IMF STAFF DISCUSSION NOTE

June 18, 2012
SDN/12/07

Fostering Growth in Europe Now

Bergljot Barkbu, Jesmin Rahman, Rodrigo Valdés, and a staff team

INTERNATIONAL MONETARY FUND

INTERNATIONAL MONETARY FUND

European Department

Fostering Growth in Europe Now

Prepared by Bergljot Barkbu, Jesmin Rahman, Rodrigo Valdés, and a staff team[1]

Authorized for distribution by Reza Moghadam

June 18, 2012

DISCLAIMER: This Staff Discussion Note represents the views of the authors and does not necessarily represent IMF views or IMF policy. The views expressed herein should be attributed to the authors and not to the IMF, its Executive Board, or its management. Staff Discussion Notes are published to elicit comments and to further debate.

JEL Classification Numbers:	O4,E6, F3, F4, F5
Keywords:	Growth, unemployment, macroeconomic policy, structural reform, fiscal policy, real effective exchange rates, euro area
Author's E-mail Address:	bbarkbu@imf.org; jrahman@imf.org; rvaldes@imf.org

[1]The staff team consisted of Derek Anderson, Bas Bakker, Helge Berger, Davide Furceri, Benjamin Hunt, Florence Jaumotte, Prakash Loungani, Ruud de Mooij, Esther Pérez Ruiz, Mika Saito, Antonio Spilimbergo, Yan Sun, Andrew Tiffin, Edouard Vidon, and desk economists for euro area countries in the European Department.

Contents Page

Executive Summary 3

I. Motivation and Context 5
II. Lifting Growth—A 20,000-Foot View 8
III. What Can be Realistically Expected from Structural Reforms?..........................9
IV. Why Do Structural Reforms Need Other Supportive Policies?.........................17
V. What Should be Done Concretely?...20
VI. Final Remarks 26
Reference 27

Tables
1. Selected Recent Studies on Labor and Product Market Reforms 11
2. Main Progress in Structural Reforms in Southern European Countries since 2010 21

Figures
1. Growth Divergences 5
2. Total Factor Productivity and Potential Growth..6
3. Euro Area Countries: Real Effective Exchange Rate and External Imbalances..................6
4. Real GDP and Unemployment Rates...7
5. Headwinds from Fiscal Consolidation and Unwinding the Credit Boom 7
6. Impact of Regulatory Reform on Efficiency, 2000–07 10
7. Short- and Long-Run Impact of Reforms in Euro Area Countries on the Level of GDP..15
8. Impact of Reforms and Fiscal Stimulus on the Level of GDP in Euro Area Countries 16
9. Change in Unemployment and Labor Market Flexibility....................................18
10. Priorities for Structural Reforms in Country-Specific Recommendations 20
11. Inflation Differentials and Possible Output Gain...25
12. Links to Global Supply Chain...25

Boxes
1. Tales from Successful Structural Reforms in Europe...12
2. Short- and Long-Run Effects of Structural Reforms 14
3. Internal and Fiscal Devaluation 19

Annexes
I. Key Gaps in Structural Policies—Cross-Country Comparisons 30
II. Euro Area: Country-Specific Structural Reform Recommendation 34

Executive Summary

Unprecedented actions have been taken by European countries and institutions to deal with severe economic and financial stresses plaguing the region. At the country level, this has included steps to rein in fiscal deficits and the recapitalization of weak banks. At the pan-European level, risks and contagion have been contained by the progressive strengthening of the firewall, comprehensive ECB liquidity support, and a new fiscal compact.

Yet the rise in unemployment and recession indicators has undermined stability and policy effectiveness. Without a clear path for recovery of employment and growth, which was tepid even before the crisis, it is hard to see fiscal revenues recovering, debt ratios declining, the weakened financial sector regaining its health, and social support for adjustment taking hold. In short, a revival of growth seems key to reversing the vicious cycle of poor confidence, flagging growth, fiscal weakness, and bank vulnerability.

Policy measures on both the supply and demand sides are needed, the former to anchor the medium-term growth prospects, the latter to support growth in the interim. These should be put in place quickly, not least because the public and markets have become accustomed to years of debate over structural reforms. Reforms also must be granular, targeting, in Southern Europe, labor market duality and the reduced competitiveness of the tradable sector, including relative price misalignments; and in Northern Europe, higher labor participation and a more vibrant services sector.

There is substantial empirical evidence that structural reforms can lift growth markedly in the medium to long term. Staff simulations show that large-scale labor, product market, and pension reforms, which cut the distance of euro area countries to growth-maximizing benchmarks in half, could boost output by 4½ percent over the next five years. A pan-European approach is important: a quarter of this additional growth is expected to derive from positive cross-country and cross-reform spillovers. But one must be realistic that the near-term impact on growth, as opposed to the effect on overall confidence, will likely be modest.

However, the current economic slack and cyclical headwinds argue for a more supportive approach. It is important that this point not be dismissed as yet another call for stimulus. Rather, it is consistent with fiscal consolidation proceeding rapidly where market pressures are severe, and gradually elsewhere, allowing automatic stabilizers to work, and for the composition of adjustment to be as growth-friendly as possible. While the fiscal compact is therefore an essential pillar of the growth strategy, consideration should be given to substituting the current pro-cyclical nominal targets with structural balance objectives. Monetary policy should also remain supportive.

There is a further and crucial point about demand—namely that it is very uneven across Europe. Demand is still growing in the North but is collapsing in the South, which most needs it to facilitate fiscal consolidation and reduce record high unemployment. To

channel more external demand to the South (from both within and outside the euro area) and thereby alleviate the pressure on the weakest links in the euro zone, relative prices in Southern Europe need to fall vis-a-vis the North. Reversing the competitiveness gap since the adoption of the euro will entail higher inflation in the North than in the South. Relatively speaking, the South needs nominal wage restraint, and the North to let wages rise in line with productivity and market developments (though not beyond, in order to preserve the competitiveness of the euro area as a whole).

Restoring the health of the financial system is also critical to buttressing demand. The region's economies rely heavily on bank credit. Bank and corporate restructuring, including through FDI, should be actively encouraged. Bank recapitalization should be promoted, with public back-stops where needed. Capital injection from centralized resource pools involving due control over the recapitalized institutions would help prevent adding to the strains on public finances where debt ratios are already on elevated trajectories. Over time banks receiving centralized support should be overseen by a pan-European regulation and supervision system, bridging to the long-run euro area architecture.

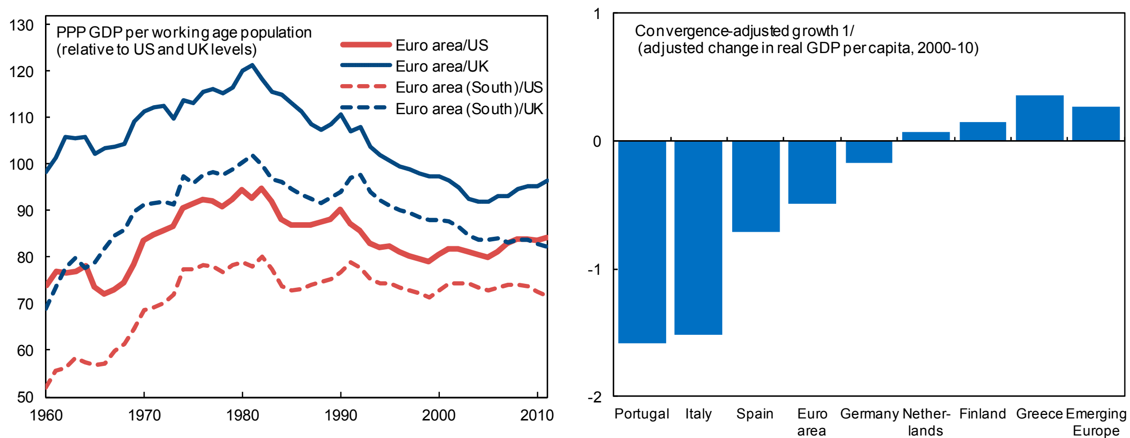
More active policies at the central level would complement these efforts. The union would benefit from increasing its common pools of resources. Efforts should aim for stronger links between tradable sectors in Southern countries and global export networks. Reallocating existing funds to favor improved functioning of markets, e.g., labor market policies, would yield significant short-term gains in employment.

