CHAPTER 5

What Do Past Reforms Tell Us about Fostering Job Creation in Western Europe?

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SHOCKS AND LONG-STANDING REFORM GAPS

Between 2007 and 2012, Western Europe lost about 4 million jobs. Unemployment, youth and long-term unemployment in particular, reached unprecedented levels, especially in the euro area (EA) periphery. However, the effect of the crisis differed across countries, with only some experiencing very large surges in unemployment. To a great extent, these unprecedented unemployment levels can be understood through the prism of cyclical adjustment and as a reflection of the deleveraging needs in many sectors, as discussed in Chapter 3: faced with having to repair their balance sheet exposures and restore profitability, many firms resorted to reducing their wage bills, often through employment reductions. This chapter complements that analysis by taking a longer, more structural view of labor market performance in Western Europe.[1] Its main conclusion is that recent labor market outcomes were also significantly influenced by structural policies undertaken in the past 20 years and the way these policies interacted with institutions and longer-term or structural shocks.

The past two decades presented European economies with two main changes in the economic environment: the information and communication technology (ICT) revolution and globalization. Many European countries' delays in adopting new technologies left them vulnerable to increased competition from emerging market countries. Inflexible labor market institutions became an important impediment to allocating labor efficiently given that these two global shocks created the need for vast labor reallocation across sectors, which, in turn, required more flexible labor markets, especially as concurrent euro adoption meant that nominal wage increases could no longer be accommodated by nominal exchange rate adjustments. The next section discusses in a cross-country context how these shocks interacted with preexisting institutions and their implications for labor market outcomes, in light of findings from the literature. The subsequent section

[1]Chapter 6 focuses on labor market experiences in the Balkan economies.

describes the policy responses to these challenges and the labor market implications of different policy choices. It is followed by a section that discusses individual country experiences, in particular those in Germany, Italy, and Spain.

DIAGNOSIS—INTERACTION OF SHOCKS AND INSTITUTIONS

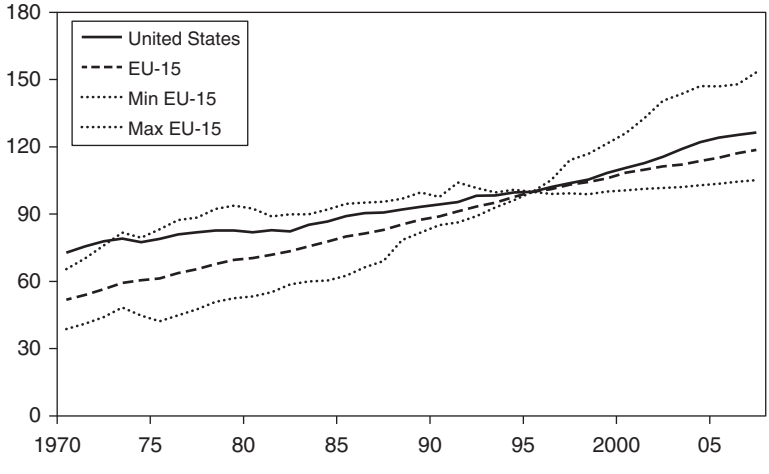
Two Structural Shocks and the Euro

In the late 1990s, the United States experienced high levels of investment in rapidly advancing ICT, followed by strong productivity growth in the services sector] early in the first decade of the 2000s (Jorgenson, Ho, and Stiroh, 2005). In contrast, during the same period the European Union (EU) economies registered, on average, a significant productivity slowdown. As a result, the productivity gap between the two began widening about 1995 (Figure 5.1). The EU productivity slowdown was largely due to slower multifactor productivity growth in services, particularly in trade, finance, and business services (van Ark, O'Mahony, and Timmer, 2008).

Some EU countries also faced strong competition from emerging markets because globalization resulted in the entry of major exporters into the world market and in large flows of foreign direct investment. On the trade side, increased competition came mainly from the EU's enlargement via Eastern Europe and from China's entry into the global supply chain.

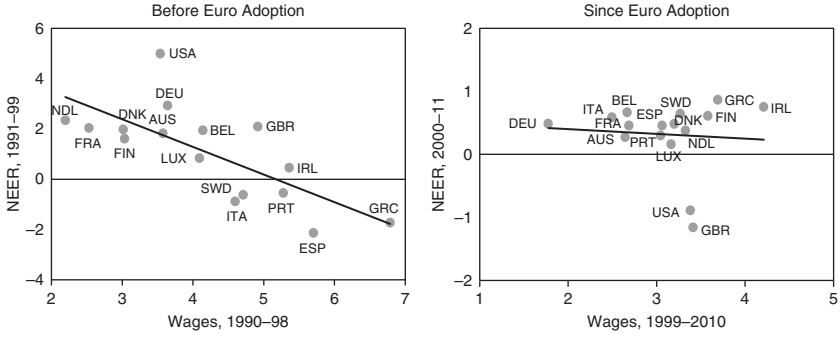
At the same time, adoption of the euro limited member countries' ability to accommodate nominal wage increases by devaluation—any real exchange rate adjustment had to fall on relative prices, reflected in the correlation between

Figure 5.1 Labor Productivity per Hour Worked *(Index, 1995=100)*



Source: Klems database.
Note: EU-15 comprises Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom.

Figure 5.2 Correlation between Wages and Nominal Effective Exchange Rate (NEER)
(Annual percent change)

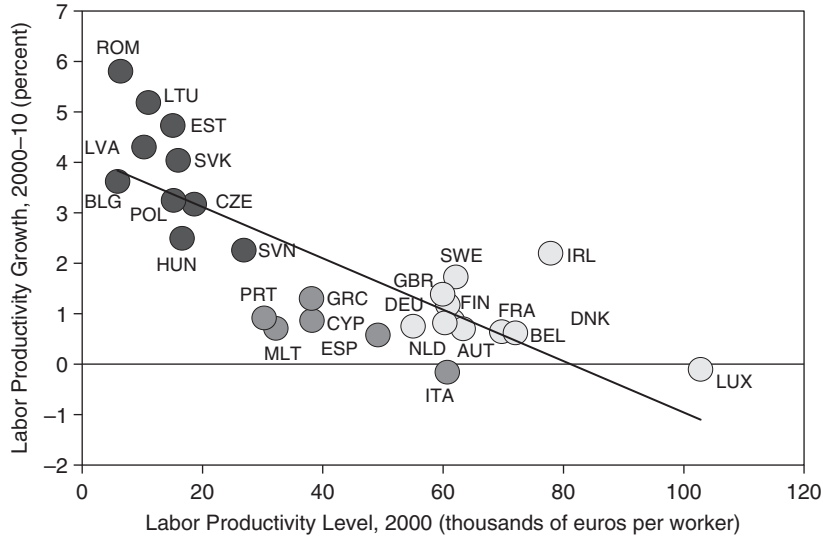


Source: OECD database.

wages and the nominal effective exchange rate, which turned from strongly negative in the pre-euro era to insignificant after its adoption (Figure 5.2).

Economic and Monetary Union (EMU) also created expectations that the periphery economies, on the back of a rapid decline in borrowing costs and abundant global liquidity, would catch up with higher-income EMU countries, which led to large foreign capital inflows to the periphery. However, the bulk of the inflows financed consumption and investment that yielded low returns, particularly in the nontradables sector, with limited impact on potential growth. Additionally, real appreciation following euro adoption favored nontradables and reduced export competitiveness, limiting the pace of convergence for some countries, relative to others in the EU (Figure 5.3).

Figure 5.3 Convergence Growth in European Union



Sources: AMECO database; and IMF staff estimates.

Structural Shocks and Institutions Interact

Although not the only impediment, the existing labor market institutions proved inadequate for coping with the ICT revolution, delaying new technology adoption and improvement in productivity growth, and potentially contributing to lower investment in human capital.[2] Slow productivity growth also left many European countries vulnerable to competition from non-European emerging markets, with existing institutions hampering the needed labor reallocation across sectors.[3] These hindrances had implications for employment, unemployment, and wages.

High unemployment and long unemployment duration

Relatively strict employment protection legislation (EPL) in much of Europe adversely affected labor market outcomes. Although its impact on unemployment is theoretically and empirically ambiguous because it tends to lower both entry into and exit from employment, high EPL increased average unemployment durations and gave rise to dual labor systems in many economies.[4] Because employment protection was higher for workers on permanent contracts, firms shifted hiring toward more temporary workers,[5] especially affecting the young and the low skilled and making them more vulnerable to employment losses, particularly in downturns. Firms also had less incentive to train temporary workers, limiting human capital accumulation and longer-term growth.

