

Transatlantic Forum
sponsored by the Observatory of the ECB (OBCE)
on the occasion of The Bernácer Prize award ceremony

**“Coping with the economic challenges ahead:
The role of hours worked. Europe vs US”**

Madrid, 29 June 2005
Jean-Philippe Cotis

The theme of this Conference is very topical. Prof. Prescott made a fascinating presentation and R. Layard's discussion was no less stimulating. At the OECD, we have worried, over the years, about the interruption of economic convergence between Member Countries.

Why is it that, starting from the late 1970s, GDP per capita in Continental Europe failed to catch up with US levels?

A first, descriptive, answer is: a diverging path in hours worked per capita. But part of the answer may also lie in weak European productivity. It is true that GDP per hour worked looks at least as high in Germany, France and Italy as in the US. But in fact, European productivity figures are boosted by a “selection bias”. First, a large share of unskilled people are not in employment in Europe and, by definition, their relatively low productivity is not taken into account in the statistics. Also, given the reduced number of weekly hours worked, the productivity of the marginal hour has to be high! After correcting the figures, it seems that, in reality, Europe is lagging both in terms of hours worked and productivity. But still low hours worked represent a major part of the GDP per capita gap.

What are the factors behind this gap in working hours? How much do differences in societal preferences matter versus differences in policies? I am of the view that bad policies did a lot to reduce hours worked in Europe.

I would certainly agree with Prof. Prescott that high marginal tax rates did contribute to depress hours worked in Europe (female employment). But high effective marginal rates may be part of a more global policy configuration, also featuring highly regulated labour markets and distortionary benefits.

Prof. Prescott notes in his research paper that he was surprised to find that the rise of the effective marginal tax rate was large enough in Europe to account for all of the diverging path in total hours worked across the Atlantic. In such a context, labour market regulations and benefits can only play a residual role. Looking at OECD empirical research, however, regulations and benefits are found to be important. So, in the end, the impact of highly effective marginal tax rates may be overrated in as much as it captures the influence of an underlying set of highly correlated variables.

Because we are confronted with such a set of strongly correlated policy variables, I would like to shed some light on the distortionary impact of transfers.

I shall focus on the employment rate of people aged 55 and above. This is where Europe's employment is really weak. Otherwise, employment rates for people aged between 25 and 55 are not that different in the US and Europe.

The employment rate of ageing workers fell as a result of misguided attempts at reducing unemployment through various kinds of work-sharing. These policies backfired: rather than reducing unemployment, they depressed employment rates.

The worst of those policies aim at encouraging early retirement through highly distortionary subsidies. They provide public transfers to ageing workers. Such transfers are not lump sum since they depend on recent labour income. They are also contingent on stopping work. They generate **marked departures** from the principle of actuarial neutrality that should prevail in pension systems.

To evaluate the extent of departure from **actuarial neutrality**, we have calculated indicators of "implicit marginal taxes on continued work". By definition, there is an "implicit tax on continued work" when working one additional year is reducing your "net pension wealth": additional future pension benefits do not match the increased contributions you are making to the pension system.

In this respect, subsidised pre-retirement schemes are an extreme case of implicit taxation: not joining implies not only paying additional contributions but also losing pension benefits!

I would now like to comment briefly on a few charts:

- There is a wide dispersion in older worker employment rates; [slide 2]
- ... and in implicit tax rates [slide 3]
- Countries that have low rates of ageing workers employment generally suffer from high implicit tax rates on continued work [slide 4].
- Should pension and related systems become everywhere actuarially neutral, differences in employment rates would considerably narrow [slide 5] across OECD countries.

The example of "ageing" workers and how their employment prospects are undermined by distortionary transfers serves to illustrate a simple point: to test Prof. Prescott's hypothesis, the most relevant measure of marginal taxation has to include not only the effective taxation but also the "implicit" taxation arising from transfers.