I. MOTIVATION AND CONTEXT[2]

Fostering growth is always important; in the euro area it has become urgent. During the last three decades, euro area growth has fallen behind peers, although it has had impressive achievements in terms of inclusiveness. More recently, renewed weakness after a sluggish recovery from the Great Recession has pressured already deteriorated fiscal positions and public debt dynamics, and increased unemployment, particularly in the Southern euro area countries. These unwelcome developments have increased financial system fragility and exacerbated economic divergence within the euro area, threatening the stability of the monetary union. Unprecedented policies from both European institutions and country authorities have avoided catastrophe. But attaining higher and more sustainable growth, while containing risks along the path to recovery, is central for a durable solution to the stress observed in the last few years.

From a long-term perspective, euro area growth has fallen behind its best performing peers (Figure 1). From 1960, euro area GDP per person of working age increased rapidly toward the United States' level and overtook the United Kingdom. However, starting in the early 1980s, this and other GDP measures have lost ground relative to both the United States and the United Kingdom. Within the euro area, there has been substantial heterogeneity as the convergence of Southern euro area countries (Greece, Italy, Portugal, and Spain) to the richer Northern euro area countries has stagnated. While Eastern Europe grew relatively fast, almost all Southern euro area countries have expanded in the last decade much less than what expected convergence—convergence explained by initial income differences—would predict.

Figure 1. Growth Divergences



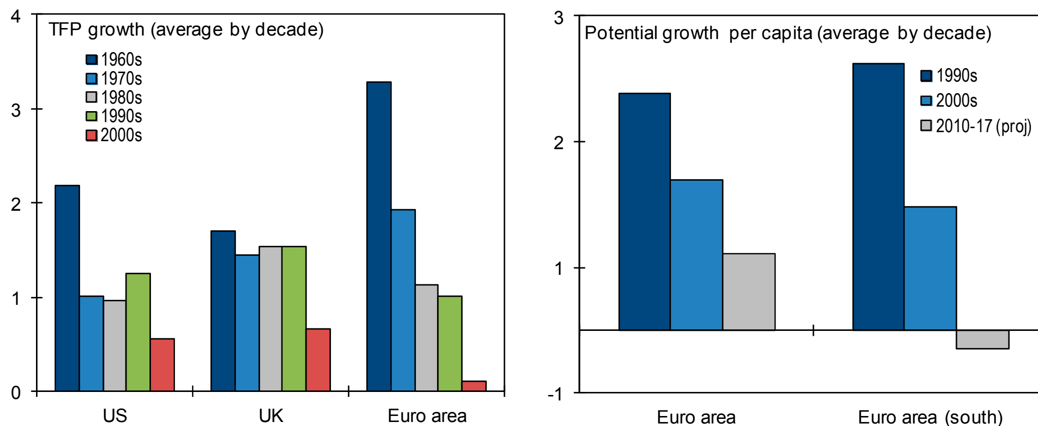
Sources: April 2012 WEO; October 2011 Europe REO; and OECD.

1/The adjusted growth measures the difference between each country's actual growth rate and the growth rate that could be expected given initial income levels.

[2]The theme of growth in Europe is by no means new. See for example, Allard et al., 2010, the World Bank, 2012 and OECD, 2012, for a discussion of policy priorities in Europe.

Slower productivity growth explains the decline in euro area potential GDP growth, while lower labor utilization is behind the lower GDP level with respect to peers. The sharp decline in total factor productivity growth in the euro area (Figure 2) had the largest contribution to the trend growth decline observed in the last three decades. While potential growth rates have come down significantly, the slowdown is more pronounced in the Southern euro area countries. But productivity is not the entire story: Mourre (2009) shows that lower labor utilization explains two-thirds of the differential in the GDP per capita level between the euro area and the United States in 2006.

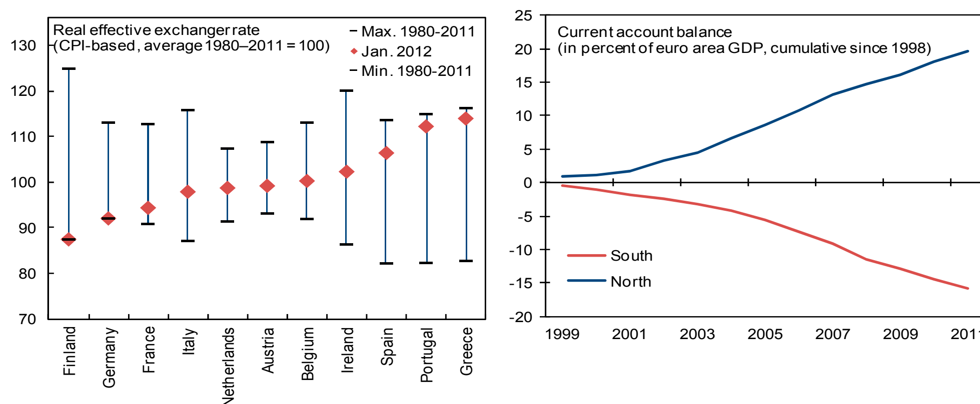
Figure 2. Total Factor Productivity and Potential Growth



Source: April 2012 WEO, European Commission.

During the last decade, dissimilar patterns of growth across countries and increasing competitiveness differentials exacerbated each other. Exports drove growth in Northern euro area countries, while Southern countries relied on domestic demand with a large share of the employment created in the cyclical and credit-dependent non-tradable sectors, e.g. real estate. Much of the foreign capital that flew into the Southern euro area during the last decade was in the form of debt while the tradable sector limped, creating brittle fundamentals for growth and resource generation for servicing this debt. Relative prices, including nominal unit labor costs, diverged rendering Southern euro area countries uncompetitive (Figure 3).

Figure 3. Euro Area Countries : Real Effective Exchange Rate and External Imbalances



Sources: April 2012 WEO, IFS, and staff estimates.

Cyclical developments since the Great Recession also suggest that Europe has a disadvantage with respect to peers and suffers considerable heterogeneity (Figure 4). Output recovery has been much slower in the euro area than in the United States. Also, euro area countries are experiencing persistent and higher unemployment than the United States and the United Kingdom. The Southern euro area is expected to contract further and recover modestly next year, implying weak prospects for reversing the sharp increase in unemployment, particularly youth unemployment. The region has to go through considerable balance sheet repair, with its negative short-run implications on activity. Bank deleveraging, which is a necessary unwinding of the pre-crisis credit boom, higher private sector savings, and unavoidable fiscal consolidation will remain powerful headwinds, particularly for the South (Figure 5). Euro area countries are projected to improve their cyclically-adjusted fiscal balance by 1½ percent in 2012 (excluding Southern Europe, ¾ percent). Recent estimates also show that fiscal multipliers are higher during times of downturn than in normal times, implying a higher negative impact from the planned consolidation on output, domestic absorption, and employment in the North (IMF, 2012b).