Generous unemployment benefits are also thought to increase the level and duration of unemployment by raising reservation wages. By protecting labor market insiders from the risk of income loss, unemployment benefits reduce the sensitivity of wages to general economic conditions, thereby preventing a swift adjustment in the aftermath of shocks (Blanchard and Wolfers, 2000).

Moreover, wage-setting institutions in several Western European countries made wages less responsive to the productivity slowdown, often forcing adjustment through employment.[6] Theory suggests a hump-shaped relationship between unemployment and the degree of centralization and coordination of wage bargaining: both full decentralization and full centralization lead to lower unemployment rates, while an intermediate level of coordination yields the worst labor market outcome (Calmfors and Driffill, 1988). Intermediate systems are characteristic of many Western European economies.

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[2]See Colecchia and Schreyerb (2002) on how ICT adoption increases productivity growth and Chapter 7 of this book on how structural reforms could boost productivity growth.

[3]This chapter complements Blanchard (2005) by introducing two recent shocks and studying the interaction of these shocks and labor institutions.

[4]Blanchard, Jaumotte, and Loungani (2013) discuss in more detail how high employment protection and generous unemployment benefits could hamper the reallocation of workers to jobs, a reallocation that is needed to sustain growth (micro flexibility).

[5]See OECD, 2006; Betcherman, 2012; Bentolila and Dolado, 1994; Blanchard and Landier, 2002; Cahuc and Postel-Vinay, 2002; Dolado, García-Serrano, and Jimeno, 2002; Jaumotte, 2011; and Nunziata and Staffolani, 2007

[6]Blanchard, Jaumotte, and Loungani (2013) also discuss in more detail how certain types of bargaining systems can hamper an economy's ability to adjust to macroeconomic shocks (macro flexibility).

High unit labor cost

Some features of European labor market institutions may constrain productivity through more than one channel. First, they may dampen firms' incentives to innovate and grow (Braguinsky, Branstetter, and Regateiro, 2011). Second, strong EPL could interfere with optimal labor reallocation across sectors (OECD, 2010; Betcherman, 2012; Martin and Scarpetta, 2012). Third, high unemployment benefits can hinder optimal matching, for example, by discouraging the low-skilled from accepting productive jobs (OECD, 2007).[7]

In addition to affecting export competitiveness directly, the initially higher unit labor cost (ULC) in the EA periphery relative to Eastern European newcomers to the EU may have prevented early entry into the global supply chain. The experience of successful Eastern European countries suggests that attracting upstream producers or hubs that will locate a part of their downstream production in these countries can be helpful for economic performance: over time, this action created a virtuous circle whereby domestic value added increased hand in hand with foreign value added, enhancing the role of exports in growth and encouraging new technology adoption (see Chapter 10 in this book).

POLICY RESPONSES AND LABOR MARKET OUTCOMES

Similar Global Shocks but Different Domestic Policy Responses

Overall, technology and globalization shocks have resulted in a substantial and steady decline in the relative demand for low-skilled labor in most countries. However, policymakers responded differently to these changes. The United States relied mainly on wage flexibility to absorb these structural shocks, resulting in strong employment growth, but also a widening wage-skill gap. By contrast, many continental European countries made more use of redistributive (typically wage-compressing) institutions—including EPL, unemployment insurance (UI) systems, and early retirement—to limit income inequality, but at the cost of lower employment (Bertola, 1999; and Layard and Nickell, 1999).

Although capturing general trends, this characterization masks important institutional asymmetries among European countries. Esping-Andersen (1990) divides European labor markets into four broad models:

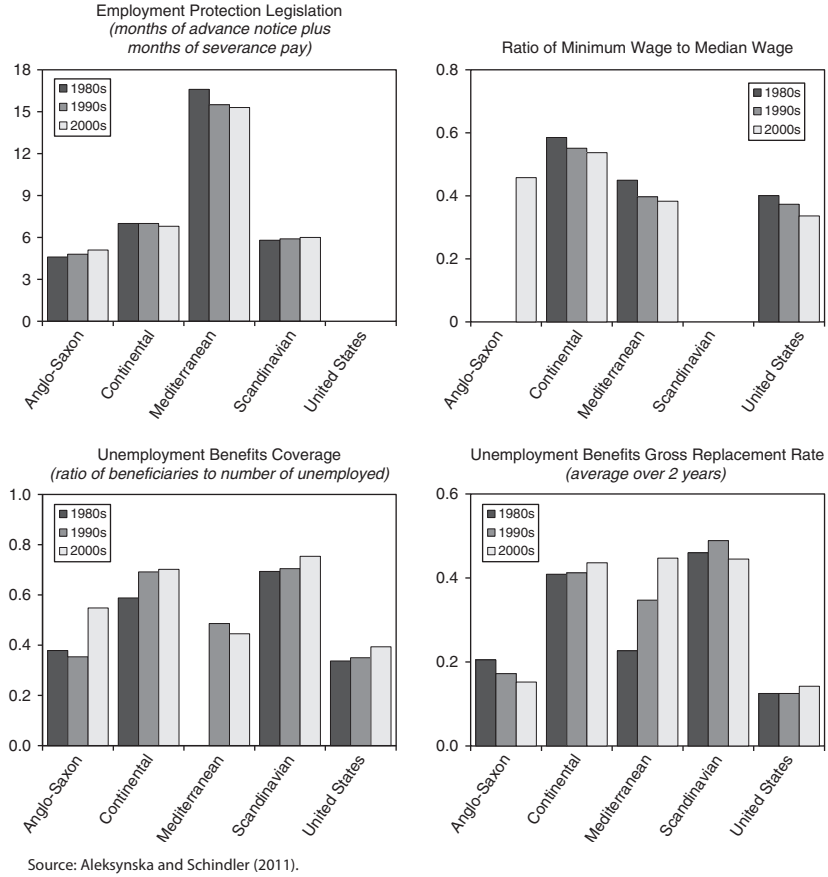
- Anglo-Saxon countries, featuring limited government intervention, weak unions, decentralized bargaining allowing for substantial wage dispersion, low labor taxes, and employment-linked social benefits and active labor market (ALM) policies.
- Continental European countries, featuring strong unions and centralized bargaining, high labor taxes, generous UI, and in some cases, strong EPL.

[7]However, it should be noted that very low unemployment benefits may also hinder optimal matching because many unemployed have to leap at the first offer.

- Mediterranean countries, relying heavily on stringent EPL and centralized bargaining, but offering low UI and limited ALM policies.
- Scandinavian countries, relying more on UI rather than EPL to address unemployment risk, and also featuring high labor taxes, strong unions, and compressed wage structures.

This taxonomy remains broadly relevant today, with the notable exception of recent developments in wage dispersion and UI replacement rates for the Mediterranean country group (Figure 5.4).[8]

Figure 5.4 Evolution of Labor Institutional Arrangements



Source: Aleksynska and Schindler (2011).

[8]Although the broad labor market taxonomy proposed by Esping-Andersen (1990) remains instructive, a finer gradation could be devised, for example, based on differences in EPL across workers or on different durations of unemployment benefit eligibility.

Partial Reform and Dualism—Analytical Issues

An assessment of partial reforms requires taking a general equilibrium perspective with a focus on the impact on labor wedges of long-term changes in job creation and destruction rates.[9] To provide a perspective on the analytics, the general equilibrium effects of certain market policies studied by Boeri (2011), holding other policies unchanged, are summarized here:

- *Increase in unemployment benefits (UB).* This reform's short- and long-term effects are in the same direction. Higher UBs increase workers' reservation wages and, in the medium term, the job separation rate, and lower the job-finding rate, unambiguously raising unemployment and average wages.
- *Increase in firing taxes (EPL).* On impact, EPL lowers the job destruction rate (by maintaining lower-productivity matches) and increases wages (through a stronger employee bargaining position). In the longer term, however, a tighter labor market could offset these effects, depending on ALM policies and the generosity of UB. The overall impact on unemployment and wages is thus ambiguous, entailing both lower job-loss and job-finding probabilities, potentially even reversing the short-term effects.
- *Increase in employment-conditional incentives (ALM).* On impact, these incentives decrease wages at the low end and reduce unemployment. Long-term effects include a lower productivity threshold at which matches can be maintained and longer average job duration, unambiguously reinforcing the partial equilibrium effects. The overall result is lower unemployment and lower average wages, with the effects being larger in the long term (higher job-finding rate combined with lower job-loss probability).[10]
- *Increase in activation programs (ALM).* The short-term effects are similar to the ALM scheme discussed above because lower recruitment costs raise the vacancy-to-unemployment ratio. Longer-term effects are in the opposite direction, however, because lower turnover costs lead to job destruction at a higher productivity threshold. The overall impact includes both higher job-finding and job-loss rates, with an ambiguous effect on unemployment and wages, possibly reversing the partial equilibrium effect.

