undertake new investment projects in such an uncertain situation. This experience appears now to have been common throughout the economies of the Western World.

5. Relatively lax monetary policies in the early seventies followed by restrictive demand policies led to higher nominal interest rates. These added to pressures on company financing. Cash flow and liquidity were affected adversely and companies found themselves with relatively poor balance sheets.

6. Another factor was associated with the expansion of the public sector which tended to squeeze resources available for private expenditures. An unwillingness to finance public spending by additional taxation placed claims on the supply of savings, so raising the cost of capital to firms. In cases where taxation was raised real wage resistance led to an increase in costs and hence a squeeze on profits.

7. The failure of real wages to adjust quickly enough to the weakening profitability situation has also been an important factor as already mentioned. In addition to this shorter run aspect of the problem, there is a longer run dimension of a continuing nature which has affected the observed trend decline in profitability.

8. An analysis of those statistical indicators judged most appropriate for purposes of comparison suggests the following broad conclusions:

(i) The gross rate of return on invested capital in the Community enterprise sector, measured at replacement cost, declined considerably over the period 1960 to 1981 and significantly more so than in the United States. Although the rate of return on invested capital in the period 1960 to 1972 appears to have been higher in the Community than in the United States, the contrary now appears to be the case.

(ii) The decline noted is even more pronounced if one takes account of capital depreciation and calculates net rates of return measured at replacement cost.

(iii) The fall in the rate of return appears to have been associated with a rise in the stock of capital required to produce a unit of output, thus implying a decline in the average productivity of capital.

(iv) Real compensation per employee over the whole period 1960-81 increased substantially in the Community. Moreover, this acceleration was much faster than that which occurred in the United States.

(v) There has been a steady rise in the volume of capital used per employee in virtually all Community countries, whereas in the United States the ratio of capital to labour appears to have changed relatively little. Further, this increase appears to have been associated with the rise in labour rewards relative to the rewards to capital.

(vi) There are some indications that post-tax profits on equity capital have declined considerably less than has the gross return on invested capital. It is likely that the various kinds of incentives to investment together with loan interest subsidies available in most countries have been a contributing factor.

(vii) All of the above suggests that the aggregate efficiency of fixed investment in the Community has been declining for some considerable time.

9. In making these judgments and comparisons, the Committee considered a wide range of alternative statistical indicators of profits performance. Other statistical measures such as the share of gross profits in the money national income, or conventionally calculated company profits at historic cost may show a different picture of events. These alternatives however, do suffer from certain limitations and for the purposes here the Committee favours what is perhaps the most widely used measure of profitability namely, the gross and net returns on capital at replacement cost.[1, 2]

IV. Recent developments

10. Currently:

(i) The most recent profitability indicators are subject inevitably to a certain degree of uncertainty. The general liquidity position of the enterprise sector in the four largest Community countries suggests, however, that a considerable recovery has occurred from the trough in 1981. A similar profile is observed for the United States although the upturn occurred from the middle of 1982. This improvement is estimated to have continued through 1984 and with a relatively optimistic projection for 1985. Graph 1 suggests that the share of gross profits in money output should, by 1984, have reached the level observed in the years immediately before the first oil price shock. This increase in the profit share, however, does not imply that the rate of return on invested capital has reached a satisfactory level.

(ii) Tables 3 and 4 taken with Graph 2 present a picture of an unchanged level, or at best, a modest improvement in the rate of return on invested capital in 1983 and 1984 at the wider Community level.[3] There appears to have been a more noticeable improvement in the United States. Even though the rate of capacity utilization in the Community

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[1] The historic cost profit measure takes no account of the effects of inflation in valuing the current worth of a business. Thus in times of rising prices it will tend to understate the true decline in the rate of return on capital.
The factor share indicator suffers from an important limitation in the current context; namely that it can remain broadly constant because a decline in the rate of return is offset by a rise in the capital output ratio (fall in the productivity of capital). This can be seen from the identity:

$$\frac{\text{Gross profits}}{\text{Output}} = \frac{\text{Gross profits}}{\text{Capital stock}} \times \frac{\text{Capital stock}}{\text{Output}}$$

[2] Greater detail on both the concepts and data has been made available by services of the Commission in *European Economy*, July 1984, No 20, 'Profitability, relative factor prices and capital/labour substitution in the Community, the United States and Japan, 1960-83'.
There are, however, severe measurement problems affecting the capital stock. In particular, the low rate of return in recent years could be due in part to an over-estimation of capital stock because of an underestimation of scrapping.

[3] Due to the relatively large impact on the Community rate of return calculation exerted by the imputation of labour income to self-employed the margin of uncertainty in the figures is rather large.

began to improve rapidly through 1984, the rate of return for that year remains far below that observed in the 1960s when the employment situation was relatively more favourable.

(iii) The rise in the share of profits in value-added in the Community has been associated with a pronounced slowdown in the rate of increase of the real product wage as seen from Table 5. The real product wage in the Community seems to have risen on average for the four years 1981 to 1985 by only 0.9%, somewhat more than half the increase in the United States, which relative to the period 1973/81 is a record of achievement. Real output per person employed in the Community is estimated to show an increase of close to 2% per year on average for the years 1981 to 1985. Thus, real unit labour costs in the Community may show a decline of 1% per year on average for the period (as compared to an increase of 0.4% per year in the United States and Japan).

(iv) On the basis of a number of simplifying assumptions it is possible to divide the growth of output per employee into that part which is due to the increase in capital per employee (capital deepening or labour saving) and a component which shows the increase in capital and labour productivity considered jointly.[1] Table 6 shows that at the Community level, for the period 1981 to 1985, output per employee is projected to grow at an annual average rate of about 2%. Nearly one half of this increase (0.8%) is accounted for by capital deepening of about the same rate as that in the period 1960-81. The contribution of total factor productivity is thus projected to be 1%. One would normally expect that the recent and considerable slowdown in real wage growth would have led to an immediate improvement in profitability. However, the more or less unchanged pace of capital deepening or labour saving has served to work in the opposite direction. This suggests that the recent and considerable slowdown in real wage growth has probably not yet been able to effect a sufficient improvement in the rate of return. Table 6 indicates that this capital deepening process is not to be found in the United States (at least not when measured, as done in Table 6, for the whole economy). This constitutes an additional explanation as to why the rate of return has improved more strongly there than in the Community.

V. The adequacy of current profitability

11. Given the recent recovery of profit shares, it may be asked whether in general there still exists a 'profitability problem' in the Member States. While this is not a simple question to answer, the broad assessment, at the level of the EC as a whole, is:

(i) The profit share in national income has in many countries returned close to levels of a decade or two ago.

(ii) But, importantly, the rate of return on invested capital has not improved and although the decline has to some extent been arrested the present level is low in absolute terms by historical standards. It is low in relation to interest rates which have risen considerably and may well remain high. Further it is low also relative to the position in the United States.

[1] Further explanation is given in *European Economy*, July 1984, No 20, 'Some aspects of industrial productive performance in the European Community: An appraisal'.

(iii) This apparent conflict of evidence might be explained by an excessive pace of capital deepening or labour saving accumulation in the economy which may have contributed to the decline in the productivity of new investment. This could account for why the rate of return has improved so little.

12. The broad conclusions of the Committee are:

(i) In virtually all Community countries it is felt that profitability remains too low. There is still much ground to be recovered and in Denmark only do rates of return on capital invested seem to have now achieved an appropriate level.