Figure 4. Real GDP and Unemployment Rates

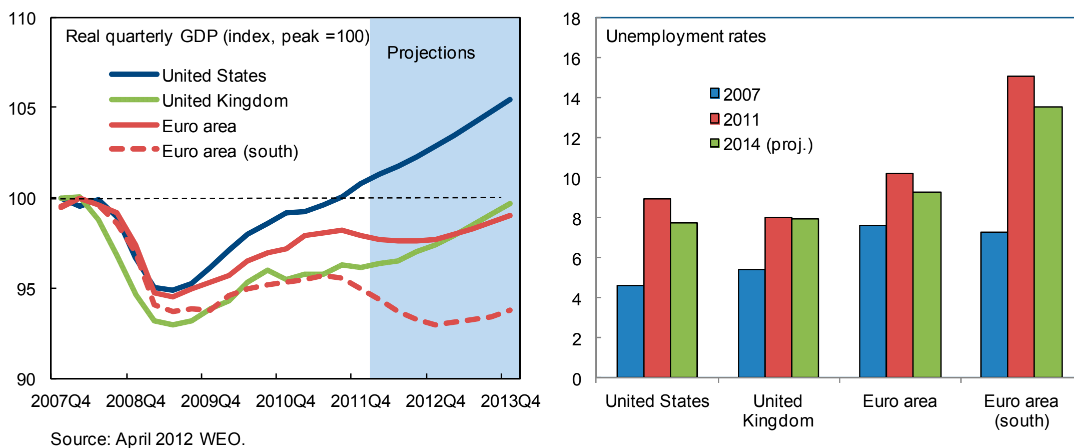
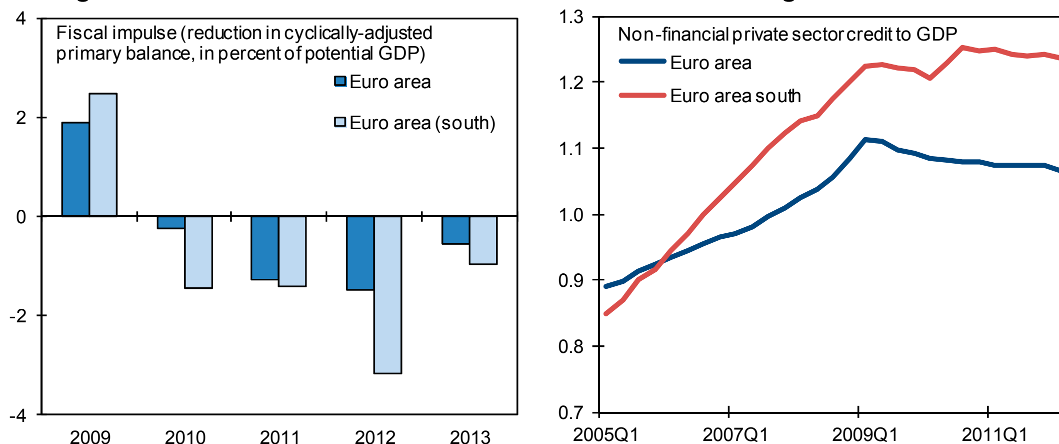


Figure 5. Headwinds from Fiscal Consolidation and Unwinding the Credit Boom



Sources: April 2012 WEO, and ECB.

Growth is crucial for stability. Persistent stagnation in the periphery can lead to private sector bankruptcies and even higher unemployment, which would compound the difficulty of fostering confidence in governments as well as the private sector. Consolidation could become ever more elusive, with mounting social unrest, growth spiraling downward, and ever higher debt ratios.

II. Lifting Growth – A 20,000-Foot View

Against a background of low trend growth, relative price misalignment in several countries, and cyclical headwinds, the euro area needs a multipronged approach. Any sensible strategy has to acknowledge that part of the current subpar performance is unavoidable as it represents the needed correction of past excess in some countries. It also needs to recognize that increasing growth is a daunting task, with payoff that sometimes accrues only slowly. But the region should be able to soften the cycle and improve prospects considerably if a comprehensive approach is taken.

The region needs to boost potential output, which would also deliver short-run benefits. Structural reforms are critical to improve the capacity of the economy to grow over time through both a more intensive use of resources and higher productivity. Moreover, they should be implemented without delay because they take time to deliver their full potential, and a simultaneous push should be encouraged to benefit from potentially large positive cross-country spillovers. In addition, through confidence and wealth effects and by facilitating relative price adjustments, structural reforms can also promote aggregate demand in the short run, particularly investment, if they are perceived as part of a coherent policy strategy.

However, structural reforms alone may not deliver a sufficient boost to short-run activity in the current environment of high unemployment, large output gaps, and cyclical headwinds. While there is substantial evidence of their long-run benefits, the immediate gains from reforms, discussed in the next section, are not fully understood and are unlikely to be very large. A distinct threat is that, in an environment of weak aggregate demand, supply-side measures and restructuring fail to boost output, leaving part of Europe in a period of protracted stagnation. Because insufficient demand in the periphery has the potential of being overly disinflationary, this could complicate monetary policy management. Moreover, low growth and high unemployment may hamper the credibility of fiscal consolidation, which needs to be sustained during several years requiring political support.

Therefore, it is also critical to foster aggregate demand, taking into account country-specific needs and constraints. As in other cases where a domestic demand-driven growth cycle came to an end, net exports will be critical for lifting lagging countries (Southern Europe), but this depends on a significant improvement in competitiveness, including changes in relative prices, and reallocation of resources to emerging industries in tradable good sectors. In parallel, Northern countries need to strengthen their domestic demand, ideally with the private sector taking the lead. Macroeconomic policies to soften headwinds

from the needed fiscal consolidation and ongoing balance sheet repair are critical. The financial system should be put in shape to support growth of emerging sectors.

Policies should leverage Europe's many strengths and build on recent progress at the euro area level. The European Union is the largest common market, the euro is a strong reserve currency, the euro area does not have imbalances vis-à-vis the rest of the world, and while, some countries are facing acute fiscal challenges, the aggregate fiscal situation, in terms of both deficits and debt, is stronger than in many other economies. Recent actions to tackle risks at the euro area level—through the fiscal compact, a strengthened euro area firewall, comprehensive ECB liquidity support, and strong policy actions in individual countries— have helped reduce risks and move toward a more supportive pan-European policies and institutions. However, more is needed to get firmly ahead of the crisis and lift confidence.

A comprehensive approach should also include policies to address vulnerabilities and be consistent with a clearer path to the shared-view of the euro area's long run architecture. Tail-risks that dent confidence and thereby jeopardize growth should be promptly addressed, ideally at the central level. This includes, but is not restricted to addressing financial sector weaknesses. Similarly, strengthening common resource pools, in parallel with implementation of the fiscal compact, would signal progress toward more fiscal integration.

III. What Can Be Realistically Expected from Structural Reforms?

Recent studies

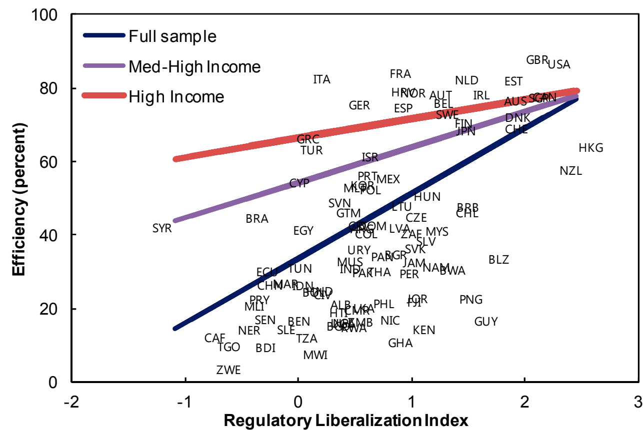
Structural reforms can lift growth considerably, particularly in the medium and long run. Most empirical studies find a positive long-term effect of labor and product market reforms on total factor productivity, growth, and employment (Table 1). In some analyses, comprehensive and ambitious reforms in product and labor markets would boost GDP levels by more than 10 percent in most euro area countries over a decade (OECD, 2012; Goldman Sachs, 2012).

Improving institutions can yield positive results in the labor market. Empirical studies find that collective bargaining, unemployment benefits, and employment protection explain a large part of the cross-country differences in labor market performance, particularly when interacted with macroeconomic shocks (Blanchard and Wolfers, 2000; Fitoussi et al, 2000; and Mourre, 2006). However, studies do not agree on the role of specific institutions, and the evidence is sometimes contradictory for some indicators. This is largely because labor market institutions interact with one another, and with the macroeconomic environment, making a one-size-fits-all reform recipe unsuitable. Studies on Europe find that high employment protection, longer and more generous unemployment benefits, high tax wedges, and collective bargaining systems that are more favorable to wages than employment affect employment and productivity negatively (Nickel et al., 2005; Bassanini and Duval, 2006; Annett, 2007; Fialová and Schneider, 2008; and Jaumotte, 2011).

Product market reforms can boost growth, but country-specific factors matter. There is considerable evidence that excessive product market regulation contributes to higher mark-ups and lower output, investment, and employment (Table 1). In particular, the effect of product market deregulation on productivity growth is larger in more advanced countries, especially in those with better governance. The issue of complementarity between labor and product market reforms is still debated. Some studies find that product market deregulation is more effective when labor market regulation is high (Fiori et al., 2012), others find it more effective when labor market regulation is low (Berger and Danniger, 2007). However, many studies find important synergies in implementation of product and labor market reforms.