A comprehensive reform strategy necessary to support employment would generally extend beyond the labor market sphere. Therefore, addressing features of the broader tax and welfare system may also be crucial. High marginal tax rates and social welfare systems with high replacement rates could generate additional "second-best" issues, entailing supply constraints, demand constraints, or both, in specific segments of the labor market even if substantial labor market liberalization has already been achieved. For instance, reforms that focus

[9]Search models by Mortensen and Pissarides (1999), Blanchard and Diamond (1989), and Boeri (2011) formalize these insights.

[10]However, this analysis does not internalize the government's budget constraint: higher distortionary taxes to finance the employment subsidy would partly offset the beneficial labor market impact.

only on reducing wages at the low-skill end would not appreciably improve labor market performance to the extent that high marginal tax rates or welfare benefit replacement rates for this segment of the labor market keep reservation wages high. These factors appear especially relevant in the current context because the low-skilled are also the main victims of the recent ICT and globalization shocks.

Implications of labor market dualism

Given the asymmetric impact of the ICT and globalization shocks, some governments opted for separate institutional regimes for low-skilled workers, typically in the form of temporary contracts exempted from regulations applying to regular contracts. Dualism can affect labor market outcomes in two broad ways: (1) indirectly through interaction with labor market and fiscal reforms and (2) directly by affecting employment volatility over the cycle and by altering the stabilizing properties of the social safety net. Asymmetric labor market reforms in a dual setting can have a profoundly different impact on labor market outcomes compared with the homogeneous case. To illustrate, three of the reforms discussed above are examined, drawing again on Boeri (2011):

- *Increase in UB.* If applied only to regular jobs, the impact on job destruction remains as above. However, with a different regime now available for entry jobs under temporary contracts, the job creation rate is unaffected. The end result is still an increase in unemployment, but lower than in the homogeneous case, and a larger skill wage premium on continuing jobs.
- *Increase in firing taxes (EPL).* If applied only to regular jobs, increased firing taxes would increase the wage tenure profile and the share of employment in entry jobs, exacerbating dualism—because the rate of conversion of temporary into regular contracts falls and the average duration of continuing jobs increases. Compared with the homogeneous case, dualism is accompanied by less ambiguity, that is, unemployment is more likely to decline.
- *Increase in employment subsidies for entry jobs (ALM).* This reform does not affect the job-destruction rate for permanent contracts, but increases the job-finding rate and job-destruction rate for temporary contracts because the rate of conversion of temporary into regular contracts declines. This suggests increased ambiguity about the reform's impact under dualism compared with the homogeneous case—under dualism, employment subsidies could end up raising unemployment.

The implications of dualism for incorporating reform of the tax and benefit systems into a comprehensive reform strategy appear more straightforward. In the face of recent shocks, the rationale for introducing temporary contracts has been to support employment at the low-skill end of the labor market. This is the segment in which high marginal tax rates and welfare benefit replacement rates are likely to keep reservation wages high, making fiscal reform all the more urgent.

Transitional dynamics of labor market outcomes

Transition to the long-term equilibrium can be a protracted process. When low-EPL temporary contracts are introduced alongside regular contracts with prohibitively strict EPL, the long-term equilibrium would require a "corner solution," with all employment under temporary contracts (with permanent contracts disappearing via attrition), and no long-term employment gains. In the transition, however, employers can take advantage of the low-EPL regime at the start of the reform to boost employment in good times, even though the long-term equilibrium would look very different—a pattern that Boeri and Garibaldi (2007) term the "honeymoon effect." There is a fundamental asymmetry here because there would be no scope to exploit the more flexible contract regime in bad times.

Beyond its impact via interaction with reforms, dualism can affect labor market outcomes (and other macro variables) more directly:

- Given the level of EPL for permanent contracts, a higher degree of dualism (that is, a higher share of temporary contracts) would mean a higher elasticity of employment to output, and hence higher volatility of employment over the cycle; this is the flip side of the honeymoon effect.
- Given more generous UI for workers under permanent contracts, a higher degree of dualism would mean reduced coverage of income support schemes for job losers, implying smaller automatic stabilizers and leading to additional output and employment volatility over the cycle.

Precrisis Reforms and Labor Market Outcomes

Against this background, three cases of comprehensive reforms stand out among advanced European countries: the early efforts by the United Kingdom and the Netherlands, and the more recent German reforms:

- The U.K. reform effort spanned the early 1980s to the mid-1990s. The initial emphasis was on fostering decentralized wage bargaining in the direction of wage moderation, flexibility, and differentiation. Supporting policies included reductions in marginal tax rates, especially at the low end with the introduction of a negative income tax, and reductions in both the level and duration of UB. Later stages of the reform focused on further improving incentives, with emphasis on making social benefits conditional on employment—the "welfare-to-work" program.
- The Netherlands reforms covered approximately the same period. A wage moderation agreement in the early 1980s was supplemented by major labor market and fiscal reforms. Fiscal consolidation provided room for a steady reduction in labor taxes, and sharp reductions in benefit replacement rates, particularly disability benefits, eased supply-side constraints. Moreover, EPL was significantly loosened, and a separate youth minimum wage was set at one-fifth of the national minimum wage.
- The "Hartz reforms" in Germany are discussed in greater detail below.

In other EU countries, the reform record is more mixed. Although the total number of recorded instances of reforms during the period 1980–2007, at 868, was quite large, they can be generally described as fragmentary, incremental, and pursuing mixed objectives[11] (Aleksynska and Schindler, 2011):

- In most cases, reforms covered limited aspects of labor market institutions: 85 percent of the recorded reforms relate to a single area.
- The vast majority of recorded reforms (slightly fewer than 90 percent on EPL and more than 90 percent on UB) were incremental in magnitude, rather than discrete, and are unlikely to have made a discernible impact on labor market institutions.[12]
- Implemented reforms were often internally inconsistent, as illustrated by their impact on the wedge between the marginal product of labor and its opportunity cost. Although the implemented ALM reforms were predominantly in the direction of reducing the wedge, reforms in EPL, UB, and early retirement were split almost 50–50 between wedge-reducing and wedge-increasing. UB reforms in particular substantially raised replacement rates in France, Switzerland, and three of the four Mediterranean countries (Italy, Portugal, and Spain)—for the latter group, undermining the effectiveness of a moderate loosening of EPL.
- Reforms strengthened dualism in some cases. Among implemented reforms, "large" reforms tended to be predominantly "two-tier" (geared only to specific segments of the population); moreover, two-tier reforms tended to make up large shares of each reform category—ranging from 45 percent of UB reforms to 75 percent of early retirement reforms. Regarding the interaction of reforms with preexisting institutional asymmetries, four two-tier reforms out of five actually widened asymmetries in regulatory regimes, thereby strengthening dualism (Boeri, 2011).[13]

Cross-country comparisons suggest that comprehensive reform carries substantial benefits. Following their reforms, Germany, the Netherlands, and the United Kingdom performed better than most other EU countries in unemployment (Figure 5.5) and labor force participation (Figure 5.6)—and the impact of reforms seems to materialize fairly quickly.

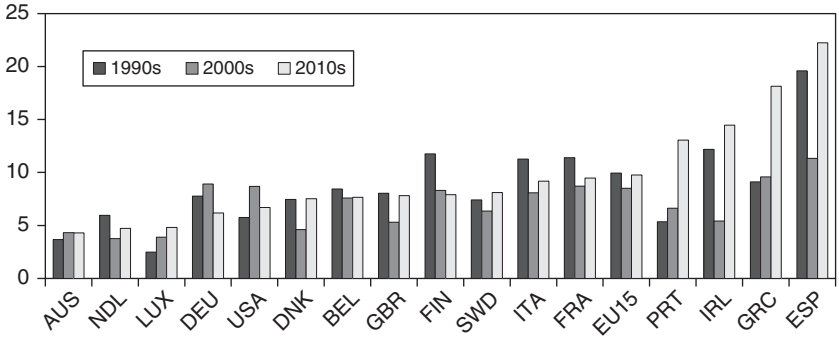
Regarding reforms reinforcing dualism, employment typically surged after the introduction or extension of temporary contract regimes, consistent with a honeymoon effect. However, the expansion of dual regimes increased labor market turnover and employment volatility, even under a favorable macroeconomic

[11]There is, however, an inherent arbitrariness in how reforms are measured. For example, should a reform package consisting of lower tax rates and lower UBs be counted as one reform or two?

