Executive summary

The analytical focus of this review...

This second edition of the Employment and Social Developments in Europe (ESDE) Review builds on the integrated approach to employment and social analysis embarked on in the first ESDE Review last year. Our concentration on cross-cutting themes covering the employment and social domains, such as in-work poverty, wage polarisation and income inequalities in the 2011 Review, has met with a positive reception. The discussions which followed with stakeholders have helped shape our further analytical focus.

...reflects a deepening economic and social crisis in Europe.

The recent economic and social developments have also driven the choice of analytical subjects for this 2012 Review. Since 2011, the economic slowdown has gradually turned into recession in the EU, as the escalation of debt crises in several Member States led to significant policy shifts toward sharp fiscal consolidation by and large across the EU with adverse effects on aggregate demand. As a result, the previous timid employment growth has come to a standstill in the recent quarters and unemployment has reached levels not seen in more than a decade. Simultaneously, the social situation is deteriorating, especially in Member States in southern and eastern Europe, as the effect of national automatic stabilisers, which played an important role in keeping up household expenditure and protecting the most vulnerable in the first phase of the crisis, has weakened more recently.

Divergence between different parts of the EU is growing...

Very importantly, the social and employment trends are diverging significantly in different parts of the EU. A new divide is emerging between countries that seem trapped in a downward spiral of falling output, massively rising unemployment and eroding disposable incomes and those that have at least so far shown some resilience – partly thanks to better functioning labour markets and more robust welfare systems, although there is also uncertainty about their capacity to resist continuing economic pressures.

...social polarisation is on the rise...

The crisis has, additionally, not impacted uniformly across the whole population and has often led to an even worse situation for groups already at heightened risk, notably young adults, children and to some extent migrants, thus contributing to social polarisation. Indications from recent consumer surveys are that the social situation has further deteriorated since 2010 in most Member States, with the poorest quartile being affected more than the average.

...and gender differences still remain.

The gradual expansion of women's employment has stopped and gender differences still remain. While the gap in unemployment rates between men and women has largely disappeared since the beginning of the crisis, many Member States show no signs of closing the gender pay gap and women still face higher risks of poverty or exclusion than men. Specific labour market trends help explain this apparent paradox – part-time jobs, a traditional domain of female employment, have been the only

labour market segment continuously expanding even during the crisis, thus optically improving the labour market situation of women, but with only a limited impact in terms of income gains.

What, in such a complex situation, are the most relevant subjects for social and employment analysis?

The crisis has strongly increased the risks of long-term exclusion.

The absence of tangible recovery has strongly increased the risks of long-term exclusion for the most heavily affected people. Understanding the risks and mechanisms of long-term exclusion is crucial for successful policy intervention. Long-term exclusion needs to be looked at bearing in mind its nature as a dynamic phenomenon, whereby individual transitions – between different labour market statuses, to and from poverty – provide the key to the analysis.

Two chapters of this year's ESDE Review take a closer look first at the specific labour market dimension of long-term exclusion in the form of long-term unemployment, and, second, at the broader social dimension.

Long-term unemployment has increased in most Member States...

While long-term unemployment has increased in most Member States in recent years, the problem appears most concentrated in Spain and a few other Member States, affecting more severely specific groups, such as men, young people or low-skilled workers, predominantly those employed in declining occupations and sectors. Looking at the most recent available data on transitions, inflows into unemployment have returned close to pre-crisis level, but return rates to employment remain diminished for both short and long-term unemployed. The economic cycle remains a powerful factor explaining changes in levels and flows to and from long-term unemployment, but there are also strong country effects whereby some countries (such as the Netherlands, Sweden and Finland) ensure high transition rates back to employment thanks to good policy mix, in contrast with others which are less successful in this respect (for instance Slovakia, Greece and Bulgaria). Particularly in countries where temporary contracts play an important role, repeated multiple spells of short-term unemployment are also a widespread phenomenon.

...creating significant marginalisation risks.

In general, one in five long-term unemployed in the EU has never worked, three quarters of these being young people below 35 years of age. This points to strong risks of marginalisation for the affected group and underlines the urgency of defining effective policy combinations including active and passive measures both to protect from poverty and to provide incentives and support to finding a job.