Less-burdensome regulations are associated with not only more use of labor and capital but also greater economic efficiency. Recent empirical work by IMF staff (Tiffin, 2012) shows that a high degree of liberalization in product, labor, and credit markets boosts a country's efficiency—the difference between the total factor productivity and a time-varying frontier for all countries (Figure 6). This effect is particularly pronounced for low- and middle-income countries, where catch-up gains are more readily available, but are significant for high-income countries as well. For example, a one standard-deviation improvement in the reform index is associated with a 9½ percentage point increase in efficiency in a middle-income country and a 5 percentage point increase in a high-income country. The Swedish experience stands out as an illuminating example in this regard (Box 1).

Figure 6. Impact of Regulatory Reform on Efficiency, 2000-07



Source: Tiffin (2012).

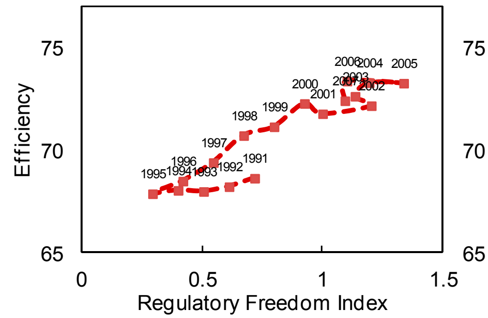
Table 1: Selected Recent Studies on Labor and Product Market Reforms

Study	Sample	Finding
Everaert and Schule, 2006	EU countries	Product and labor market reforms have sizeable steady state effects, well above 10 percentage points of GDP for some countries, depending on pre-reform rigidities.
Annett, 2007	14 EU countries, 1980-2003	Higher tax wedge and benefits affect labor supply negatively. Benefits of wage moderation are higher in countries with more liberal product and labor market regulations.
Berger and Danninger, 2007	OECD, 1990-2004	Comprehensive and large-scale labor and product market reforms can lead to additional employment growth of 1-1.3 percentage points annually.
Bassanini and Venn, 2008	OECD, 1982-2003	Strict employment protection depresses productivity growth in industries where this is binding.
Ostry, Prati, and Spilimbergo, 2009	91 developed and emerging countries,	Structural reforms boost income growth, but growth effects depend on reform sequencing.
Allard et al, 2010	G20, Europe	Labor and service market reforms to fill half the gap with the three best EU performers could yield ½ percentage points of additional annual growth over the next 5 years, based on IMF and EC studies.
Gomes et al, 2011	Euro area	Benefits from implementing reforms are large and cross-country coordination adds extra benefits by limiting the deterioration in relative prices that occur if reforms are implemented unilaterally.
Goldman Sachs, 2012	183 countries, euro area	Product market reforms could boost potential growth substantially, by up to 1.7 percent annually in euro area periphery countries.
Pérez and Yao, 2012	20 OECD countries, 1985-2008	A policy package combining services deregulation, a reduction in tax wedges, and replacement rates could reduce unemployment rates by ¾ -5½ percentage points, depending on a country's initial conditions.
OECD, 2012 (Bouis and Duval, 2011)	OECD, euro area	A comprehensive country-specific reform package could yield an overall gain in potential GDP of more than 10 percent of GDP for most euro area countries over a 10-year period.
The World Bank, 2012	OECD, EU members, and accession countries	Strict employment protection, high labor tax, and minimum wages are associated with lower participation and higher unemployment rates.

Box 1: Tales from Successful Structural Reforms in Europe

The Netherlands in the 1980s and Sweden in the 1990s are examples of how reforms can turn poor economic performance around. Before the reforms, both countries had experienced a prolonged period of subpar performance. When the malaise was further exacerbated by a deep recession (Netherlands, 1980–82) or a banking crisis (Sweden, 1990–92), policies shifted course, and over a decade, extensive macro-economic policy and supply side reforms were implemented. The public expenditure-to-GDP ratio was lowered significantly, allowing a reduction of both the high fiscal deficit and high tax levels; labor markets were made more flexible with increased incentives to work; and product markets were reformed to boost competition. Sweden has experienced two decades of rapid growth; and the Netherlands, which previously was associated with the "Dutch disease," became known for its employment miracle.

Sweden, 1991-2007

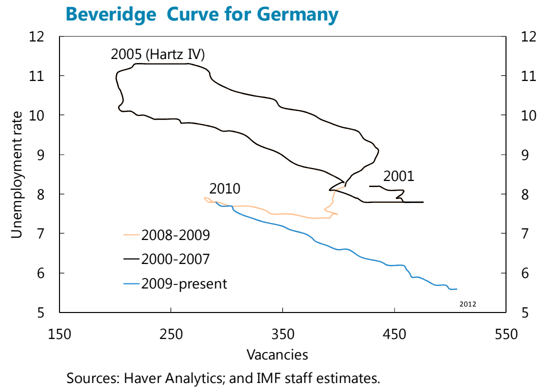


What then are the lessons of these experiences for other countries? First, what needs to be reformed is country-specific. In the Netherlands, reforms focused on increasing the very low employment rate (the result of too rapid wage increases); in Sweden, reforms focused on boosting dismal productivity growth (which was held back by outdated industries and excessive regulation). In Sweden, large downward adjustment in the real effective exchange rate resulting from currency depreciation also helped jump-start the economy. Reforms in both countries, however, had common elements—reducing the role of the government in the economy, increasing competition, and changing incentives.

Second, reforms need to adapt over time, as bottlenecks change. In the Netherlands, the problem initially was the lack of labor demand, and policies focused on reducing wage costs. As employment expanded, reforms shifted to boosting labor supply.

Third, the full impact of reforms builds up over time. In the Netherlands, the employment rate increased from 53 percent in the 1980s to close to 67 percent in 2011. In Sweden, annual labor productivity growth increased from 1 percent in 1977–92 to 2.5 percent in 1992–2007. Cross-country research suggests that the Swedish reforms facilitated a 5½ percentage points increase in efficiency over 10 years relative to the global best-practice frontier (an increase in real output per worker of almost 15 percent). (continued)

Box 1: Tales from Successful Structural Reforms in Europe (Continued)



Sources: Haver Analytics; and IMF staff estimates.

A third, more recent example, of successful labor market reform is Germany. Faced with high structural unemployment, low growth, and an urgent need to reform its social security system in the early 2000s, Germany embarked on a broad reform program (*Agenda 2010*) that included a set of labor market (*Hartz*) reforms. The reforms were carefully timed and aimed at (a) introducing flexibility to the labor market by creating temporary employment agencies and setting up the legal framework for the creation of small jobs; (b) increasing the effectiveness of labor market agencies by restructuring them and redesigning active labor market policies; and (c) raising incentives to work by, among others, reducing the duration of unemployment benefits and reducing restrictions on re-assignment. Faced with a shifting environment, core labor market institutions also changed. The wage bargaining process became increasingly decentralized and firm-level agreements traded job security for flexibility, including by reducing paid overtime through work time accounts and linking compensation to firm profitability. The impact of the reforms and the broader change in Germany's labor market institutions on unemployment were not immediately visible. The matching efficiency of the labor market improved, and unemployment dropped from above 11 percent in 2005 to below 9 percent by 2007, and currently stands at around 6 percent.

Short- and long-run impacts of reforms

The full effects of structural reforms may only materialize over time. Several studies find that reforms have a small, and in some cases even negative, short-term effect on output and employment because of costly and timely reallocation of resources and restructuring, with a temporary rise in unemployment and potentially high social costs (Table 1, Box 2). To the extent reforms enhance credibility and confidence, some of the short-run negative effects may be countered. In any case, the full impact on growth and employment are likely to materialize only over a medium- to long-term horizon.

Box 2. Short- and Long-Run Effects of Structural Reforms

Structural reforms have different effects on output and employment in the short and long run for several reasons:

1. Some reforms are implemented gradually and thus their effects mature over time.
2. There are (non-convex) costs of adjustment that make a gradual response optimal. For example, moving resources from one sector to another, or accumulating capital does not happen instantaneously. Similarly, imperfections in the financial market may delay investment.
3. Losers from reforms—agents who enjoyed rents created by protection—will reduce consumption immediately. In contrast, agents who benefit from the new opportunities are not identified and take time to increase consumption.
4. Investment may take time to increase and even decline for some time. Potential investors may wait and see before making big investment decisions. Similarly, confidence that changes are permanent takes time to be established.
5. An increase in productivity implies a decrease in employment in the short run when demand for the final product is inelastic.
6. Labor reforms that lower dismissal costs increase aggregate employment because firms hire more freely. However, in the short run companies may shed labor and increase productivity.
7. If there is substantial economic slack and unemployment, some reforms may in the beginning reduce disposable income as unemployment increases.