[12]EPL is an example: although 199 reforms were recorded, only three countries (Germany, the Netherlands, and the United Kingdom) registered a change in EPL score between 1980 and 2007

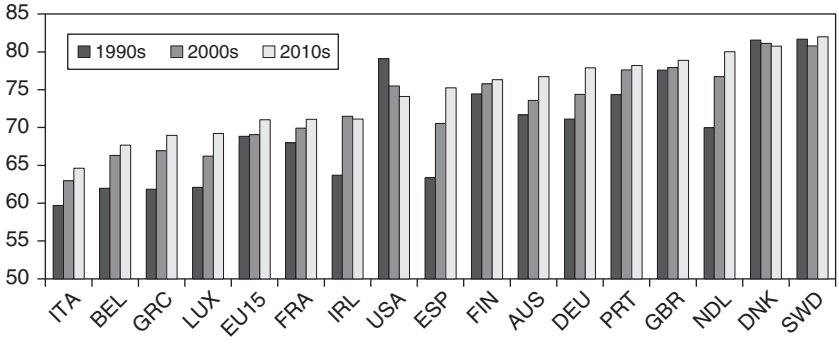
[13]These concerns are particularly relevant for countries such as Italy and Spain, where the scope of temporary contracts has been expanded substantially.

Figure 5.5 Unemployment Rate



Source: OECD database.

Figure 5.6 Labor Force Participation Rate



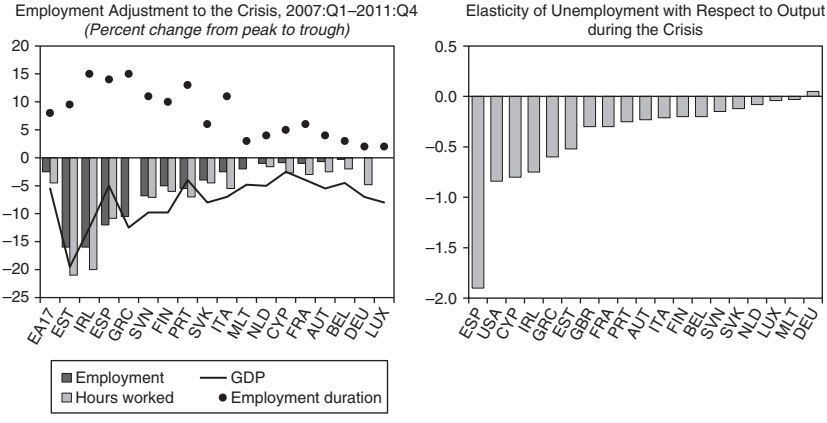
Source: OECD database.

environment: during the period 2004–08, the transition probability from employment to unemployment was much higher for temporary than for regular contracts, ranging from 5 to 25 times across euro area countries (ECB, 2012).

Postcrisis Experience in the Euro Area

The financial crisis caused marked divergence in labor market performance in the EA. Employment losses ranged from –0.4 percent to –16 percent (peak to trough) across EA countries (Figure 5.7)—a degree of divergence far exceeding cross-country differences in output losses. The sectoral composition of the economy (particularly the shares of industry, finance, and construction), as well as workforce age composition and human capital, carry explanatory power for employment dynamics (ECB, 2012). But differences in employment performance across countries also reflected differences in institutional structures and structural reform paths.

Figure 5.7 Employment and Unemployment during the Crisis



Source: European Central Bank (2012).

In the periphery, where capital inflows helped compensate for losses in competitiveness before the crisis, the absence of past reforms now adds to the drag on activity and employment. The reverse also holds—the two EA "comprehensive reformers," Germany and the Netherlands, have seen the elasticity of unemployment with respect to output decline, whereas it was much higher in almost all other EA countries (see Figure 5.7). This dichotomy suggests that comprehensive reform can be very effective in providing enough flexibility to insulate the labor market, at least temporarily, from even very large output shocks.

Labor market developments during the crisis also confirm that extensive dualism tends to increase the sensitivity of employment to fluctuations in output; during major economic downturns, this would amount to a reverse honeymoon effect as employers respond by shedding temporary workers. Indeed, countries with a high incidence of temporary contracts have experienced large employment losses during the crisis. The average probability of becoming unemployed has been almost 12 times higher for temporary workers than for workers under regular contracts (ECB, 2012). The estimated transition probability from employment to unemployment reached levels of more than 14 percent in Spain and Estonia, and about 10 percent in France, Finland, and the Slovak Republic.

Since the onset of the crisis, most EA countries have introduced additional measures to support employment. On the supply side, ALM policies have been the most common instrument: almost all countries have introduced additional training programs for the unemployed, and about half have stepped up job search assistance. Some countries have moved to extend UB (benefit levels, duration, or eligibility criteria).[14] On the demand side, employment subsidies were most widely resorted to—including subsidies for short-time work schemes for workers

[14]By tightening UB eligibility, Greece has been an exception in this regard.

facing layoffs and fiscal incentives to hire unemployed workers. About half of the EA countries pursued reductions in nonwage labor costs, mainly by cutting social security contributions.[15]

Although these measures broadly served their purposes and generally prevented further increases in labor market dualism, they were no substitute for genuine reforms. In fact, it could be argued that increasing UB generosity could be counterproductive if it changed incentives in the longer term. And some of the reforms undertaken—for example, measures inspired by the success of the German Hartz reforms—might be less effective under different conditions elsewhere. Finally, care must still be exercised in interpreting the role existing labor market institutions played in economic outcomes. For example, Schindler (2013) argues that the temporary nature of the shock to the German economy was an important reason for the effectiveness of its short-term work schemes in preventing layoffs. The Germany case study below will take up some of these issues.

CASE STUDIES

To further help disentangle the role of institutions, policies and shocks, this section discusses the experiences in Germany, Italy, and Spain in greater detail (Table 5.1).

TABLE 5.1

Germany, Italy and Spain: Labor Market Institutions and Reforms at a Glance

	Germany	Italy[1]	Spain[1]
Nondiscriminatory unfair dismissal			
Precourt resolution required	Some	Yes	Yes
Pretrial conciliation mandatory	Yes	Yes	Yes
Pretrial conciliation outcome enforceable	Yes	n.a.	Yes
Conditions defined	Broadly, "socially justified"	No	Yes
Reinstatement mandatory	Yes, but rarely applied; either party can dissolve	Yes, if "manifestly unfounded"	No, employer decides
Compensation (if not reinstated)	12–18 months wages	12–24 months wages	maximum 24 months wages[2]
Mandatory legal representation	No	Yes	No
Length of procedure	14.3 months	23–26 months	n.a.
Fair dismissals			
Severance pay	0.5m for each year of service	[3]	maximum 12 months
Application to public sector	No	No	Yes

(Continued)

[15]However, a few countries faced with tight fiscal constraints, including Estonia and Greece, actually raised social security contributions.

TABLE 5.1 (*Continued*)

Germany, Italy and Spain: Labor Market Institutions and Reforms at a Glance

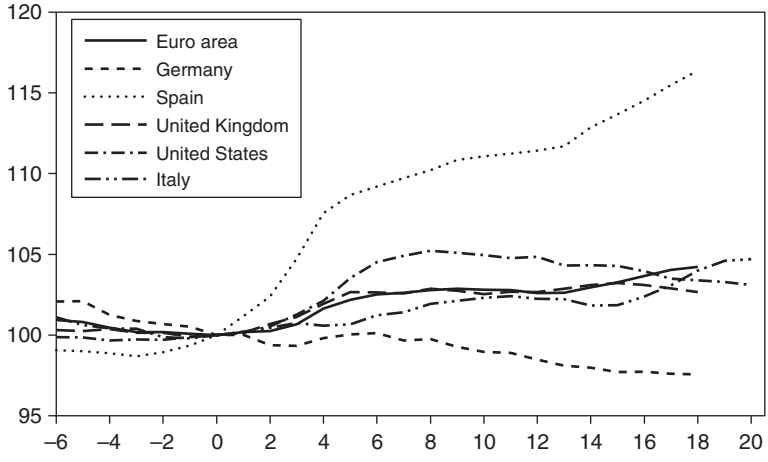
	Germany	Italy[1]	Spain[1]
Fixed-term contracts (FTCs)			
Objective and material reasons for FTC	Yes, with exceptions	Yes, excluding first FTC	Yes
Incentives in favor of open-ended contracts	No	Yes	Yes
Maximum number of successive FTCs	4	2	2
Maximum cumulative duration of successive FTCs	24 months	36 months	24 months
Internal flexibility (vs. national contracts)			
Opt-out clauses	Largely used	Allowed, but little used	Eased for firms in distress[4]
Short-time schemes	Yes	Yes	Yes
Other			
Focus on activation policies	Strong	Little	Some
Unemployment insurance	Linked to activation	Gradual move to universal	Not addressed in the reform
Memo: Labor market outcomes			
Unemployment (%, October 2013)	5.2	12.5	26.7
Temporary employment (% total employment, 2005–10)	12.9	9.7	24.7
Inactivity rate (% of 15–64 year old; 2010)	23.4	37.8	26.6
Public expenditure on ALMP (% GDP, 2005–09)	0.9	0.5	0.8