(ii) Some qualifications to the above are necessary in the case of: The Netherlands where outside of the natural gas sector the profitability problem, although recovering to some extent, has been acute; – Ireland where rates of return in the bigger multinational companies are noticeable better than those in the domestic firms; – Belgium where profitability in the more exposed sectors is particularly weak.

(iii) In most countries, despite recent progress in Belgium and Denmark, the dominant structural cause is seen to be excessive real employment costs and the need to moderate the evolution in these.

(iv) The structural profitability problem is thought to be at least as important as the current cyclical position.

(v) In most countries the financial or balance sheet position of the enterprise sector has improved considerably and in many instances might be considered satisfactory. Significantly however, this has been achieved largely through the cutting back of company spending on investment and inventories.

13. The Economic Policy Committee concludes therefore, that there does remain a profitability problem in that real rates of return are still too low. There is a deep seated need to ensure that real employment costs bear a more appropriate relationship to productivity performance. The apparently favourable climate in financial terms has been obtained largely at the expense of reducing real spending on new capacity. This does not in itself hold promise for the future growth of productive potential.

VI. Some policy issues

14. The rate of profitability is not a final objective of economic policy. Its importance lies in its influence on the rate of investment, employment, and on economic activity in general. Those forecasters who were relying on a more conventional relationship between aggregate demand and investment may well have neglected the considerable improvement in the financial position of the enterprise sector as illustrated in Table 2. Hence the investment recovery was insufficiently foreseen. In addition, expectations of future profitability are at least as important as current profits in determining the investment and employment behaviour of enterprises. This underlines the importance of the sustainability of policies influencing profits, as opposed to ephemeral financial incentives.

Macroeconomic strategy; wages and profits

15. Demand expectations which depend in part on the balance of macroeconomic policies and wage evolutions are a major determinant of profitability expectations. Since the social partners are largely responsible for setting wage costs, the central tasks of public policy lie in:

(a) setting a clear macroeconomic strategy within which the social partners shall negotiate;

(b) seeking to enhance public understanding and consensus over how the coherence of macroeconomic policy and income trends can have favourable effects on employment and stability;

(c) in present circumstances, and to the extent that profitability is still inadequate in much of the European economy, wage incomes should for some time increase in real terms somewhat less fast than productivity, or in some cases not increase at all;

(d) where wage moderation not only reduces inflation to an acceptable rate, but also leaves the real economy unduly weak, macroeconomic policy should be such as to sustain aggregate nominal demand adequately.

Investment incentives and the taxation of profitability

The Committee has not undertaken an extensive review of this complex field, but draws attention to certain points. It is true that the profitability of enterprises may be helped either by tax allowances attached to investment (with possible differences in treatment by type of asset, sector and region) which lower the cost of capital, or reductions in the general level of income or profits tax. In the past, investment incentives have often been favoured because of the wish to pursue specific policy objectives like increasing the rate of technological progress, regional development, etc. The Committee notes some tendencies now in favour of securing a more neutral approach; lowering the general level of income and profit taxation, while simplifying and possibly reducing some more specific fiscal allowances, including investment incentives. The justification for this view is:

(a) first, the concern over the excessive number, and complexity of specific tax concessions which for these very reasons can become self-defeating or difficult to evaluate in practice;

(b) secondly, the evidence of perhaps excessive and almost certainly inefficient capital deepening, a symptom of which has been a decline in the marginal productivity of capital;

(c) thirdly, the growing excess supply of labour, which makes fiscal measures favouring the use of capital rather than labour more difficult to justify.

Non-wage labour costs

From the immediate standpoint of the enterprise, lower non-wage labour costs (social security charges, payroll taxes, implicit costs of labour market regulations, etc.) may be similar in effect to a lowering of direct wage costs. However the complete economic effects are different. The counterpart to lower social security charges on companies implies either reductions in social benefits, increases in other taxes, or increases in public borrowing. The Committee cannot in the present report go beyond the positions adopted in the Annual Economic Report on these extensive issues. However the Committee notes that in general, non-wage costs have been a particularly large and inflexible part of the rise in total labour costs in the Community over the last two decades, and Member States are reluctant to increase any of the major taxes. Reductions in implicit costs of labour market regulations have, of course, no direct budgetary implications.

Profit-related employee remuneration

One technique for assuming some flexibility in labour costs, and in safeguarding against excessive swings in income shares, lies in pay contracts which include a profit-related element. Among industrialized countries Japan appears to have gone furthest in extending such schemes to as much as 30% of total employee remuneration in the industrial sector. In Europe such schemes often exist only on a rather small scale. The Committee has not examined this question in detail, but it may warrant more attention. Such arrangements may help achieve more constructive attitudes towards the role of profitability in the expansion of the economy and of employment in particular.

VII. Summary

16. The Committee's Opinion may be summed up as follows:

(i) The rate of return on invested capital, which is the most significant important indicator of profitability, declined in the 1960s and 1970s in the Community.

(ii) In the period 1981 to 1984 the rate of return in the Community as a whole appears to have remained more or less constant. Its present level is probably lower than adequate from the standpoint of fostering sufficiently strong investment, employment and economic growth.

(iii) Profitability has recovered more strongly in the United States, which helps to explain in part why investment there has grown even more strongly despite the high rate of interest.

(iv) The profit share of national income in the Community has to some degree recovered its earlier level. This however is not such a positive indicator since it has been associated with an increasing bias in the economy, towards capital and a decline in the productivity of this factor. This may well constitute an important part of a structural explanation as to why the rate of return has not increased so much and indicates clearly that the efficiency of investment in the Community has been declining.

(v) Since profits are an endogenous variable in the economy, they can be controlled only partly by direct policy action. The most important influences on profitability are the general stance of macroeconomic policy, the development of employment costs, productivity performance and the resulting degree of competitivity. These were the subject of recommendations in the recent Annual Economic Report adopted by the Council. It should be recalled here that, since profitability remains inadequate in the Community, wage incomes should for some time increase somewhat less fast than productivity, or in some cases even not increase at all.

(vi) There is some tendency in the Community now in favour of lowering the general level of income and profit taxation, while simplifying and possibly reducing specific fiscal allowances. This tendency towards more even-handedness should be encouraged.

(vii) Reductions in non-wage labour costs may, from the enterprises' point of view be similar to lower direct wage costs and be helpful to profitability and employment growth. There are, however, budgetary implications to consider.

(viii) The further extension of profit-related elements in pay contracts may be helpful for the flexibility of labour costs. This may also help achieve constructive attitudes towards the role of profitability in the expansion of the economy and employment in particular.

Table 1

Recent indicators of the share of profits in income[1]

	D	F	I	UK	USA
1977	21.8	13.4	25.6	15.2	8.7
1978	22.4	13.3	26.1	15.3	8.9
1979	22.2	13.3	27.9	16.9	8.1
1980	20.7	12.9	28.3	14.6	6.7
1981	19.9	12.4	25.6	13.8	6.4
1982	20.4	12.5	25.5	14.2	5.2
1983	21.7	13.3	25.0	15.7	6.8
1981 I	20.1	12.1	26.9	12.9	6.8
II	19.4	12.5	27.5	13.4	6.3
III	20.1	12.5	24.6	14.2	6.5
IV	19.8	12.4	23.5	14.6	6.1
1982 I	20.1	12.9	29.3	12.7	5.3
II	20.3	13.0	25.5	14.1	5.3
III	20.5	12.0	22.4	14.7	5.3
IV	20.5	12.2	25.4	15.3	4.9
1983 I	21.2	13.1	25.6	15.0	5.6
II	22.3	13.6	22.5	15.0	6.6
III	21.3	13.1	23.7	16.4	7.3
IV	21.8	13.4	21.9	16.3	7.6
1984 I	21.5	14.5	25.5	17.1	7.8
II	22.5	14.2	23.5	16.8	8.0
III	22.7		23.8	17.3	

[1] Definitions vary substantially across countries and are presented to illustrate recent developments in profitability in individual countries.