Risks of entering and escaping poverty vary greatly across Member States...

Policies to address and prevent poverty and long-term exclusion need to be tailored to the specific country situations and population groups most at risk. Our results show that the risks of entering into and exiting out of poverty vary greatly across Member States, with three main groups of countries identified.

In the first group, consisting of Austria, France and the UK, rates of entry into and exit from poverty are high, although in some of these countries, a significant share of those at risk of poverty form a 'core group' that does not take part in the churning. In the second group, consisting of the Baltic States, Bulgaria, Greece, Italy, Malta and Spain, there is a high risk of entering into poverty, and low chances of getting out of it, creating a massive poverty trap. As the evidence relates to pre-crisis data, the situation is worsening as the current perspectives are gloomy for this subgroup. The last group of countries, including the Nordic and Benelux countries, displays low rates of entry into and exit from poverty. In these, the share of people at risk of persistent poverty is however high, which is a sign of a preoccupying social polarisation, with a group of people at risk of poverty for which there are few chances of getting out of it.

...and some population groups are affected more.

Evidence-based profiling of the different population subgroups facing poverty or social exclusion suggests that individuals trapped in poverty for a longer period have a specific profile compared to those experiencing shorter (even though possibly repeated) poverty spells. Individual profiles indicate that young adults, inactive or unemployed women, lone mothers, or older working age adults out of the labour market are among those facing higher risks of persistent poverty. Typical profiles vary across countries, suggesting that these people face specific structural and institutional barriers in different countries, which points to the need for further country-specific research in this field.

The welfare state faces major challenges.

The unfolding debt crisis and the subsequent wave of austerity policies raise important questions about the viability of European welfare states. At the same time there appear to be major differences in the way various social models have reacted and performed under the recent stress. In order to explore policy implications and identify ways for welfare states to adapt, two chapters of this volume assess the functioning of social protection systems and some tax implications of their financing with regard to both efficiency and equity goals of employment and social policies.

Social protection benefits have cushioned the crisis' effects, but have weakened over time...

Social protection benefits have generally significantly helped cushion the effects of the income shocks on households from the economic crisis, especially in the period 2007-09, as available data clearly illustrate. However, a more detailed analysis reveals significant differences between Member States' social protection systems with respect to their anti-cyclicality, poverty reduction effects and employment friendliness.

... while similar levels of social spending often achieved different outcomes.

For example, while pensions are generally considered as a less anti-cyclical type of social spending, especially in comparison with unemployment benefits, they have strongly anti-cyclical effects in Italy and Poland. Importantly, in terms of poverty reduction, Member States with similar levels of social spending achieve significantly different outcomes and, conversely, similar poverty reduction requires very different levels of spending in different Member States. Larger welfare states tend to have higher employment rates, and the design of the tax-benefit systems as well as incentives for job search and take-up play an important role in terms of the employment friendliness of social spending. One aspect that is shown to facilitate the take-up of jobs, in particular among women, is the provision of childcare services. There has, however, been little progress in this field.

Revenue side design of welfare systems is equally important...

The design of the revenue side of the European welfare systems is equally important, and the chapter on taxation assesses its impacts on the goals of the Europe 2020 strategy with regard to employment and poverty. While there is a long-standing proposition to shift taxation away from labour to other sources to increase the employment rate, it is important to consider that such a measure may be most effective when targeted at the most vulnerable groups in the labour market. In turn, the outcome of the tax shifts away from labour may differ significantly in different Member States depending on the characteristics and composition of their workforce.

... and distributional aspects need to be considered.

At the same time, distributional aspects of tax redesign call for a cautious approach when looking for alternative sources to replace the lost revenues from lower labour taxation. While the value added tax, various green taxes and property taxation are the most obvious candidates in this respect, their increase, if not properly designed, can have unfavourable distributional effects and hamper the goal of decreasing poverty.

No 'silver bullet' taxation solutions, but some elements better than others.

Our analysis demonstrates that while there are no optimal solutions for tax shifts from an integrated employment and social policy point of view, an appropriate design might increase the desirability of some tax shifts. For example, the regressive effects of VAT can be mitigated by providing compensation to targeted groups (unemployed, retirees), and by focusing on standard rather than reduced rates and exemptions. Similarly, proper taxation of imputed rent has socially favourable effects. Finally, measures aimed at tax simplification, such as reform of tax expenditures, and at reduction of tax evasion can positively contribute to both employment and social policy goals.