Sources: Eurostat; International Labor Organization; OECD database; and IMF staff.
[1] Reflects the latest reform proposals, where applicable.
[2] For contracts signed after February 10, 2012; otherwise maximum of 42 months' wages.
[3] No severance pay as such; there is an end-of-employment contract indemnity (TFR), a wage share set aside by employer and paid upon employment termination.
[4] Priority given to the use of firm-level agreements over industry- or region-wide collective agreements.

Case Study 1: Germany

The German labor market has weathered the Great Recession particularly well. Despite a severe recession, labor market conditions remained remarkably stable. From peak to trough, Germany's real GDP fell 6.8 percent—its biggest decline in the post-war period and also larger than the recessions in the United Kingdom, the United States, or even Spain. In contrast to most other EU countries, however, the German unemployment rate remained flat (Figure 5.8), and then fell by end-2012 to its lowest level in 30 years. The low unemployment rate was not the result of lower activity rates either, with the employment share in the population remaining on an upward trend.

Figure 5.8 Unemployment after the Cycle Turned (*Peak quarter real GDP = 100*)

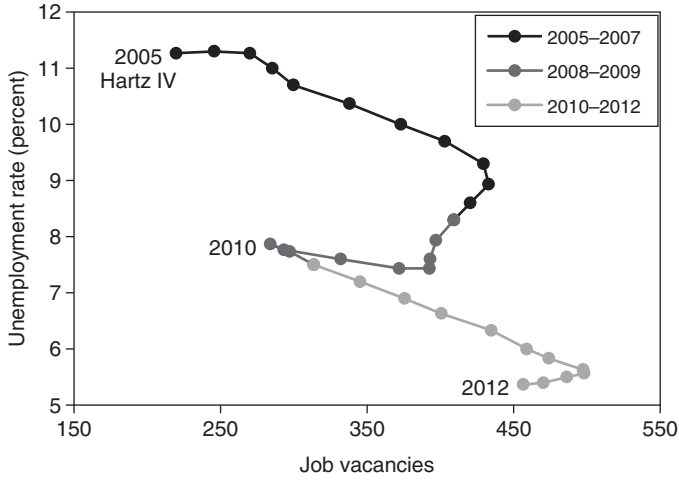


Sources: OECD database; and IMF staff calculations.
Note: For euro area, Germany, Spain and the United Kingdom, 2008:Q1=100; for the United States 2007:Q4 =100; for Italy 2007:Q3 =100.

Most observers agree that the labor market reforms enacted early in the first decade of the 2000s played a major role in limiting job losses during the crisis. The "Agenda 2010" and a series of reforms implemented between 2003 and 2005 (Hartz I–IV) had three main goals: (1) improve the quality of employment services and reorient them from passive income support to activation of the unemployed, (2) increase incentives to take up employment by reducing welfare benefits, and (3) deregulate the labor market (Jacobi and Kluve, 2006). Unemployment benefit duration was reduced further in 2006, and early retirement options were phased out between 2006 and 2010 (OECD, 2012). These actions had three major effects (OECD, 2012):

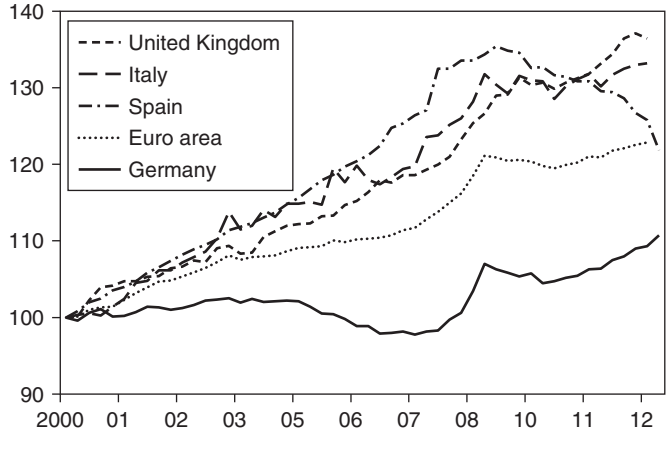
- *Increased labor market efficiency*. Job matching improved as employment offices were reorganized and temporary employment agencies were established. This improvement can be seen by the inward movement of the Beveridge curve after the reforms (Figure 5.9) (Gartner and Klinger, 2010). Moreover, labor inflows from unemployment increasingly became directed to employment instead of inactivity (Fahr and Sunde, 2009).
- *Enhanced firms' flexibility to manage employment through the cycle*. Introduction of working time accounts allowed for greater use of flexible working hours. Rules governing hiring of temporary workers were also loosened.
- *Reduced work disincentives for older workers*. Early retirement options were curtailed, making voluntary dismissal of older employees more difficult. As a result, workers with longer tenure became less likely to enter unemployment, and their employment rates also increased (Dlugosz and others, 2009).

Figure 5.9 Germany: Beveridge Curve



Sources: Deutsche Bundesbank; and Statistisches Bundesamt.

Figure 5.10 Nominal Unit Labor Cost *(Index, 2000:Q1=100)*

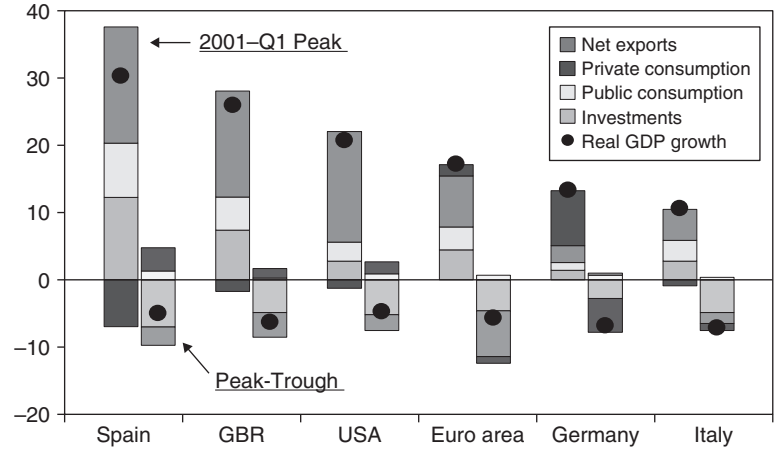


Source: Eurostat.

Wage moderation also played an important role in the good performance of the German labor market (OECD, 2012). Between 2000 and 2008, the nominal ULC in Germany remained essentially flat (and fell 7½ percent in real terms) whereas it swelled by almost 15 percent in the euro area (Figure 5.10). In fact, wage moderation may account for as much as 20 percent of the "missing" decline in employment in Germany during the crisis (Burda and Hunt, 2011). Three factors likely contributed:

- *The Hartz reforms*, via their impact on work incentives and the reservation wage, especially for the low-skilled (Gartner and Klinger, 2010);

Figure 5.11 Germany: Contributions to Real GDP Growth (*Percent*)



Sources: Eurostat; and IMF staff calculations.