Sources and definitions

D: Statistisches Bundesamt; Gross income from entrepreneurship and wealth as a % of GNP at market prices. Quarterly figures from Bundesbank; seasonally adjusted data on same definitions.

F: INSEE, 'Les comptes et aggrégats' for annual data. Gross financial surplus of non-financial enterprises as a % of GDP, seasonally adjusted for quarterly data.

I: Prometeia data. Data from 1982 are model-simulated and express net operating surplus of the private sector as a % of GDP at market prices.

UK: CSO. Gross trading profits of companies as a % of GDP (income based), seasonally adjusted national accounts basis.

USA: *Survey of current business*: corporate profits after stock appreciation and deduction of capital consumption as % of GNP seasonally adjusted.

Table 2

Enterprises' appropriation account (EUR 4)[1]

('000 million ECU and % change)

	1981	%	1982	%	1983	%	1984	%	1985
1. Gross value-added	1 191	9.1	1 300	9.0	1 416	7.1	1 517	7.0	1 623
2. Compensation of employees	753	7.9	813	6.6	867	5.9	918	6.0	973
3. Gross operating surplus[2]	330	11.1	367	9.6	402	9.7	441	7.6	474
4. Net property and transfer income	-128	13.3	-145	-7.1	-134	9.9	-148	7.4	-159
5. Direct taxes	-45	21.5	-54	8.9	-59	4.4	-62	4.5	-64
6. Gross saving (=3+4-5)	158	6.4	168	24.2	209	11.1	232	8.5	251
7. Net capital transfers received	26	28.7	34	9.3	37	7.8	40	6.6	42
8. Gross capital formation	243	5.9	258	3.9	267	12.6	301	11.6	336
9. Net lending or borrowing (=6-7+8)	-59	-5.3	-56	-60.5	-22	34.7	-30	43.1	-43
10. Gross saving as % of gross value-added	13.3	:	12.9	:	14.7	:	15.3	:	15.5
11. Net lending as % of gross value-added	-5.0	:	-4.3	:	-1.6	:	-2.0	:	-2.6

[1] Aggregate of data for Germany, France, Italy, and United Kingdom covering non-financial corporate and quasi-corporate enterprises (S10) plus credit institutions (S40) plus insurance enterprises (S50).

[2] Gross value-added less compensation of employees and an estimated amount of indirect taxes less subsidies.

Source: Commission services.

Table 3

Gross rate of return on invested capital, enterprises excluding housing[1]
(capital stock valued at replacement cost)

(%)

	B	D	F	I	NL	UK	EUR[2]	USA	Japon
1960-73	10.6	11.6	13.1	8.3	11.6	9.2	10.8	10.2	11.9
1974	10.3	9.1	11.4	6.5	10.1	5.9	8.6	8.6	8.8
1975	8.6	8.6	9.6	4.2	8.7	5.0	7.3	8.4	6.5
1976	8.1	9.6	9.0	4.9	10.1	6.3	7.8	8.8	6.1
1977	7.7	9.6	8.8	4.3	9.8	6.9	7.9	9.3	5.7
1978	7.5	10.0	8.7	4.5	9.6	7.1	8.0	9.4	6.3
1979	7.5	10.3	8.4	5.7	9.0	6.2	8.0	9.1	5.8
1980	6.9	9.4	7.3	6.2	8.6	5.3	7.3	8.3	5.8
1981	6.0	8.8	6.2	4.3	8.9	4.9	6.5	8.3	5.2
1982	6.1	9.1	6.1	4.0	8.7	5.0	6.5	7.4	4.8

[1] Gross operating surplus as % of gross capital stock, imputed labour income of self-employed assumed to be equal to the per capita labour income of employees.
[2] Weighted with GDP at 1975 purchasing power parities.

Source: DIW on behalf of the Ministry of Economic Affairs (EC average – Commission services).

Table 4

Net rate of return on invested capital, enterprises excluding housing (capital stock and depreciation measured at replacement cost)[1]

(%)

	B	D	F	I	NL	UK	EUR[2]	USA
1960	10.9	16.3	15.3	6.8	14.5	11.4	12.9	7.2
1961	11.7	13.8	14.2	7.7	12.4	10.8	11.9	7.7
1962	10.6	12.5	14.2	7.8	11.7	9.1	11.1	9.4
1963	9.9	11.4	13.7	6.6	10.4	9.7	10.5	10.2
1964	11.0	12.3	13.6	5.0	11.0	10.2	10.6	10.6
1965	11.2	11.9	13.9	6.3	10.7	8.9	10.6	12.3
1966	9.8	10.7	14.7	8.1	8.7	7.7	10.3	13.0
1967	9.4	10.0	14.5	8.4	9.2	8.1	10.2	12.4
1968	10.2	12.3	13.8	10.0	9.9	8.0	11.0	11.7
1969	11.4	11.5	14.0	11.9	10.0	6.2	10.9	9.8
1970	12.3	11.0	14.3	9.0	8.7	4.6	9.9	7.5
1971	11.2	9.9	13.6	5.7	7.4	6.5	9.1	8.3
1972	11.6	9.6	14.5	6.1	8.1	5.6	9.2	9.1
1973	12.3	8.9	14.1	5.3	9.1	5.5	8.8	9.9
1974	10.4	7.3	11.0	3.9	7.8	2.2	6.6	7.4
1975	7.6	7.0	9.4	0.3	5.6	1.4	5.0	7.2
1976	7.2	8.2	7.6	1.4	7.9	3.5	5.7	7.8
1977	6.4	8.6	7.3	0.5	10.5	4.3	5.9	8.6
1978	6.2	9.1	7.1	0.8	10.1	4.5	6.0	8.5
1979	6.0	9.6	6.8	2.9	9.0	2.5	6.0	7.8
1980	4.8	8.0	5.1	3.6	7.4	2.2	5.2	7.0
1981	3.3	7.1	3.6	0.6	8.0	1.5	3.9	7.0
1982	3.5	7.5	3.4	0.3	7.8	1.7	3.9	5.6
1983	4.0	8.0	3.4	-0.2	8.0	1.7	4.0	5.9
1984	4.0	8.3	3.4	0.0	9.0	1.7	4.2	6.0

[1] Net operating surplus as % of net capital stock excluding housing, imputed labour income of self-employed assumed to be equal to the per capita income of employees. Depreciation on capital is measured at replacement cost.
[2] Weighted using GDP at 1975 purchasing power parities.

Source: DIW on behalf of the Ministry of Economic Affairs (EC average – Commission services).