At the same time, the announcement of comprehensive structural reforms can have a larger short-term effect if investor and consumer confidence reacts immediately in response to the anticipated effects. Both expectations of higher future income and profitability and the perception of a lower risk of tail events can foster consumption and investment today. This speaks to the necessity of an effective communication strategy, possibly coordinated at the European level. This boost in confidence is particularly relevant in the present circumstances of weak aggregate demand.

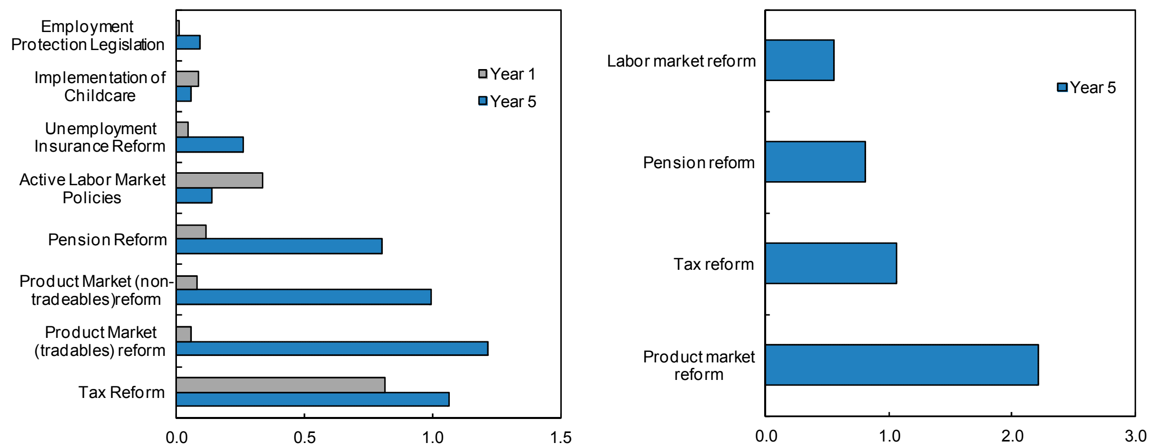
To compare short-and long-term impact, IMF staff simulated the effects of different reforms on output. The analysis is based on a calibration of the IMF's Global Monetary and Fiscal (GIMF) model that uses as input OECD empirical estimates of the dynamic effects of structural reforms on labor participation, unemployment, and productivity.[3] GIMF is a structural model that brings together both economic agents that optimize freely (firms maximize profits, and households maximize utility from consumption and leisure) and liquidity-constrained agents that consume their income fully—foundations that can be used to compare the impact of individual reforms and macroeconomic policies. Still, for this analysis, the model is not able to capture all potential effects. In particular, the model does

[3]GIMF is a general equilibrium model where all markets clear, though it features nominal and real rigidities and incomplete asset markets. The gradual implementation of reforms, combined with the gradual adjustment of labor supply and capital in response, drive the difference between short and long-run effects. The simulations are conducted with monetary policy constrained at the zero lower bound in the short run, but this only exacerbates the magnitude of effects, it does not change the sign.

not allow for involuntary unemployment and the analysis is conducted around an initial steady state that does not account for different cyclical or competitiveness positions across countries which could affect the extent of reforms that can be implemented or their full effects (e.g., of solving a relative price misalignment). The estimates are therefore illustrative examples of what can be achieved in the short and long run, rather than the precise pay-off from specific reforms.

The gains from reforms are large and materialize predominantly in the medium term. GIMF results suggest that eliminating 50 percent of euro area countries' gap with OECD best practice in labor market and pension policies could boost their GDP on average by almost 1½ percent after 5 years, and by another 2¼ percent through product market reforms (Figure 7). While these potential gains are substantial, the efforts required to implement reforms of this scale are also large. The results show a positive impact in the short run for all reforms. Combined reforms in the labor and product market could yield additional output of up to 0.6 percentage point in the euro area in the first year. Active labor market policies could have an immediate positive impact, larger than its long-term effect, mainly because they entail fiscal spending. The benefits from product market reforms are mostly achieved in the long run, and given the greater distance from "best practice," the gains appear considerably higher than the labor market reforms.

Figure 7: Short- and Long-Run Impact of Reforms in Euro Area Countries on the Level of GDP (in percent)



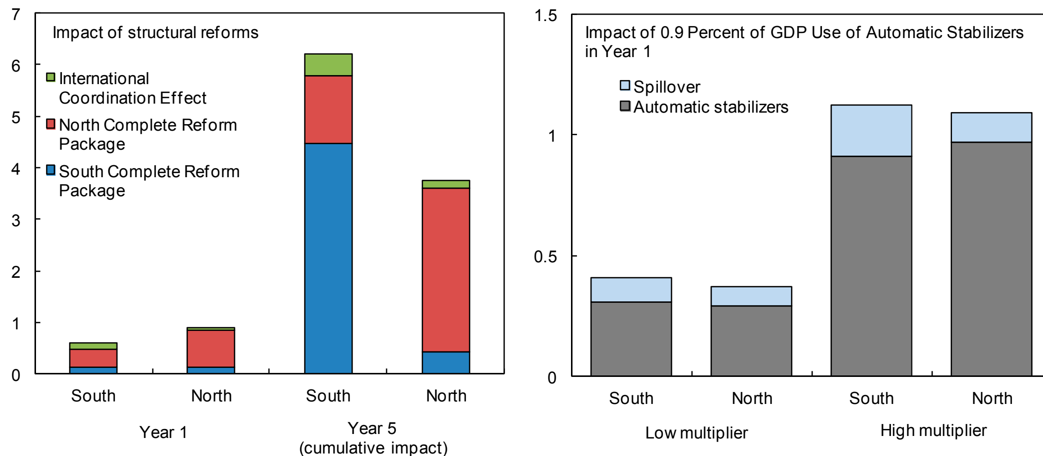
Source: GIMF estimates.

The simulations suggest reforms can produce sizeable spillovers, counting for one quarter of the total gains in growth. Trade and technology spillovers imply that structural reforms in one country increase growth in other countries (Figure 8). The GIMF analysis shows that the Southern euro area countries would gain more from reforms in the Northern countries than vice versa, for three reasons: (i) the larger size of Northern countries implies a more important trade impact; (ii) productivity improvements would spill over from the more advanced Northern countries (effectively the frontier to which Southern euro area countries would gradually converge to); and (iii) in an environment where the zero interest rate floor is

binding, higher aggregate demand from activation policies would lead to higher inflation, thereby reducing real interest rates and boosting output. Within a country, the effect of specific reforms also depends on whether other reforms are implemented (e.g., a labor market reform would have a higher payoff if product markets are also reformed).[4] All these underscore the importance of coordinated efforts.

However, spillover gains in reality could be smaller if relative price adjustments do not take place quickly enough. To the degree euro area countries compete with each other and countries in the South are at a competitiveness disadvantage, gaining further competitiveness in the North could create negative spillovers on the South. Likewise, if progress in the North generates further disinflation need in the South in order to reestablish competitiveness, the zero lower bound would take effect, causing real interest rates to increase, and domestic demand to weaken. Targeted and short-term interventions, particularly fiscal devaluation, could be useful in this regard, but success would depend on country-specific circumstances, with coordination among countries playing an important role (Box 3).

Figure 8: Impact of Reforms and Automatic Stabilizers on the Level of GDP (in percent) in Euro Area Countries



Source: GIMF estimates.

The simulations also suggest that the positive impact of reforms on activity is modest in the very short run, even under the benign conditions assumed here. Concretely, the impact is equivalent to a temporary fiscal expansion of close to 1 percent of GDP. Incidentally, this is comparable to the effects of all euro area countries letting automatic stabilizers work after experiencing a negative output growth shock of around 2 percent. This lower output growth would imply an increase in the budget deficit in the order of 0.9 percent of GDP; suppressing automatic stabilizers is equivalent to offsetting the deficit with additional fiscal consolidation measures. Instead, letting automatic stabilizers operate would

---

[4]This also raises the issue of sequencing. Blanchard and Giavazzi (2003) argue that, by reducing rents, greater competition in product markets facilitate labor market reforms.