- *Declining bargaining power of trade unions*, with union density declining by almost 5½ percentage points between 2000 and 2008, ending up 13 percentage points below the EU average (OECD, 2012); and
- *Competition from Eastern Europe*, with outsourcing of part of the production chain to Eastern Europe supporting productivity—an effect estimated by Hansen (2010) and Marin (2010) to have been as high as 20 percent.[16]

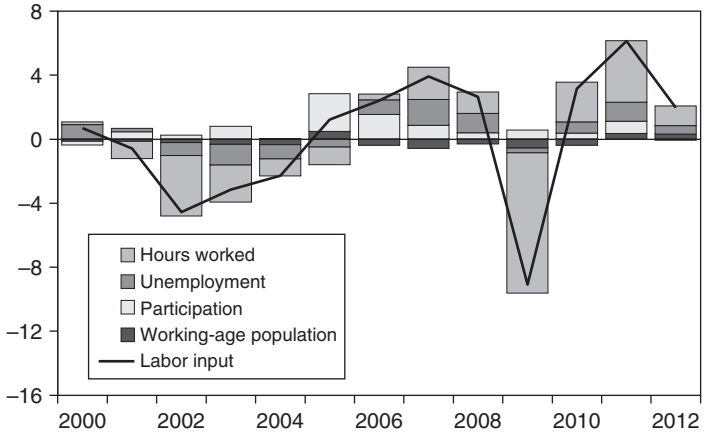
The nature of the recent recession also influenced labor market outcomes. Before the crisis, more than 60 percent of GDP growth in Germany came from net exports (Figure 5.11). Uncertainty about whether the boom would last probably contributed to a low elasticity of employment growth to GDP growth in the manufacturing sector (OECD, 2012). Once the Great Recession started, Germany was hit by collapsing world trade. With the trade shock perceived as temporary, firms had room to retain labor in expectation of the upcoming recovery. Burda and Hunt (2011) estimate that about 40 percent of the missing employment decline during the recession can be explained by lower-than-expected job creation before the crisis.

Working time flexibility is another relevant factor (Figure 5.12). In response to the crisis, German firms significantly cut working hours while keeping employment unchanged. Two factors encouraged working time flexibility:

- *Short-time work programs* (*Kurzarbeit*). Firms could participate in the scheme if they otherwise would have had to cut employment by at least 10 percent

[16]See IMF (2013) for a detailed discussion of the German–Central European supply chain.

Figure 5.12 Germany: Evolution of Labor Input and Its Components *(Percent)*



Sources: Eurostat; and IMF staff calculations.

for economic reasons, and if they had exhausted other measures to cut hours. Workers whose hours were cut at least 10 percent were then eligible for short-time work benefits for the reduced hours equal to the unemployment benefits replacement rate. Participating firms paid the social security contributions on the hours not worked, reducing incentives to abuse the scheme. Boeri and Bruecker (2011) estimate that as many as 435,000 jobs may have been saved by the Kurzarbeit.

- *Working time accounts*. To smooth hours worked over the cycle, employees' hours were recorded on individual accounts, allowing for a buildup of credit during booms that could be drawn down during recessions, reducing the need for paid overtime. By 2005, the share of workers with working time accounts increased to 48 percent, from 33 percent in 1998 (Gross and Schwarz, 2007). Burda and Hunt (2011) estimate that this scheme contributed significantly to employment stability during the crisis.

What lessons does the German labor market experience hold for other countries? The answer is, unfortunately, not a simple one. For example, although short-term work schemes operate in many countries, their replacement rates, duration, and eligibility differ, resulting in significant deadweight costs (Boeri and Bruecker, 2011). Working time accounts resulted in significant employment savings in Germany but may not be as effective in countries with larger shares of small and medium-sized enterprises. Labor market reforms likely reduced long-term unemployment and increased welfare for employed households. Benefit reduction may have, however, contributed to higher income inequality and lower lifetime consumption of the remaining unemployed (Krebs and Scheffel, 2013), though this effect may be difficult to disentangle from the worldwide rise in inequality experienced in recent decades.

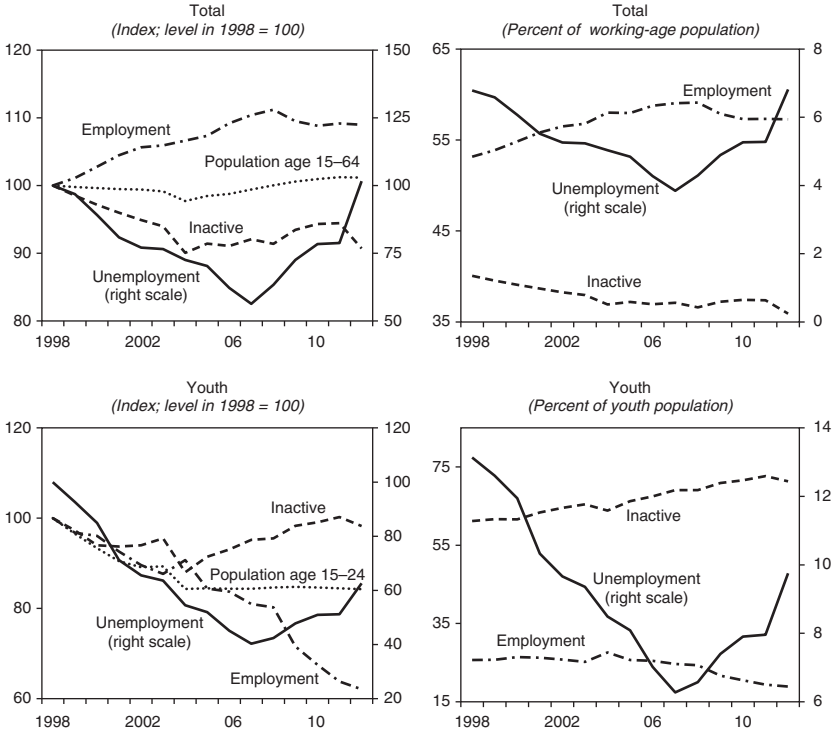
Case Study 2: Italy

The Great Recession hit Italy hard as well. By 2010, real per capita GDP had dropped 10 percent below its 2007 level, no higher than its 1998 level. Employment declined sharply early in the crisis before eventually stabilizing, with the south of the country, and young and temporary workers, particularly affected (Figure 5.13).

The crisis has exposed and exacerbated the structural weaknesses of Italy's labor market—its dualism along various dimensions (age, skill, sector, region, wages, social safety net), high inactivity, and a mismatch between wages and productivity (Figure 5.14).

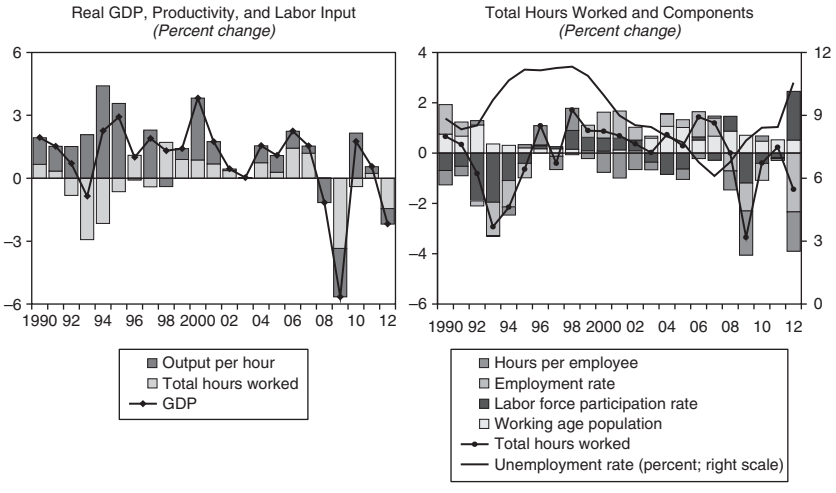
- The labor market is segmented between protected permanent workers and many, especially younger, workers moving from one short-term contract to another, with limited possibilities—and little incentive—to accumulate human capital (productivity loss), to find a better match in the absence of the social safety net (efficiency loss), and to contribute toward future pensions (longer-term sustainability risk).
- Wage setting reflects neither regional productivity differences nor firm-specific factors, and although wage flexibility is allowed, in reality it has meant flexibility only in the upward direction. Derogation clauses from

Figure 5.13 Italy: Labor Market Evolution, 1998–2012



Sources: Istituto nazionale di statistica (Istat); and IMF staff calculations.

Figure 5.14 Italy: Growth, Productivity, and Labor Input, 1990–2012



Sources: Organization for Economic Cooperation and Development; and IMF staff calculations.

national agreements have hardly been applied in practice. Rigidities at the core and high firing costs for permanent workers (especially because of an inefficient judicial system) have further encouraged atypical contracts.[17] Thus, despite overall wage moderation, wage-productivity gaps have persisted, eroding competitiveness.