Table 5

Real product wage

(% change)

	1973/1960 (average)	1981/1973 (average)	1985/1981 (average)	1982	1983	1984[1]	1985[2]
B	4.6	3.7	1.0	0.6	1.2	1.2	0.8
DK	3.6	1.6	0.1	1.1	-0.6	0.0	0.1
D	4.7	2.4	0.6	-0.3	0.5	1.4	0.8
GR	5.8	4.1	1.9	2.3	1.3	2.4	1.4
F	4.8	3.5	1.0	0.9	0.7	1.2	1.1
IRL	4.0	3.9	0.5	-0.7	-0.0	2.7	0.1
I	5.9	2.3	0.7	-0.3	0.8	2.0	0.4
L	3.3	3.0	-0.2	-1.1	-0.9	0.0	1.3
NL	5.1	1.5	-0.4	0.1	1.7	-2.1	-1.2
UK	3.0	0.9	2.2	1.2	3.0	1.6	2.9
EUR 10	4.4	2.3	0.9	0.4	1.1	1.2	1.0
USA	2.1	0.5	1.6	1.2	2.1	1.4	1.8
Japan	7.9	4.2	4.0	3.3	2.5	2.8	2.9

[1] Estimates.

[2] Forecasts.

Note: The real product wage is defined as compensation per employee deflated by the GDP deflator.

Source: Eurostat and Commission services.

Table 6

Total factor productivity and the capital/labour mix

(% change)

	1973/1960	1981/1973	1985/1981
Germany			
Output per person employed	4.2	2.5	2.2
of which attributable to:			
– total factor productivity	3.0	1.6	1.3
– weighted change in capital/labour ratio	1.2	1.1	1.0
France			
Output per person employed	4.9	2.4	2.3
of which attributable to:			
– total factor productivity	4.3	1.0	1.3
– weighted change in capital/labour ratio	0.6	1.4	0.9
United Kingdom			
Output per person employed	2.8	1.0	2.6
of which attributable to:			
– total factor productivity	2.2	0.0	2.4
– weighted change in capital/labour ratio	0.6	1.0	0.3
EUR 10			
Output per person employed	4.4	1.9	1.9
of which attributable to:			
– total factor productivity	3.5	1.2	1.2
– weighted change in capital/labour ratio	0.9	0.7	0.8
United States of America			
Output per person employed	2.1	0.5	1.2
of which attributable to:			
– total factor productivity	1.8	0.5	1.3
– weighted change in capital/labour ratio	0.3	0.0	-0.1

Note: The growth of real output is assumed to consist of two parts: (a) that part consisting of the growth of labour and capital inputs (b) a technical progress element, often termed total factor productivity. Given a conventional aggregate production function of the form:

$$V = A(t)F(K,L)$$

where V is the level of real output, K and L the inputs of capital and labour and A(t) the effects of disembodied technical progress, we can under certain assumptions define growth of real output per employee as

$$Y = g + ak$$

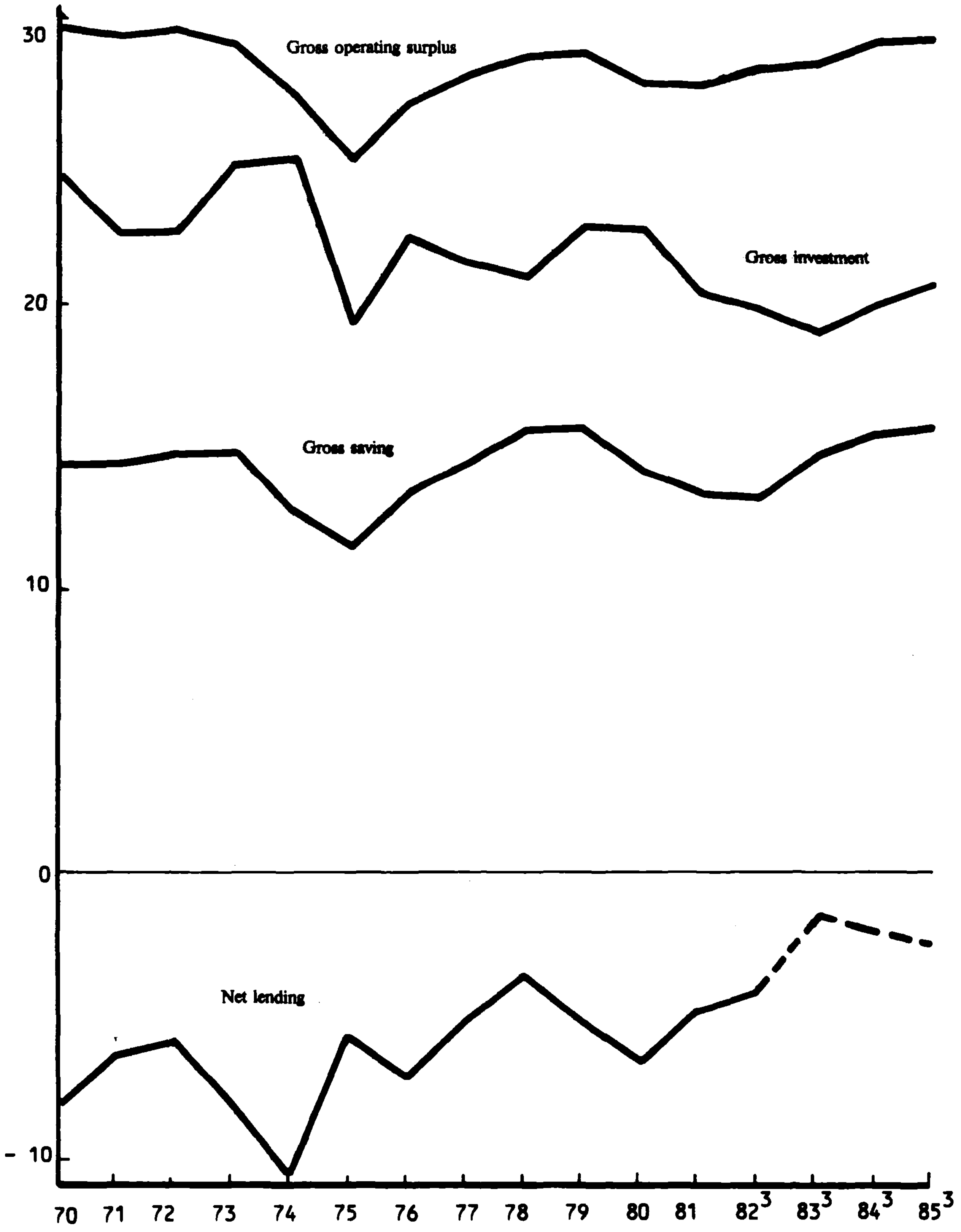
Y is the growth of output per employee, g is the rate of growth of total factor productivity, a is the share of profits in gross domestic product and k is the growth of capital stock per employee.

Source: Commission services.