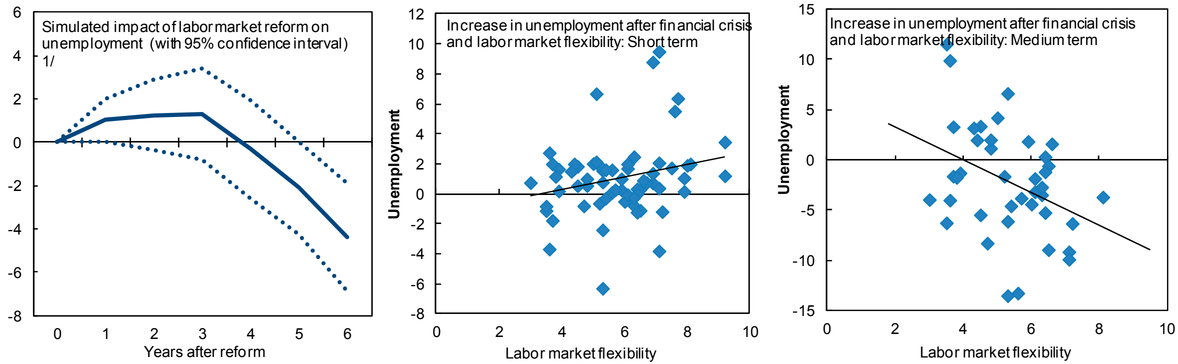
avoid a GDP contraction in the short run between 0.3 and 1 percent depending on the fiscal measure chosen, with additional impact through spillovers (Figure 8).

IV. Why Do Structural Reforms Need Other Supportive Policies?

Weak demand and excess capacity conditions risk limiting the short-term output response to reforms and, if they persist, may also damage the long-run potential. In particular, balance sheet concerns and low confidence encumber private sector decisions, thereby weakening demand and possibly hindering the effectiveness of supply side reforms. For example, relaxing employment protection may not stimulate hiring in the short term, but increase unemployment. Similarly, reducing unemployment insurance or increasing the retirement age would lower disposable income if those induced to seek work do not find jobs. IMF staff simulated a case where unemployment insurance is reduced assuming that the cuts in transfers to the unemployed, who are assumed to be liquidity-constrained, take effect immediately, while the increase in employment from higher labor supply is assumed to take place with a lag. The result is a slight output contraction in the short run, even though output expands in the long run. Overall, there are considerable uncertainties about the immediate effects of implementing structural reforms during a recession. Furthermore, because persistent weak demand can negatively impact long-run prospects through hysteresis effects in unemployment, it is imperative to increase growth soon.

Moreover, bringing unemployment down in the short run largely depends on the strength of economic activity. Recent estimates by Ball et al. (2012) show that the relationship between growth and unemployment (generally referred to as Okun's law) has been very stable for advanced countries since the 1980s, including for euro area countries. This suggests that boosting output growth, through both aggregate supply and—wherever possible—aggregate demand channels, is critical to reducing unemployment. Moreover, based on an empirical study, Bernal-Verdugo et al. (2012) find that unemployment could increase temporarily after labor market reforms are implemented (Figure 9). They also show that after a financial crisis, unemployment tends to increase more in the short term in countries with a more flexible labor market, but the medium-term increase in unemployment tends to be higher for countries characterized by a more rigid labor market.

Figure 9: Change in Unemployment (in percentage points) and Labor Market Flexibility



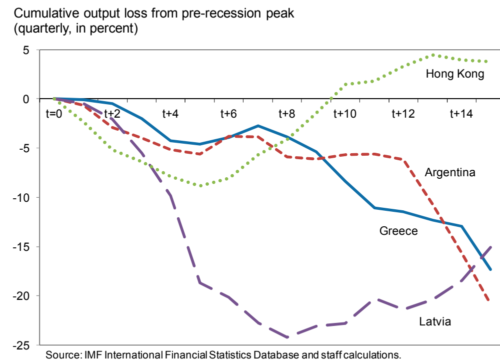
Source: Bernal-Verdugo et al (2012) and staff estimates.

1/ Estimates the impact of a comprehensive package of labor market reforms, defined as producing an annual change in a labor market flexibilty indicator which exceeds by two standard deviations the average annual change over all observations in a sample of 98 countries over 1980-2008.

Structural reforms, therefore, need to be complemented by policies that boost aggregate demand. This is not a recommendation of simple fiscal stimulus—fiscal consolidation is inevitable—but of a combination of efforts to alleviate headwinds which, importantly, includes demand rebalancing within Europe and reallocation within countries. Monetary policy and banking sector repair and reform have an important role to play. Short-run growth needs more robust (ideally private) domestic demand in the North and firmer external demand in the South. Domestic absorption would need to outpace output in the North for some time, while a more competitive tradable sector in the South should cushion its unavoidable domestic demand adjustment. Labor markets in the South are at the center of this rebalancing as wage adjustments play a crucial role in undoing the relative price misalignment in the absence of exchange rate policy. Because filling the gap in relative price is not immediate, it is important to avoid an overshooting of the domestic demand adjustment.

Box 3: Internal and Fiscal Devaluation

International experience suggests that restoring competiveness through internal devaluation is painful. As shown in IMF (2012), there are only a few cases in which a revival of competitiveness and growth through a reduction in labor costs and domestic prices outweigh the negative effects from lower income. Country experience shows that internal devaluations almost always come with drawn-out recessions, where the duration of the initial adjustment could range from 5 to 15 quarters (Figure).



Several factors are needed for internal devaluation to close a competitiveness gap, most of which do not seem to be present in the Southern euro area countries. Relative price changes have larger effects with more openness and higher factor mobility. Relative prices can change more easily if there is more price and wage flexibility. Also, a low initial public debt and the ability to use fiscal policy/transfers to attenuate the impact on the real economy are useful. Most recent experience from the Baltic countries show that even when public debt is small and flexibility exists in factor markets, the adjustment can be wrenching in terms of output and employment.

Tax reform is a useful complement to correct the price misalignment and boost the tradable sector. Shifting from employer social contributions to the VAT can—even if revenue-neutral—improve competitiveness and promote exports, growth, and employment. Indeed, with nominal wages fixed in the short run, lower labor costs on account of the reduction in social contribution rates can reduce export prices; the increased VAT, in contrast, will not bear on exports and will thus not dampen the effect on competitiveness. Only when wages adjust in response to the higher VAT might the effect eventually disappear.

The short-run effects of a fiscal devaluation can be significant. Macroeconomic models report that effects are quite marked, but not spectacular: for instance, simulations of a fiscal devaluation in Portugal suggest that a shift equal to 1 percent of GDP generates a short-term rise in net exports of somewhere between 0.2 and 0.6 percent of GDP (IMF, 2011). GIMF simulations show considerable effects. Recent econometric estimates for the euro area show large short-term effects: an average reduction in the social contribution rate of 2.6 percentage points and a standard VAT rate increase of 2.7 percentage points could have an impact on net exports somewhere between 0.9 and 4 percent of GDP (De Mooij and Keen, 2012). In reality, the improvement in net exports would also depend on the terms of trade, relative price adjustment in the non-tradable sector, and the composition of the tradable sector. While these estimated positive effects become insignificant in the long run, they last for some time, implying that a fiscal devaluation can accelerate adjustment if economies are in disequilibrium and correct distortions.

The economic effects of a tax shift are however subject to country specific conditions. For instance, if lower social contribution rates are targeted to low-skilled workers, it would likely reinforce the positive impact on jobs. The ability to increase the VAT rate may be limited in countries where rates are already high; broadening the VAT base is a better alternative in these cases. This, however, may come with adverse effects on equity so that alternative measures would need to be contemplated or other tax measures considered, or higher inflation tolerated if the VAT increases are passed through. Fiscal devaluations would best be limited to euro area countries with competitiveness problems. If all countries pursue the same tax shift, none would obtain a gain in competitiveness.