- The social safety net against unemployment risk is fragmented and uneven. It has inhibited efficient worker mobility and reallocation and, combined with decentralized and limited ALM policies, has failed to promote job matching and training. Italy's large wage supplementation fund (Cassa Integrazione Guadagni) is not designed explicitly for temporary shocks, but it can be used in cases of structural adjustment, potentially delaying needed restructuring or liquidation.
- Female and youth participation rates, especially in the south, are among the lowest in the Organization for Economic Cooperation and Development (OECD), reflecting poor job prospects, tax disincentives, and a large informal economy and home production. The transition probability from unemployed to inactive is higher than in other countries, especially for women and in the south, while inactivity tends to be almost permanent (Boschetto and others, 2011).
- In some regions, heavy reliance on attractive public sector jobs has led to significant distortions in the private sector and in educational choices, contributing to employment rigidities (Alesina, Danninger, and Rostagno, 2001).

[17]The labor cost reduction associated with the expansion of fixed-term contracts amounted to 10.4–22.4 percent in 1995–2003 (Cipollone and Guelfi, 2006).

What led to such profound weaknesses in Italy's labor market, and what role have past reforms, shocks, and other factors played in this process?

The 1997 Treu reform and the 2003 Biagi reform aimed to promote and deregulate temporary and atypical contracts, encourage fixed-term employment, and provide incentives for part-time work. Other important measures included the effective opening toward fixed-term contracts in 2001 and the introduction of generous tax incentives for hiring workers at least 25 years old with open-ended contracts. Despite earlier reform attempts, rigidities persisted, and employment protection for permanent workers remained high. The reforms focused "on the margin," primarily affecting youth. The proliferation of temporary contracts with no social protection also made the social safety net increasingly unequal.[18]

The Treu reform had a positive impact on participation and employment rates, but increased gender, regional, and skill dualism. Total labor input increased sharply in 1998, and was followed by an increase in employment that was partly offset by a drop in hours worked per employee. The unemployment rate declined by 2¾ percentage points between 1997 and 2002 in both the north and the south, but still stood at 16½ percent in the south in 2002 (as compared with 4.2 percent in the north). Empirical evidence shows that the Treu reform improved matching efficiency in the north, particularly for skilled workers, but had the opposite effect for unskilled workers in the south. Competition between skilled and unskilled workers increased, especially in the south (Destefanis and Fonseca, 2006).

Responding to global shocks (see the section titled "Policy Responses and Labor Market Outcomes"), the Biagi reform was more comprehensive, but the only measures adopted related to flexibility in labor market entry. Proposed reforms of unemployment benefits, decentralized bargaining, and labor tax reduction failed largely as a result of union opposition, and industrial relations deteriorated. The Biagi reform further entrenched dualism, youth employment stagnated or fell, and the share of temporary workers among youth increased from less than 20 percent in 1997 to almost 50 percent in 2011.

The global financial crisis struck Italy just when industrial restructuring was beginning to bear fruit, involving nearly half the firms in industry and nonfinancial services. The economy had returned to growth in 2004–07, with negative total factor productivity growth reversed, and in 2007 the unemployment rate declined to 6.1 percent—its lowest level since 1981. In response to the crisis, firms cut back on labor input, turned to more flexible work arrangements, and resorted to the wage supplementation fund, which was extended to cover previously ineligible fixed-term and atypical contracts; tax incentives for hiring youth and women were also introduced.

The crisis induced wide-ranging labor market reforms. The Fornero reform aimed to create a more inclusive labor market, by undoing some of the previous reform measures, which had led to increased flexibility at the margin ("bad flexibility") and dualism. The reform covered unemployment insurance and protection of permanent workers, but did not address flexibility at the core, female

[18]See, for example, Schindler (2009) for a review of pre-2008 labor market reforms in Italy.

participation, or public sector employment. Some reversal in inactivity from its past trend has occurred, but is still too early to assess the overall impact of the reform, the near-term benefits of which for growth and employment are likely to be modest if not negative (Lusinyan and Muir, 2013).

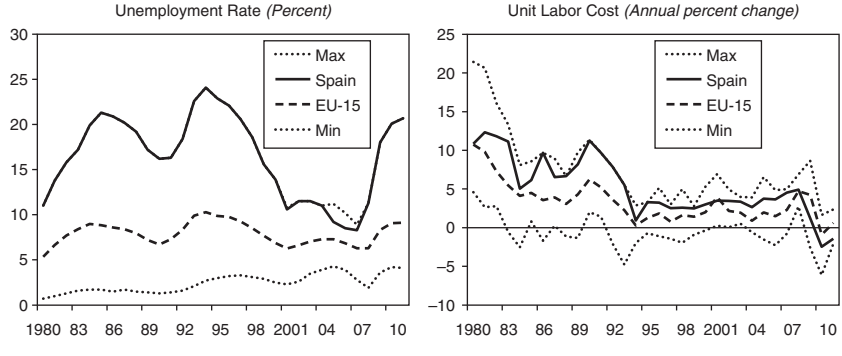
There is clearly room for additional structural efforts, in particular to further reduce dualism; increase labor market participation, especially for youth and women; and better match wages and productivity through a more flexible, open-ended contract for new hires that gradually increases employment protection with tenure. This type of contract would also facilitate the employment of young workers. To help increase female participation, the effective marginal tax rates for married second earners would need to be reduced. The agreements among social partners to allow derogation from national contracts should be made more operational. And greater differentiation of public wages across regions would support private wage flexibility and employment, especially in the south.

Case Study 3: Spain

Spain has had the highest unemployment rate among the EU-15 countries for most of the past 30 years. Following a sharp decline between 1994 and 2007, unemployment rose to more than 20 percent after the crisis hit, more than double the EU-15 average. Wages in Spain also rose faster than the EU-15 average and exceeded productivity growth during most of the past 30 years, leading to widening ULC differentials with the EU-15. Since the crisis, this differential has moderated (Figure 5.15) as the result of strong productivity growth as labor was shed, not because of lower wages.

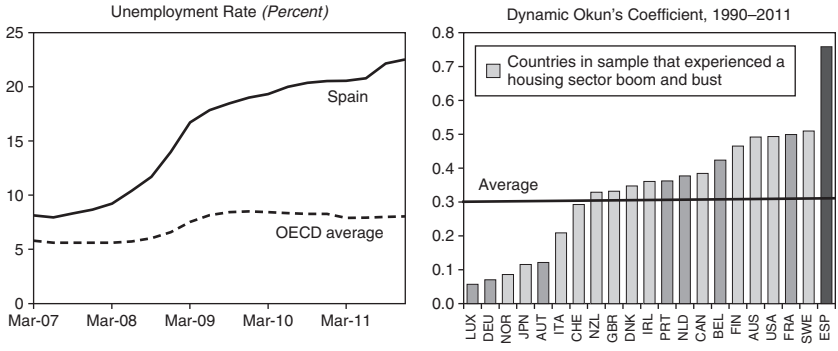
Institutions play a large role in Spain's labor market performance. Spain's unemployment has not only been among the highest, is has also been the most countercyclical and volatile in the OECD. Its dynamic Okun's coefficient is the largest in the OECD, standing at more than twice the OECD average during 1990–2011 (Figure 5.16). These differences are only partly explained by the

Figure 5.15 Spain: Unemployment Rate and Unit Labor Cost



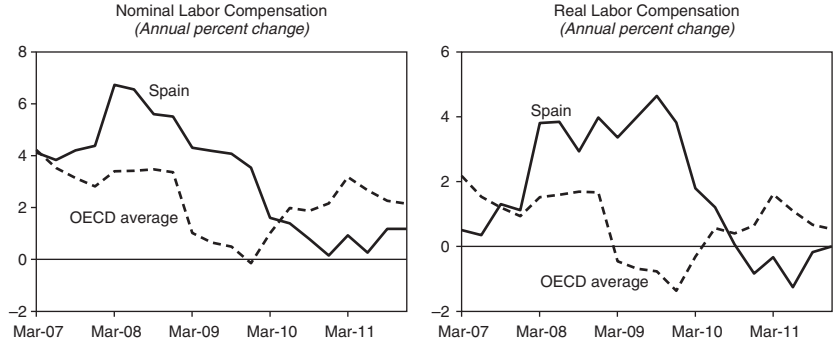
Source: Organization for Economic Cooperation and Development.

Figure 5.16 Spain: Unemployment Rate and Okun's Coefficient



Sources: Organization for Economic Cooperation and Development; Eurostat; and IMF staff calculations.