Graph 1

Elements of the appropriation account of enterprises,[1] EUR 4[2]

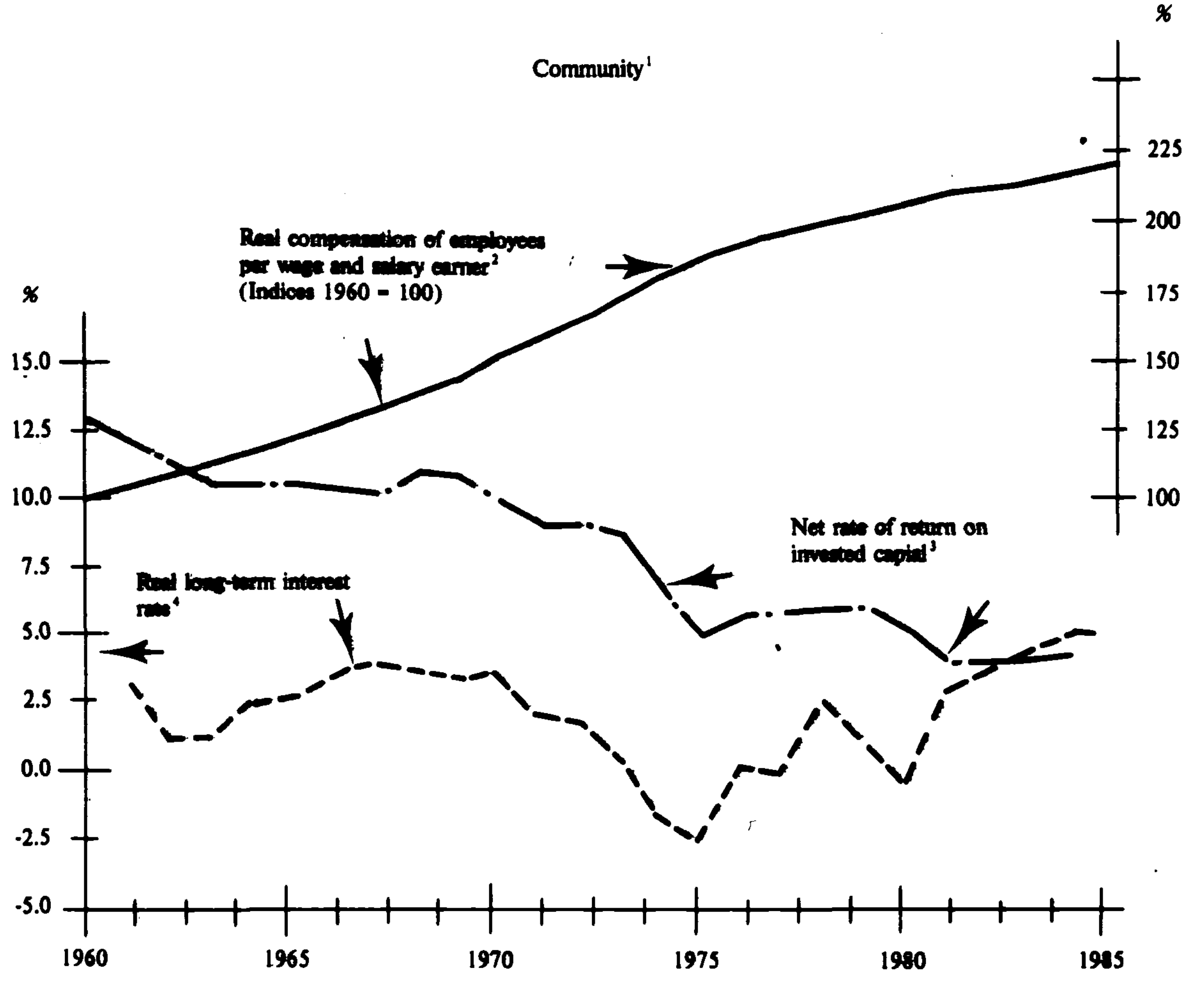
% of gross value-added at market prices



[1] Corporate and quasi-corporate enterprises (ESA sectors S10, S40 and S50).
[2] D, F, I, UK.
[3] Estimates and forecasts by the Commission services.

Graph 2

Real rewards of labour, fixed capital and financial capital



[1] Community average weighted with GDP of 1975 and 1975 purchasing power parities.
[2] Deflated with GDP-prices.
[3] Net operating surplus of enterprises (excluding housing) as % of corresponding net capital stock. Because of the definitions adopted here, the level of this curve has to be interpreted with caution and it is its evolution which is of greater relevance.
Source: Deutsches Institut für Wirtschaftsforschung (Berlin) on behalf of the Bundesministerium für Wirtschaft (Bonn). Last years and Community average calculated by Commission services.
[4] Interest rate on government bond yields. Deflated by consumer price index.

Progress report to the Council and the Commission on labour markets and employment (16 July 1985)

Introduction

1. During the last few years, the labour market has seriously deteriorated in the Community. Some of the factors behind this are due to cyclical developments, others to more fundamental disequilibria, in particular rigidities in member countries' economies.

Among these rigidities are particularly those affecting the labour market. The Economic Policy Committee, in this Report, sets out the macroeconomic need for greater labour market flexibility and the advantages which flow from it. This work forms an integral part of efforts designed to promote necessary structural change in the Community through a greater capacity to adapt on the part of markets. It is to be seen within the framework of a wider strategy for implementing a macroeconomic process leading to more employment-intensive growth.

The main findings

2. A better functioning of the labour market is one important way of contributing to the objectives of macroeconomic policy, in particular to output and employment growth, within the framework of the fiscal and monetary policies currently being pursued by Member States.

(a) There is evidence that labour markets are functioning inadequately in all the Member States; at the roots of this inefficiency are the measures implemented and behaviour introduced during a more favourable economic environment. Today in a period of slower growth and profound structural change, these factors act as rigidities and – if not corrected – may further worsen the employment situation.

(b) The issue of labour market flexibility covers a wide range of factors including policy measures, institutional behaviour and social attitudes, which differ between Member States. Therefore there is no unique Community-wide policy approach to the problem, but the Community could and should give an impetus towards a solution if, at the level of Member States, the following elements were incorporated into a wider strategy:

   (i) At the level of public authorities, remedies should, in particular, aim at:

   - an easing of regulations, not only in labour markets but elsewhere, whenever this can encourage creation of employment;
   - labour market conditions where retraining and mobility are encouraged;

- a policy for education, job choice and professional training which is better adapted to market realities and designed to promote the proficiencies and qualifications necessary for economic development in a period of structural change.

(ii) At the level of the two sides of industry, the objectives should include:

- an evolution of real wages per head which on average should grow slower than the expected growth in productivity for the period necessary to regain equilibrium; progress has already been made in this field;
- wage structures which are responsive to the development of new technology, new patterns of demand and new working methods;
- greater flexibility in wage differentials so as to adequately reflect, in each country, region and sector, the relative scarcities of different kinds of labour;
- wage flexibility sufficient to ensure both that wage costs are not so high as to result in excessive de-manning and that changes in working time are strictly cost neutral;
- slower growth of non-wage costs, in particular an alleviation or at least a pause in the growth of social security burdens and of cost-increasing regulations;
- the appropriate contractual framework for determining wage structures and the organization of work, both at the level of industrial sectors and of individual firms;
- a negotiating climate which respects the roles and responsibilities of the two sides of industry. The social dialogue should be widened to include new areas, such as, in particular, technology and the modernization of the economic base, so as to avoid the appearance of new rigidities.

3. Better functioning of labour markets is a necessary – albeit not sufficient – condition for achieving major reductions in unemployment. Greater flexibility in other markets is equally important. Macroeconomic policy should be such as to ensure that greater flexibility in labour markets is translated into higher real demand. This is quite consistent with a policy framework designed to reduce inflation and contain inflationary pressures. The exact policy stance in each country as well as in the Community as a whole, should, of course, take account of the available room for manoeuvre.