TRANSATLANTIC FORUM

Madrid, 29th June 2005

Coping with the economic challenges ahead: the role of hours worked Europe vs US

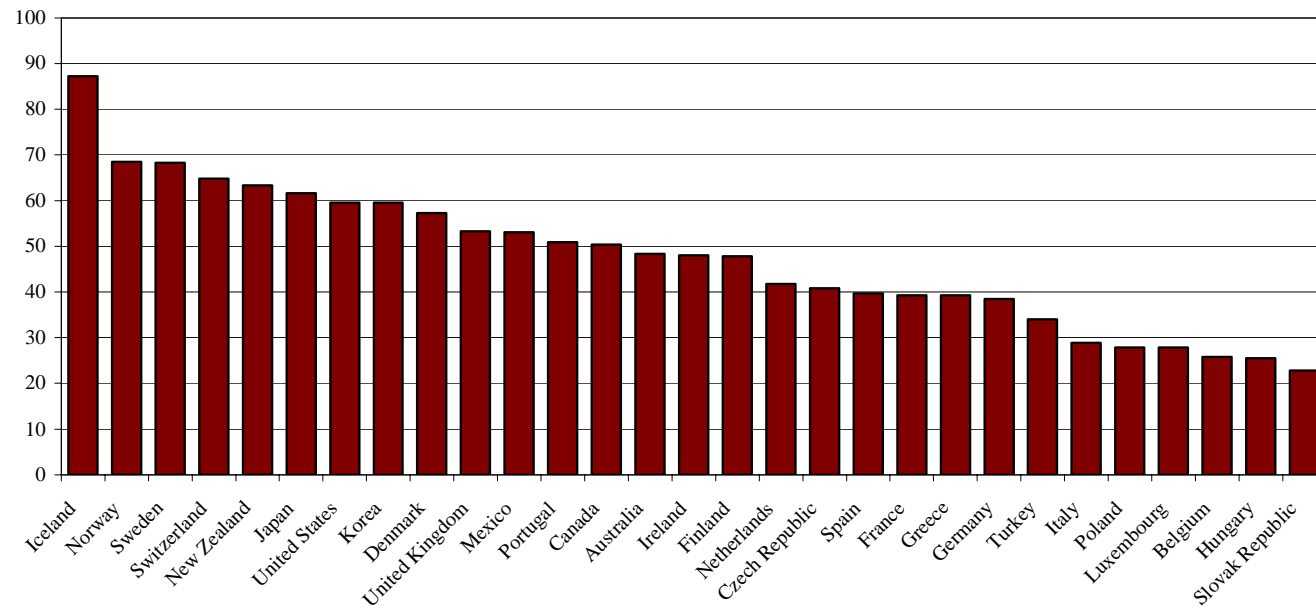
Jean-Philippe Cotis

OECD Chief Economist

There is a wide dispersion in older worker employment rates...

Employment of men and women age 55-64 as a percentage of the population age 55-64, 2002

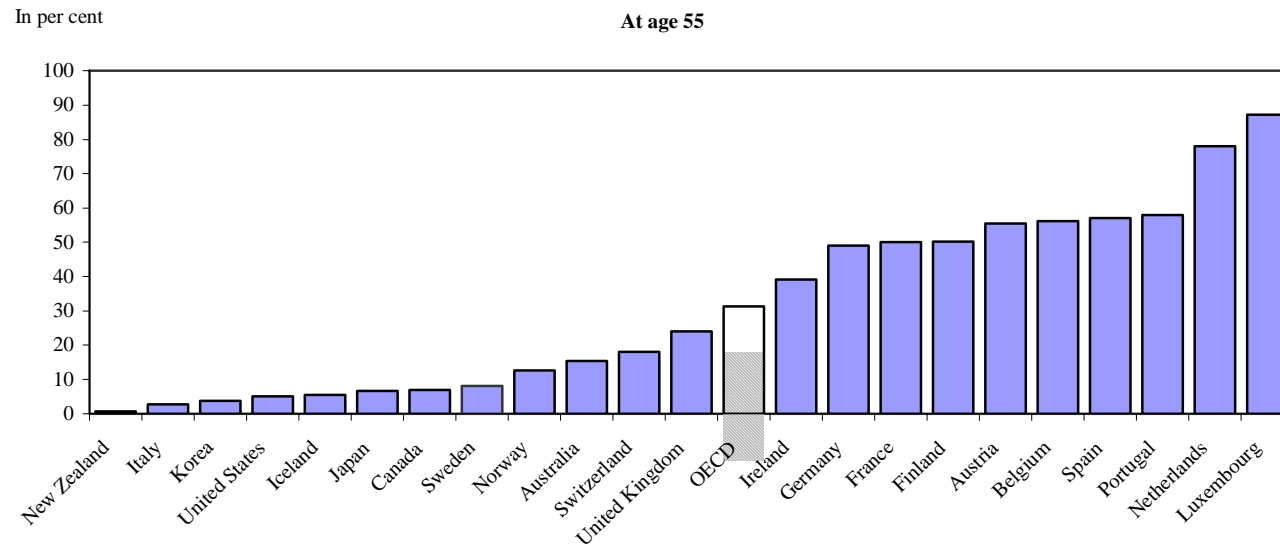
% of population age 55-64



Source: OECD.