Figure 5.17 Spain: Labor Compensation



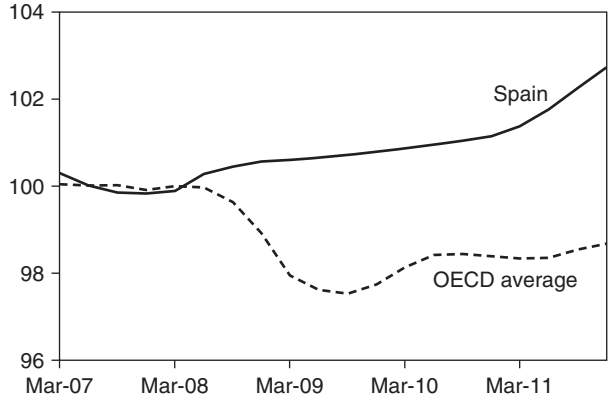
Source: Organization for Economic Cooperation and Development.

boom and bust of the Spanish housing sector during first decade of the 2000s—most economies in the sample experienced at least one similar event. Rather, the volatility of unemployment in Spain seems to be in large part due to wage rigidity, insufficient flexibility of working conditions, and high labor market dualism.

- *Wage rigidity* contributed to the increase in unemployment in Spain during 2008–09. Wages reacted little to unemployment and were more correlated to past inflation than in other OECD economies, reflecting widespread wage indexation. Spain's nominal labor compensation rose by 6 and 4 percentage points in 2008 and 2009, respectively (4 percentage points in real terms in both years), contrasting with the wage moderation seen in the rest of the OECD (Figure 5.17). Wages have moderated since 2010 because of agreements among the social partners, but the decline in real labor compensation since 2010 has not been enough to offset the cumulative differential created during 2008–09.

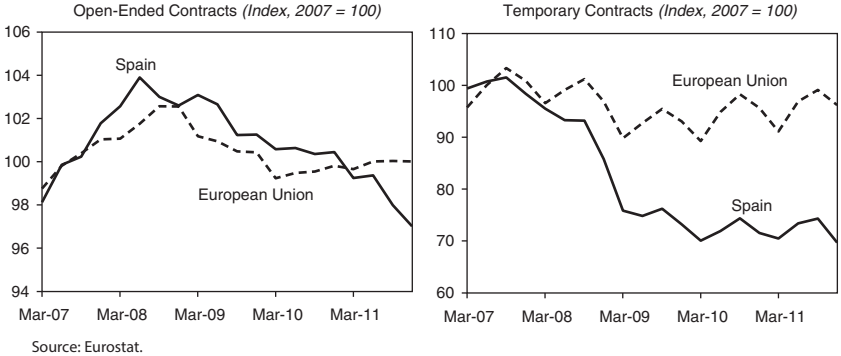
- Spain's *inflexible working time* also contributed to the rise in unemployment. Industry- or region-wide collective agreements restrict the ability of firms to modify working conditions (e.g., hours worked) to adjust to shocks. Hours worked per employee increased since mid-2008, contrasting with the fall in the OECD (Figure 5.18). This difference during 2008–09 seems to be the result of inflexible working time in Spain's collective agreements, but the difference in 2010–11 may also reflect higher uncertainty and larger dismissal costs.
- Spain's labor market is marked by a *high degree of dualism*; the country has the largest share of workers on temporary contracts in the OECD. Spanish firms adjusted to the crisis by dismissing temporary workers (Figure 5.19) instead of reducing wages or working time, largely accounting for Spain's much larger employment decline than the EU average (under similar declines in GDP).

Figure 5.18 Spain: Hours Worked per Employee *(Index, 2007 = 100)*



Source: Organization for Economic Cooperation and Development.

Figure 5.19 Spain: Employees on Open-Ended and Temporary Contracts



Source: Eurostat.

- At the same time, Spain's *dismissal costs in open-ended contracts* range between 33 and 45 days per year worked (with a maximum of 42 months) for unfair dismissals,[19] compared with an EU-15 average of 21 days per year worked (with a maximum of 24 months). Dismissal costs under temporary contracts, however, are much lower in Spain, at nine days per year worked. This large gap is responsible for the use of a large share of temporary workers as an insurance mechanism against adverse shocks.

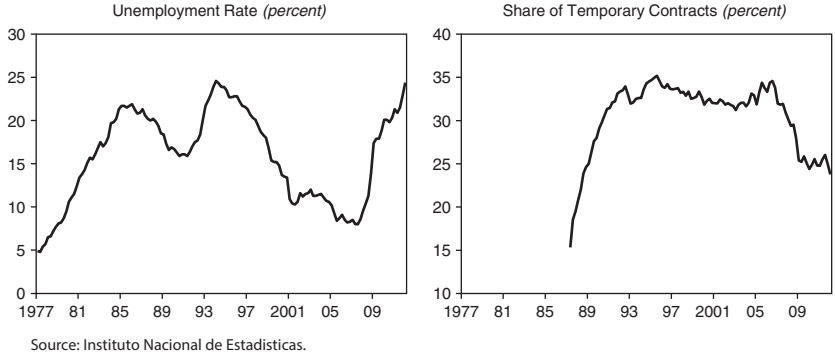
Several reforms were introduced in the 1990s and 2000s to reduce labor market dualism. Enacted when unemployment was low or declining, these reforms promoted hiring with open-ended contracts and more stringent regulation on temporary contracts (Figure 5.20). Dualism, however, was not reduced because severance payments for open-ended contracts were lowered only marginally.

Two additional reforms in 2010 and 2011 attempted to foster job creation (reduce job destruction) by cutting dismissal costs for permanent contracts, by easing opt-out from collective agreements, and by giving firms more flexibility to set working time. Once again, however, these reforms made only marginal changes to the existing legislation, and left open the possibility of allowing sectoral agreements to supersede firm-level agreements if social partners agreed to do so.

The reform introduced in 2012 promises a significant improvement in the functioning of the labor market by reducing dualism, wage rigidity, and firms' internal inflexibility:

- Dualism is reduced by lowering the costs of unfair dismissals for permanent workers, easing and clarifying the use of fair dismissals for firms in distress, reducing procedural costs, and eliminating the need for prior administrative approval. The goal is to make fair dismissals the regular channel for dismissing workers with permanent contracts in distressed firms.

Figure 5.20 Spain: Unemployment Rate and Share of Temporary Contracts



Source: Instituto Nacional de Estadisticas.

[19]Dismissals are deemed unfair when the labor authorities consider that the employers' decision of terminating the employment contracts is not due to objective economic, technical, organizational or production reasons (collective dismissals), or to a serious contractual breach (individual dismissals). Dismissals are deemed fair in the opposite case.

- Wage rigidity and firms' internal inflexibility are reduced by giving priority to firm-level agreements over wider collective agreements. The reform also allows distressed firms to change working conditions, temporarily suspend contracts, and reduce working time. In addition, it limits the automatic extension of expired collective agreements to one year.

The reform's success hinges on implementation; the effectiveness of past reforms was compromised, in part, by restrictive interpretation by the courts. The reform could also be strengthened by harmonizing protection for open-ended and temporary contracts and by eliminating indexation and automatic extension of expired collective agreements (ultra activity). In the absence of sufficiently rapid progress, policymakers should prepare contingency plans, for example, by moving to an opt-in system for collective bargaining.

CONCLUSION

Employment and growth are high on the policy agenda in Europe, and rightly so. High unemployment rates hinder growth and undermine political consensus for reforms. Unemployment among youth is especially difficult to accept and constrains potential growth. The dismal state of European labor markets is not just the product of an unprecedented crisis. This chapter argues that the current crisis response stems from an inadequate policy response in several countries in Western Europe (especially in the periphery) to shocks before the global financial crisis.

These shocks changed the relative demand for skilled and unskilled labor and required new flexibility. Some countries responded to the challenges: for example, the United Kingdom, the Netherlands, and Germany implemented important and comprehensive reforms that improved labor market performance and mitigated the economic and social costs of the crisis. Other countries, especially in the periphery, implemented partial and incomplete reforms, likely constrained by political realities and by the power of insiders. Partly masked by high precrisis growth, the internal policy contradictions exploded with a dramatic increase in unemployment, especially in youth unemployment, when the crisis hit.

Key lessons from these experiences are that partial or incomplete reforms may be counterproductive and lead to negative outcomes, and that the benefits of comprehensive labor market reform extend to periods of crisis—in fact, a well-functioning labor market that facilitates adjustment is particularly helpful during crisis periods. But an effective structural reform strategy must go beyond labor markets: efficiently operating product markets and strong legal frameworks and fiscal institutions are key ingredients to improving a country's economic performance, including during crises. Chapters 7 and 8 address such broader structural reform packages from various angles.

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