The nature of the problems

4. The performance of the European economy deteriorated during the 1970s; growth slowed down and inflation accelerated. Demand management as the main tool of economic policy proved incapable of achieving levels of employment consistent with reasonable price stability. While the fiscal and monetary policies of recent years (and in some countries incomes policies) have brought down the rate of inflation, they have not yet restored socially acceptable levels of employment. It is clear therefore that more has to be done in other policy areas, and here the issue of labour market flexibility stands out. The restoration of adequate flexibility both in labour markets and also in product markets (which are sometimes at the root of labour market rigidities) is necessary to regain full employment.

5. Studies have shown that there are rigidities in the labour market of all Member States. Measures implemented and behaviour introduced during more favourable periods of considerable economic growth act, in the present slow growth environment and important technological changes, as a constraint on economic development. In consequence labour costs have risen faster than was warranted by general economic and entrepreneurial requirements; profitability has fallen and the level of unemployment has risen. During the last decade, the slowing of economic growth has made labour market rigidities in most Member States more apparent; moreover defensive reactions to internal and external economic changes has further increased these rigidities.

6. Labour market rigidities have many aspects, in particular:

(a) the overall level of wages has failed to adjust sufficiently, or quickly enough, to changes in the world economy, thus reducing the competitiveness of existing activities and the profitability of new ones;

(b) at a time when it was particularly important for resources to shift from declining to growing sectors, the stickiness of wage differentials has become all the more apparent;

(c) mobility between jobs and regions has declined when the need for such mobility has remained high;

(d) in response to demands for improved social conditions, non-wage costs of employment arising from social security contributions, rules concerning the organization of work, costs of recruiting and shedding labour etc. have risen;

(e) education and training have not responded sufficiently to the needs of industrial change and the demands of new technology.

The macroeconomic need for flexibility

7. In view of the competence of the Committee, this progress report concentrates on the general economic considerations of greater labour market flexibility.

The economic objectives should include primarily:

(a) sustained real growth, permitting increased employment;

(b) an improvement in the profitability of firms, through a moderation in the costs of production and an increase in the productivity of capital;

(c) more investment, especially in the sectors generating employment;

(d) a better capacity by firms to adapt to the evolution of demand in the market;

(e) improved use by firms of capital equipment allowing more flexible working time;

(f) effective policies to maintain nominal demand consistent with low or falling inflation.

8. These must be continuing objectives if markets are to retain their primacy in allocating resources efficiently in a changing world while providing a framework for innovation. Keeping labour costs down by shedding labour can only be one element in what should be a

wider process of economic adjustment and does not provide the complete solution required. The labour market needs to be sufficiently adaptable for workers to be absorbed quickly and effectively into new activities. This is partly a matter of costs (wage and non-wage), partly a matter of flexibility in transferring from one job to another (hiring conditions, redundancy arrangements, geographical mobility, etc.) and partly a matter of training and retraining (both within firms and more generally).

9. As new activities develop, purchasing power is shifted towards them. If domestic resources, including labour resources, are flexible, it will be easier to respond to these new opportunities otherwise this demand will be met by imports from more flexible areas of the world. If there is sufficient flexibility, innovation will not be stifled and technical changes can be more quickly translated into new products. These are the creative aspects of market flexibility which the economies of the Community urgently need to take advantage of in order to provide an internal stimulus to growth. The Community is not doomed to low growth and low employment, rather it should seize the opportunities provided by technological change so as not simply to experience its negative effects.

10. The manifold aspects of labour market determinants and their overlapping with social factors mean that action to increase the flexibility of labour markets is above all a task to be undertaken at the level of Member States, but in order to foster the necessary flexibility in macroeconomic relations the Member States and the Community should encourage actions in the following areas.

The most important fields of action

Wages and flexibility

11. Better labour market functioning would help to ensure that necessary changes in relative wages take place without upward pressure on the average wage. In addition, the evolution of real average wages should be oriented primarily towards the general economic investment and employment requirements, for the period necessary to regain equilibrium. Neither incomes policies nor free bargaining subject to non-accommodating fiscal and monetary policies have been notably successful in achieving both these objectives. Incomes policies have often not allowed sufficient scope for changes in relative wages. Nor have they achieved lasting success in containing the growth of average earnings within the real resources available. Free market bargaining within a framework of non-accommodating fiscal and monetary policy may have allowed greater movement in relative earnings, but it has not achieved an adequate slowing down in the growth of average earnings.

12. The necessity for labour markets to be flexible enough to allow above all real average wages to grow slower until a satisfactory equilibrium on the labour market is restored has been discussed above; it could be the case that this slower wage growth would dampen the growth of aggregate demand and, in spite of the beneficial effects of the lower costs of employing extra labour, have an adverse overall effect on employment in the short term. However, in today's circumstances this would not occur if the company sector's propensity to spend is as high as that of the personal sector. Also industry will have greater incentive to develop new products and thereby create supplementary demand. From this it is reasonable to conclude that, in these conditions, wage flexibility, in the form of a reduced share of

wages in the economy, would not jeopardize employment within the fiscal and monetary framework which Member States have adopted.

13. Policies with respect to minimum wages – working either through labour market regulations, legal minimum wages or through the effect of social security arrangements which effectively put a floor to wages – have two counterparts. They reduce the ability of the labour market to achieve such differentiation in earnings as is necessary to employ low skill or part-time workers and tend to raise average earnings excessively.

14. New initiatives in social dialogue may well be required to deal with the present situation. But they are unlikely to be successful unless they are accompanied by increased flexibility in relation to relative wages.

15. New forms of wage determination may help to introduce greater wage flexibility, for example greater profit sharing, more reliance on bonus payments, and possibly greater differentials between the payment of new and of established workers.

Non-wage costs as a source of rigidity

16. The costs of social security contributions have risen substantially in the last 10-15 years in (all) Member States – although in recent years there has been some moderation. Such costs are an important element in the overall cost of employing labour either because they fall directly on employers or because their imposition on employees puts upward pressure on wages.

17. The scope for reducing social security contributions is, however, limited unless the growth of social security expenditure can be curtailed. The importance of reducing non-wage costs reinforces the need to ensure that social security expenditure, along with other public expenditure, should be carefully controlled. A more modest growth in wage costs should not be accompanied by faster increases in non-wage costs, as for example could happen if wage restraint were bought through costly early retirement measures and increased pension charges.

18. In the short term it may be possible to improve the prospects for employment by reducing the burden of taxation and social security contributions on firms. Where there is scope for cutting firms' costs, concentrating such reductions on social security contributions could be helpful in focussing the initial effect of the reduction on the cost of employing labour.

19. The consequences of labour market regulations on the cost of employment are complex. Rules concerning recruitment and dismissal, organization of work, etc., which were introduced during periods of high growth and labour shortages, can, in theory, either raise or reduce non-wage labour costs. In practice, however, in a world of rapid technological change and unpredictable external shocks, they seem, in general, to have raised costs. National differences in regulatory practices, and consequently in their effects on costs, are considerable. However, some easing of regulations in labour markets throughout the Community in order to reduce such costs could be helpful to competitiveness and to employment. In any case, the addition of further regulations should be avoided in current circumstances.