Wage developments matter at both national and EU levels...

In normal times, but especially in the current severe economic downturn, wage developments are of major concern for policy makers, social partners and the public in general. Much of the current policy debate is focussed on the impact of wages on international competitiveness, aggregate demand, and their potential to contribute to the efforts to reverse rising poverty – within the Member States as well as at the level of the EU as a whole. A chapter on wages contributes to this debate by assessing wage developments before and during the crisis from a socio-economic perspective, and by highlighting the transmission mechanisms through which they impact on the realisation of the Europe 2020 employment and poverty reduction targets.

... influencing labour costs and real disposable income alike.

The analysis illustrates that both labour costs (adjusted for labour productivity and producer prices) as well as earnings (adjusted for consumer prices and taxes) have to be considered when assessing the impact of wage developments on achieving the

Europe 2020 targets related to employment and social cohesion. It finds, for instance, that although the purchasing power of minimum wages in the EU generally remained fairly stable during the period of 2001-2012 the evidence that minimum wages would impact negatively on jobs even in a severe economic downturn is limited, while other effects - such as inducement for low-skilled workers to increase labor supply - may help lowering pressure for public spending.

Skills mismatch is an increasing economic problem...

The last chapter of the ESDE 2012 Review analyses the structural problem of skill mismatch, or, in other words, the discrepancy between the qualifications and skills that individuals possess and those needed by the labour market. Available macroeconomic evidence points to increasing levels of skills mismatch in the EU, further aggravating the labour market difficulties resulting from the unfavourable economic cycle. A mismatch in skills affects economic competitiveness and growth, increases unemployment, undermines social inclusion, and generates significant economic and social costs. One out of three European employees is either over- or under-qualified, with the mismatch especially high in Mediterranean countries. Countries with higher vertical skill mismatches share some common characteristics. They tend to have lower levels of public investment in education and training, which might reduce the quality and ability of education and training systems to respond to changing labour market needs. They also have lower expenditure on labour market programmes and more rigid and segmented labour markets, as the qualification mismatch predominantly affects younger male workers on non-standard contracts.

... requiring both supply and demand side solutions.

Even a good match in terms of educational qualifications, however, does not mean that individuals necessarily possess the skills relevant for their jobs. For instance, young people tend to be more often than other age groups over-qualified with respect to the educational requirements of their jobs, but also under-skilled and in need of further training to cope well with their duties. An effective reduction of the skills mismatch requires both supply and demand side policy measures. Reforms increasing flexibility and responsiveness of the education and training systems, including the improved recognition of skills acquired outside formal education or abroad, need to be combined with pursuing the creation of innovative and high-skilled jobs in sufficient numbers.

Conclusion: stronger employment and social policies are needed to tackle the crisis...

Europe has been struggling to find appropriate policy responses to mitigate the various adverse effects of the crisis and restore a credible path to sustained recovery. In terms of economic and fiscal policies, this path involves stronger macroeconomic governance in the framework of the Europe 2020 strategy.

Until recently, the governance aspects in terms of stronger employment and social policy coordination and a joint reform agenda have received comparatively little attention, largely as a consequence of political focus on emergencies in the financial markets and government finances. However, this situation is changing. As President Barroso stressed in his State of the Union 2012 Address, the structural adjustment agenda can only succeed if it is fair and equitable. Describing the situation in some parts of Europe as a real social emergency with rising poverty and massive levels of unemployment, especially among young people, he called for modernisation of European social protection systems and creation of better and fairer taxation systems, underlining that *"an effective social protection system that helps those in need is not an obstacle to prosperity. It is indeed an indispensable element of it."*

... and new Commission initiatives indicate possible solutions.

Several new Commission initiatives, including the Employment Package of April 2012, the Youth Employment Package of December 2012 and the Social Investment Package currently under preparation, have sought to develop policy responses capable to lift Europe from the present crisis back on a path of progress towards the Europe 2020 targets. The Employment and Social Developments in Europe Review 2012 attempts to underpin this process with solid analysis that will feed into the European semester 2013.