V. What Should Be Done Concretely?

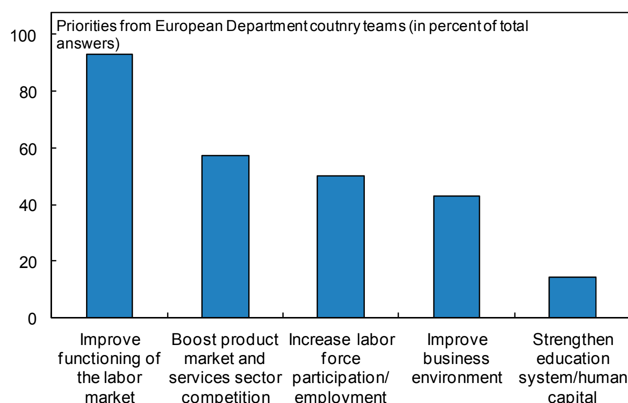
Structural reforms need to tackle many of the pre-crisis or "older" challenges. While some policies are applicable at the euro area level, granularity is necessary, as there is no one-size-fits-all strategy, nor silver bullets.[5] Annex II gives a detailed assessment of country-specific progress and priorities. In the Southern euro area, structural policies need to target the efficiency of tradable goods production and help to regain competitiveness. Elsewhere, they need to open business opportunities in the services sector to boost potential growth. Labor market reforms would need to be country specific, targeted to facilitate relative price adjustment in the South and increase participation in the North. Facilitating mobility across countries would ease rebalancing and ultimately make the euro area more resilient to shocks.

But weak demand conditions pose "new" policy challenges. Policies should aim at softening demand headwinds as well as facilitating resource reallocation across firms and sectors, and rebalancing across countries. There is no silver bullet here either. Appropriate macroeconomic policies, targeted actions in credit markets, fostering changes in relative prices, and stronger policies at the central level are all needed to reinvigorate private sector demand.

Older challenges

Structural reforms need to be sustained in several areas. Some countries, particularly in the South, have made significant progress in the last couple of years, with increased impetus in the last few months, but more needs to be done (Table 2). Significant gaps still exist between actual and potentially growth maximizing benchmarks (Annex I). In Southern euro area countries, the major gaps are in the areas of administrative and regulatory environment conducive to set up or expand businesses, and in employment legislation and the wage bargaining system, which hinder wage sensitivity to economic conditions. For the North, priority policy actions are needed to reduce barriers to competition in the services sector, increase labor participation, and scale back tax wedges. Overall, current structural priorities are not very different from what Allard et al. (2010) proposed. Country-specific

Figure 10. Priorities for Structural Reforms in Country-Specific Recommendations



Source: IMF European Department country teams.

[5]This note does not delve into important longer-term labor market issues, such as adverse demographics and immigration, the size of the government, and the role of innovation and non-bank financial institutions.

recommendations are concentrated in labor and product markets (Annex II, Figure 10), but a broader inventory is as follows.

Labor markets

While the degree of difficulty of reforms will vary considerably country by country, based on long tradition, reforms should generally aim at:

- *More inclusive labor markets*. This entails lowering duality by reducing excessive protection for insiders, and dismissal costs, and creating better incentives for remaining in or re-entering the workforce (e.g., more flexible part-time arrangements).
- *More responsive wages.* Intermediate level coordination in collective bargaining in Southern euro area countries prevents wages from being more responsive to macroeconomic shocks and productivity developments. Bargaining systems that are more favorable to employment than wage increases should be encouraged and automatic indexation minimized. Minimum wages need careful calibration to productivity realities.
- *Higher labor force participation*. This is a key to raising potential output in the context of adverse demographics. The pension system should provide incentives to increase the working age. At the other end of the spectrum, the transition between school and labor force should be facilitated.
- *Higher labor mobility*. This would help countries deal with specific shocks and cycles. While culture and languages remain a deterrent, portability of social benefits (pensions and unemployment insurance) and some degree of harmonization in labor market conditions across countries would help.

Table 2: Main Progress in Structural Reforms in Southern European Countries since 2010

Country	Areas of Reform
Greece	Labor market reforms to reduce entry-exit costs, promote firm-level bargaining, reduce rigidities in collective bargaining, lower minimum wage and legislate a gradual reduction in the labor tax wedge; product market reforms to liberalize restricted professions, transportation services and energy, and simplifying processes for business start-ups, and licensing and judicial procedures.
Italy	Labor market reforms to foster decentralization in wage bargaining and allow firm-level contracts to deviate from national contracts; product market reforms to liberalize restricted professions and industries, enforce competition, and simplify administration.
Portugal	Labor market reforms to implement organized decentralization in wage bargaining, reduce severance payments and unemployment benefits, and rationalize automatic extension of collective bargaining agreements; product market reforms to improve competition, including abolishing state special rights in companies, revising the Competition Law, and liberalizing restricted professions, reduce costs in network industries, particularly in the electricity and telecommunications sector, and improve corporate insolvency framework.
Spain	Labor market reforms to allow distressed firms to modify wages, working time, and temporarily suspend contracts, provide subsidies and tax incentives to promote hiring of young and long-term unemployed with permanent contracts, and ease dismissal conditions and opt-out clauses from collective bargaining for firms in distress.

Product markets

Reforms should include:

- *Full implementation of the EU service directives*. Several countries, especially within the euro area, have been slow in adopting the necessary internal reforms, as the principle of "necessity, proportionality, and public interest" has opened the door for half-hearted implementation. Relevant areas include wholesale and retail trade and community and personal services.

- *The specific area of professions remains critical*. Professions are still highly (self-) regulated and professional orders often stand in the way of effective competition. Coordination at the EU level could also foster effective competition across countries.

- *Modified land/zoning regulation*. Land regulation is ultimately in the hands of local authorities, which often do not internalize all economic effects and may face biased incentives. This often results in ineffective use of land and/or real estate cycles.

Public sector reform

To improve the business environment, the following reforms are recommended to remove unnecessary procedures and costs that weigh on entrepreneurship, and harmonize bankruptcy proceedings to facilitate exit of inefficient firms.

- *Justice system reforms*. A properly functioning justice system is key for all sectors but, in particular, for the labor market, FDI, and innovation. Good labor market reform may not deliver any result if not supported by a proper judicial system. Foreign investors are deterred from uncertainty related to jurisprudence. Innovation will not take off if property rights are not properly defended. Judicial systems are by definition a national institution, but the EU should exert pressure on countries which do not guarantee a minimum acceptable standard.

- *Education*. Education policy is key to upgrading the labor force, especially in countries where production relies mostly on unskilled labor. Countries in the South have been lagging on this.

- *Regulation*. The thrust toward federalism has left many countries in Europe with a plethora of regulating authorities at the EU, national, regional, and municipal levels. This excess is a deterrent to entrepreneurship and some simplification is in order.

- *Privatization*. Countries should renounce the policy of keeping significant participation in some key companies. Privatization at the local level should also be encouraged.

- *Growth-friendly budgets.* Tax and expenditure compositions are not neutral for growth. Pro-growth programs, such as expenditure on education, R&D, and infrastructure, should be preserved under expenditure cuts, while tax increases should rely on least growth-distorting instruments (Sutherland et al., 2012).

Newer challenges

Delivering on the older policy challenges remains critical, and additional actions are needed. Closing structural reform gaps might not provide enough growth lift in the current environment. Even well-designed structural reforms that minimize eventual short-run contractionary effects might not translate fast enough into rising income and employment. It is therefore crucial to accompany the older agenda with impetus in other policy interventions.

Macroeconomic policies

While the space for standard macroeconomic policies is limited, it should be used fully. The average euro area output gap is 2½ percent in 2012 and unemployment is elevated, partly due to cyclical reasons. Policy support is a must.

- *Supportive monetary policy*. Steadfast monetary policy support remains essential as long as the inflation forecast points to falling and very low rates of inflation on the policy horizon. Should inflation surprise on the downside, further monetary easing might be necessary. This should also contribute to correcting the current modest over-appreciation of the euro's real effective exchange rate, thereby further supporting growth.

- *Smart fiscal consolidation*. Consolidation will have to proceed rapidly where market pressure remains high. Where financing allows, adjustment should be conducted at a steady underlying pace that balances the need to bring down deficits against that of not undermining the recovery. If recovery falters in the North, the pace of consolidation should slow if fiscal space permits. While implementation is not straightforward, consideration should be given to modifying the current pro-cyclical nominal targets for structural deficit objectives. Priority should be given to reforming future entitlements.