20. One area in which it is important to pay strict attention to the cost of regulations concerns adjustments to working time. It is to be expected that economic growth will lead to changes in working time; there are also pressures to reduce working time on the assumption that such reductions will reduce unemployment. If done on a strictly cost neutral way, such reductions in working time can be welcomed. But if they raise costs, they will be counterproductive, both as regards income and employment growth. It is therefore important to achieve them in a decentralized way with a minimum of regulation, certainly without additional restrictions in the hours that individuals can work. Also, as noted above, it is important that early retirement does not increase social security burdens.

Greater flexibility and the 'productivity paradox'

21. Increases in productivity resulting solely from de-manning can have adverse economic effects by adding to unemployment, indeed the Community has suffered from this phenomenum during the recent period of adjustment. Where increases in productivity are in this way directly associated with increases in unemployment, this indicates generally that wage (or non-wage) costs per unit of labour input are too high, relative to costs per unit of capital, for labour to be fully absorbed. Higher absorption could come about either through adjustment of individual processes of production to make them more labour intensive or, as is more likely, through an expansion in the proportion of relatively labour intensive output in total output, or through some combination of both.

22. Productivity may be increased in other ways than through de-manning. Output may rise as a result of better organization of work, more flexible hours, greater ease in engaging workers for limited periods. These effects may operate between industries; for example greater flexibility in retailing by giving customers more choice over when to do their shopping may enable more efficient organization of factory work. The electronic revolution offers increasing scope for new working practices and for new ways of providing services. Labour markets must become more flexible to take advantage of such changes. An easing of regulations may have much to offer here.

23. Training is vital for achieving increases in productivity; retraining is critical to 'transforming' productivity in activities where demand is declining into productivity in ones where demand is expanding. Training and retraining increase the flexibility of the labour market, but they must be offered in a flexible way if they are to be as effective as possible. The relationship between the wages of trainees and trained workers (is there a sufficient incentive on employers and employees to engage in training?) and the absence or presence of restrictive practices (do retrained workers have the same access to jobs as traditionally trained ones?) are crucial. If labour markets are producing inadequate differentials or allowing existing workers to use monopoly power, training and retraining will be inadequate.

24. Adequate geographical mobility – within the Community as well as within Member States – is clearly necessary.Facilitating mobility through housing policies, development of social and educational infrastructure, standardized certification of qualifications for trained workers, etc., could have a role to play.

Encouraging structural change

25. Resisting necessary structural change and maintaining rigidities is a form of internal protectionism in that resources are retained artificially in particular sectors. Rapid industrial and technological change may appear painful for the labour market as old jobs cease to exist and workers are forced to move on to new jobs and skills. The temptation simply to resist

changes is very great. But change is not only inevitable, it is a major stimulus to growth. Therefore the costs of inflexibility are high. Protectionism, whether internal or external, is no answer to this problem as it will slow down the process of adjustment and tend to accelerate the structural difficulties. The so-called 'benefits' of protectionism are immediate and visible, while its costs are long-term and widely diffused. Although temporary protection may ease the process of transition or keep basically sound industries alive during a short period of hardship, experience shows that there is a strong danger that such temporary measures may turn out to last longer than strictly required, thus increasing rigidities and resulting in negative effects for the rest of the economy.

Opinion to the Council and the Commission on the three-year financial forecasts 1986-88 for the Community budget (14 October 1985)

1. In accordance with Council Decision No 70/244 of 21 April 1970,[1] the Commission, in order to place the Community budget within a framework of forward planning for several years, is required each year to draw up financial estimates for the three subsequent financial years[2] and to submit them to the Economic Policy Committee for its opinion. The main conclusions reached by the Committee at its meeting on 20 September are set out below.

2. While acknowledging the difficulty in preparing multiannual forecasts at national level and especially at Community level, the Committee stressed the importance of such forecasts for the Commission's medium-term strategy and also for the Council's examination of the following year's budget. It also urged that the framework submitted to it be consistent with the medium-term macroeconomic forecasts.

3. The Committee reiterated the importance it gives to budget discipline in the context of the presentation of the three-year forecasts. It took the view that the Community budget should fundamentally be in line with the general stance of budgetary policy in the Member States and that new items of Community expenditure should have as their counterpart the disappearance of, or a reduction in, certain items of national expenditure. The Committee noted that starting from the expenditure forecasts the margin remaining within the 1.4% value-added tax base is very small and will disappear on the slightest unfavourable change in determining factors. Moreover, the Committee would like some improvements to be made, both in method and procedure, in order to allow a better approach and to reduce the uncertainties inherent in numerical data and their interpretation.

4. In regard to method, the Committee was pleased that the presentation of estimates has been improved somewhat in the light of its previous suggestions, for example by bringing out especially the costs of the past and by including a supplementary year of the past. Nevertheless, it takes the view that the forecasting exercise should be more transparent, should be able to draw on fuller information and should elaborate more on the figures used and on the underlying policies. So it considers it desirable:

(i) to set out the incidence of enlargement;

(ii) to indicate the extent to which figures reflect simple extrapolations, decisions already taken or measures in preparation;

[1] OJ L 94, 28.4.1970.

[2] Three-year financial forecasts 1986-88, Extract from the Preliminary draft general budget of the European Communities for the financial year 1986, Volume 7, COM(85) 175.

(iii) to elaborate variants;

(iv) to give more information on the incidence of the most important and most sensitive assumptions such as the evolution of the growth rate of GDP, the development in international trade, the dollar exchange rate and world agricultural prices;

(v) to reintroduce the breakdown between compulsory and non-compulsory expenditure with the aim of pinpointing more clearly those items that allow some room for manoeuvre;

(vi) to take into consideration in all tables the last two years preceding the actual three-year financial forecasts.

Moreover, the Committee asked the Commission staff to take into account its observations on the time-lag between commitments and payments.

5. With regard to procedure, the Committee would like to stress that pursuant to Council Decision of 21 April 1970, the examination of the following year's budget should be preceded by a discussion on the three-year forecasts. If the Council follows this procedure, it would involve the Committee examining the three-year financial forecasts in due time before the Council's meeting on the preliminary draft budget of the following year.

Maximum rate of increase of the 'non-obligatory' expenditure of the Communities' budget for 1986 (2 April 1985)

Information for the members of the Economic Policy Committee

Please note that, in the light of the comments received from members of the Committee in written procedure closed on 28 March 1985, the maximum rate of increase of the 'non-obligatory' expenditures of the Communities' budget for 1986 is 7.1%. (arithmetical average of columns (3) and (4)).

The following table shows the details of this result.

GDP and budgetary indicators for determination of the 'maximum rate'

	Percentage change 1984/1983				Relative shares in GDP in 1983 used for calculating EC averages
	GDP volume	GDP deflator	GDP value	Outturn for central government (current prices)	
	(1)	(2)	(3)	(4)	(5)
B	1.7	5.4	7.1	4.8	3.5
DK	4.3	5.7	10.3	1.1	2.5
D	2.6	1.9	4.5	2.5	28.4
GR	2.4	19.1	22.0	26.3	1.5
F	2.0	6.9	9.0	8.5	22.5
IRL	3.7	6.6	10.5	9.2	0.8
I	2.8	10.5	13.6	10.6	15.3
L	2.4	5.9	8.4	-2.8	0.2
NL	2.2	3.2	5.4	5.0	5.7
UK	2.3	4.1	6.6	5.2	19.6
EUR 10	2.4	5.4	7.9	6.2	100.0

Statement prepared by the Chairman of the Economic Policy Committee for the ECO/FIN Council of 11 March 1985 on the economic situation in the Community

1. The Economic Policy Committee (EPC) discussed the economic situation at its meeting in February. As to its assessment of the position, it felt that the situation – with one exception – was considerably better than it appeared a couple of years before. World trade was growing and the growth seemed likely to continue. Economic growth had been strong in the United States and growth was likely to persist. The uncertainty concerning the position of the US dollar was exercising a negative influence but so far this had not prevented economic upturn.