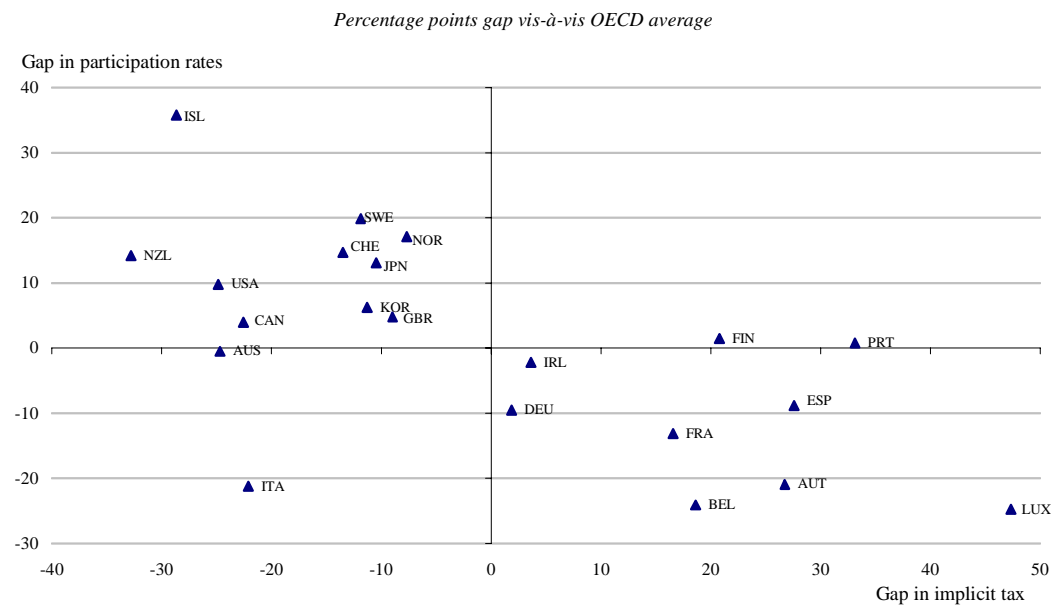
...and in social transfer programmes

Implicit tax rates on continued work over next 5 years in current social transfer programmes ¹



1. Single worker with average earnings.
Source : OECD.

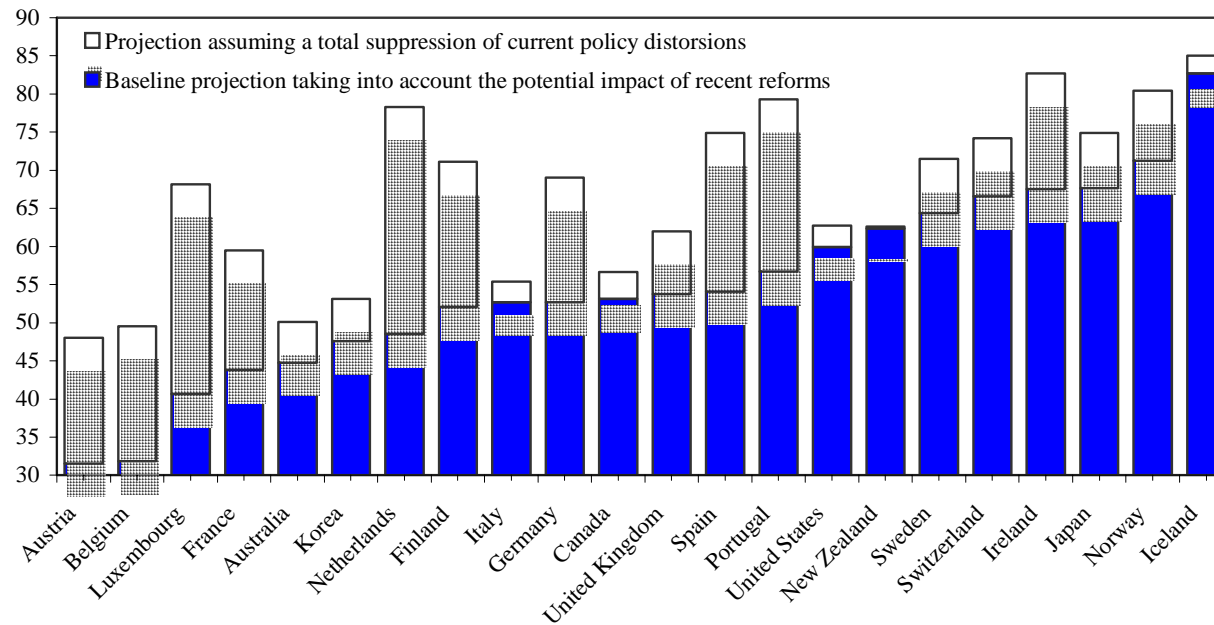
Labour force participation rates of the 55-64 year olds and the implicit tax on continued work¹



1. Average of implicit tax on continued work in early retirement route, for 55 and 60 years old.
 Source: OECD Labour Force Statistics, 2004; OECD Economic Policy Reforms: Going for Growth 2005.

Suppressing various policy distortions would have a large positive impact on the labour force participation of older workers

(projected labour force participation rates of the 55-64 age group in 2025 under different scenarios)



Source : OECD.