2. In Europe, output is rising, inflation is converging at lower levels. Despite the gyrations of the US dollar, there has been exchange rate stability inside the EMS. There has been a significant improvement in the position of the public finances in most Member States. Supply side policies are having beneficial effects. Profitability has risen from low levels and is continuing to improve. The EPC will report to ECO/FIN in the coming months on the adequacy of this movement.

3. Set against these encouraging signs, there is of course the gloomy employment situation. Employment losses have given place to greater stability and in some Member States employment is growing. But this is not having a significant effect on unemployment because the labour participation rate – at least in some countries – is still rising. The unemployment position for the Community as a whole is still very worrying – although in the Federal Republic a downward trend seems to be emerging.

4. The EPC was not sanguine about what could be done to improve the employment situation quickly – although action on this front is clearly a priority. The scope for fiscal policy is very small. As inflation falls, there will be greater stimulus to output within a predetermined monetary and fiscal policy framework. But while the reduction of inflation will in this way be directly beneficial to output, the process is not something to be stimulated artificially. To do that would risk losing the gains already made.

5. This suggests that the main emphasis in employment policies should be directed towards the labour market. Real wages need to be more realistic and labour markets need to be more flexible. The position varies between Member States. In some – from an economic point of view – real wages are still too high to give adequate stimulus to a growth in employment. In other Member States, it is necessary to ensure that while real wages grow, they grow at a lower rate than the growth of productivity. These issues were set out in the Annual Report which stresses the importance of a modest evolution of real wages.

6. It is sometimes argued that lower real wages can also have a negative influence on employment through their effects on demand. On the other hand, lower wages, by reducing

costs and prices, can stimulate output. It is interesting to note in this context work done by the Commission, published in the Annual Economic Review, and discussed in the EPC before Christmas. This suggested that a more modest evolution of wages would, in many cases, stimulate demand even when the fiscal and monetary stance was unchanged. In addition to these demand effects, lower real wages would also encourage the substitution of labour for other factors of production. This substitution should, in the longer term, do much to improve employment prospects.

7. The need for greater flexibility in labour markets is still not fully appreciated. Greater understanding of it is vital if progress is to be made in a socially cohesive way. Dialogue with the social partners can have a role to play in this and we in the EPC are engaged in this process in a modest way. But our experience so far suggests the road may be a long one and also that discussion of labour market flexibility should be linked with discussion of greater flexibility in other areas.

8. In conclusion, the EPC discussion pointed towards action concentrated on the labour markets and thus parallels important elements in the Commission's Communication.

Statement by the Chairman of the Economic Policy Committee to the ECO/FIN Council on the Annual Economic Report 1985-86 (28 October 1985)

The Economic Policy Committee (EPC) discussed the Annual Economic Report in draft. The Report has not changed in substance since then, although an introduction and summary have been added. The EPC asked me to report their conclusions to ECO/FIN.

I. General aspects

(i) The Committee welcomes the Report's basic approach and objectives. It sets out the elements of and conditions for more employment-creating growth and takes more account than earlier Reports of dialogue and social acceptability.

(ii) Although the Report contains a number of new elements, particularly the realization and mutual coordination of various steps and measures to achieve more employment and growth, it can be regarded as a continuation or development of the strategy which the Member States are already following. It takes account of the outcome of the Committee's work on a variety of subjects such as profitability, labour costs, labour markets and employment and protectionism.

(iii) The possible results of the proposed cooperative growth strategy set out in the report are in the Committee's view to be interpreted as illustrating the direction of a possible development, rather than as setting an objective – especially since extremely favourable conditions were assumed in the calculations.

II. The various elements of the strategy

(i) *Monetary policy*

The Committee shared the Commissions' view that monetary policy should continue to promote domestic price stability and greater exchange rate stability.

(ii) *Profitability and factor prices*

There was agreement that a further increase in the profitability of capital was necessary for greater growth of investment and employment. Specific investment incentives would not be a good tool. In order to counter the tendency towards greater capital deepening and the shedding of labour, there is a need for change in the evolution of relative prices of labour and capital; labour costs should fall in relation to the rewards from new investment.

(iii) *Real wages and labour market flexibility*

The Committee confirmed the importance of a moderate evolution of real wages and greater labour market flexibility. It advocated that real wages per head should on average grow slower than the rise in productivity and that wage and salary structures be adjusted in order to correspond more closely to the level of skills and sectoral and regional requirements. The EPC has been studying labour market flexibility as part of its work on market flexibility and has sent a first report to ECO/FIN. This separate report underscores the importance which the EPC attaches to the need to achieve greater flexibility in the labour market as a necessary condition for a return to full employment. I think this work is important and ECO/FIN might find it useful to discuss our report at a later meeting.

(iv) *The role of demand*

The Committee wishes to distinguish between a demand boost – where demand leads supply – and demand support where demand follows supply. An isolated demand boost would, as argued in the Annual report, run the risk of becoming counter-productive and leading to accelerating inflation without contributing to a lasting increase in employment. But to be effective, increases in supply need to be paralleled by increases in real demand. Governments will want to assure economic agents that such increases will take place – generally through the working of markets. Where markets work effectively, a moderate evolution of wages, higher profitability and lower interest rates may, of themselves, trigger adequate demand for investment and employment. But this will not always happen and governments may find they have to take action to maintain levels of demand. There are problems of timing, as market processes will inevitably take time. Also much will depend on the circumstances in individual Member States.

(v) *Budgetary policy*

There was agreement that in considering demand support, the medium-term consolidation objective should not be called into question. If public investment were used to provide support, profitability considerations should remain the main criterion. If tax cuts were used, regard should particularly be paid to their incentive effects on economic performance, and their contribution to a better evolution of relative factor prices as well as to their effect on demand.

(vi) *Cooperative strategies*

Some members felt that in pursuing cooperative strategies, account should be taken of the need to promote flexibility and to strengthen the role of markets. In some cases this could involve strengthening the position of individuals against institutions. It would be counter-productive to add to the market power of dominant groups, especially, but not exclusively, in labour markets. Those with jobs may, by achieving excessive wages, damage the employment prospects of others.

(vii) *Action step by step*

(a) The parallelism of measures and commitments

Some members pointed out that their governments could not take measures solely on the basis of declarations of intent or commitments on the part of management and unions. They therefore argued that agreements should be equally binding for all. Pledge should be matched with pledge and action with action.

(b) The timing of steps

There was agreement that any individual steps should be carried out within a medium-term framework, but that a degree of flexibility should also be retained so that in each case an appropriate reaction to changing conditions would be possible. Longer-term commitments might stand in the way of this. But there was a balance to be struck; flexibility should not effect credibility.

Conclusion

Finally, the Economic Policy Committee is able to commend the broad approach set out in the Commission's Annual Report. All in all, the Report contains a clear message and a balanced presentation of the proposed strategy's elements and implications. It provides a good foundation for a fruitful dialogue with economic agents on the many elements necessary for an 'employment-creating adjustment phase' to be successful.

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