Credit markets

Well-functioning credit markets are key to growth. A legacy of the debt crisis is that, absent policy intervention, credit markets, especially in the Southern euro area, will not work normally and funds will not flow to new investment opportunities, which is critical for structural reforms to pay off. The cost of funding for banks incorporated in countries with high public debt will possibly remain high with an impact on lending rates. Moreover, lingering tail-risks that jeopardize growth and dampen confidence need to be addressed.

- *Steer bank deleveraging*. Financial supervisors will have to carefully calibrate bank deleveraging, following European Banking Authority guidelines. Consideration should be given to facilitating access to credit by new emerging sectors, e.g., through partially underwriting credit risk.

- *Bank restructuring*. Bank consolidation should be encouraged, possibly through an EU-level policy. Countries in the South in particular should be ready to see foreign banks take a significant domestic credit share. FDI should be actively encouraged through a euro area policy to avoid distortionary competition.

- *Bank recapitalization*. Domestic backstops should be enhanced if market pressures intensify and the private sector cannot cope with capital needs. Consideration should be given to using centralized resource pools to provide direct capital support to banks (against acquisition of due control), limiting the adverse feedback loop between banking and sovereign risks. Over time, banks receiving pan-European support could be subjected to centralized regulation and supervision, a joint bank resolution authority with a common backstop, and a single deposit insurance fund. This would be the first step toward a unified financial stability framework operating in the single financial market, a crucial pillar of an ideal architecture for the euro area.

Rebalancing within countries and within Europe

Reversing the cross-country divergence in the external current account can be done with less disruption on activity if relative prices adjust. Southern euro area countries need to lower their current account deficits due to sustainability considerations, and the surplus countries can help such adjustments. This can happen with smaller effects in activity if Southern countries regain competiveness not only through increased productivity, but also through lower relative prices and wages.[6] From a multilaterally consistent perspective, it is not possible for the euro area as a whole to have a large current account surplus.

- *Tolerate inflation differentials*. Given the euro area at-large inflation target, the *relative price* adjustment needs higher (lower) than usual inflation in the North (South) (Figure 11). This should ideally be the result of domestic demand outpacing output in the current account surplus countries and continued adjustment toward higher net exports in the deficit economies, developments that should be carefully steered.

- *Restrain nominal wage growth in the South*. Nominal wage restraint (e.g., in the form of freezes or cuts, initiated by public sector wage discipline) in Southern euro area countries would accelerate the process of regaining competitiveness. Wages in the

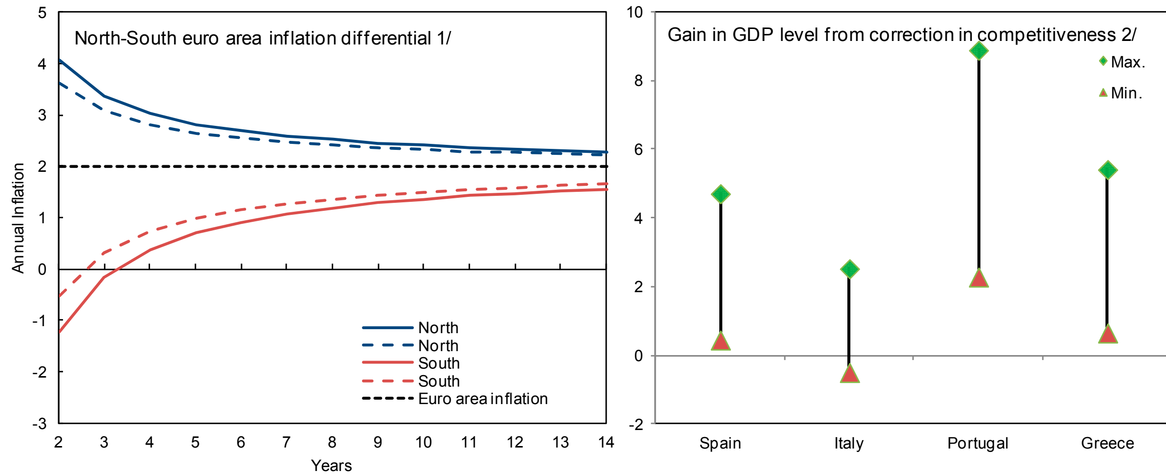
---

[6]The south needs to regain competiveness with respect to all its trading partners, not only northern Europe. Convergence of the north to the competiveness levels of the south is not a solution.

surplus countries should be allowed to keep pace with market developments, safeguarding their flexibility.

- *Fiscal devaluation*. Deficit-neutral tax reforms that shift revenue from labor or social security taxation to VAT in the periphery would be helpful, mostly in the short run. Moreover, this policy would need to be well-coordinated across countries as a simultaneous implementation of such a policy would not yield the intended gains.

Figure 11. Inflation Differentials and Possible Output Gain



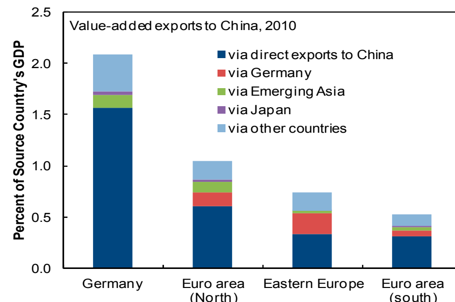
1/ Combinations of inflation rates (respecting 2 percent euro area average) and number of years to close the gap accumulated in real effective exchange rates. The solid lines refer to closing the North-South gap that has been accumulated since 1998 and the dotted lines refer to closing the South's gap versus its trading partners, comparing current real effective exchange rates with the 1980-98 average.
2/ Range of possible gains in GDP levels from closing competitiveness gap based on staff estimates of the range of real exchange rate misalignement.

More active policies at the central level

There is also potential for common resource pools to be increased and better targeted. Past evidence shows that structural funds are allocated to projects with limited spillovers and low impact on EU-wide growth (Santos, 2008). In particular, transnational projects represent only around 2.5 percent of total funds. A strategy to connect the Southern euro area to those countries and regions that lead world growth promises potentially large returns. Here — although of course opportunities will differ across countries—the successful cluster around Germany could potentially serve as a connecting link to the dynamic growth markets in Asia and elsewhere (Figure 12).

- *Targeted investment.* In addition to providing stronger incentives for reforms, the structural funds need to be better targeted towards investment in infrastructure and human capital to connect to export chains and facilitate private sector FDI from the surplus countries, particularly in countries where sovereigns face market

Figure 12. Links to Global Supply Chain



Sources: OECD Input-Output Database, OECD Bilateral Trade Database, WEO, IMF staff estimates.

stress. Funding policy interventions that improve the functioning of problematic markets and have a large positive short-run payoff. For example, labor and financial market policies should have priority.

- *Leveraging common pools.* Currently, common pools represent a small fraction of total fiscal resources. A larger common pool—with a corresponding reduction in domestic budgets—as well as project bonds, would allow more flexible allocation and facilitate public investments where they are most productive. Further steps towards fiscal integration should be considered.

VI. Final Remarks

To meet Europe's growth challenge, structural reforms need to be implemented now, and complemented by other policies. The long-run gains from product and labor market reforms are found to be substantial, offering a much-needed opportunity to increase Europe's growth potential. Moreover, a simultaneous push for reform could generate positive cross-country spillovers. However, gains from structural reforms accrue gradually, and the immediate gains are unlikely to be large. With the current weak economic outlook, combined with fiscal and financial stability woes, supportive macroeconomic policies need to accompany the structural reforms, even if the policy space is limited. Hence, accommodative monetary policy should continue, and, while fiscal consolidation should proceed, it should be structured to avoid excessive procyclicality. Bank and corporate sector restructuring, including through FDI, should be actively encouraged, and bank recapitalization promoted, possibly with support from centralized resource pools and moving propped-up banks to a new pan-European regulation and supervision system.

A consistent policy package at the euro area level that takes into account country-specific reform priorities would yield large gains and facilitate rebalancing within the euro area. Despite important ongoing efforts, the scope for structural reforms remains considerable in many euro area countries, and recommendations tailored to country-specific needs along the lines in Annex II can help focus attention where potential gains are larger. For many countries, priorities include reducing barriers to competition and improving the business environment. Empirical evidence shows that such product market reforms can provide a substantial lift to growth in these cases. Labor market reforms, in addition to raising growth and employment in the long term, can help achieve the price re-alignment that is needed to regain lost competitiveness for some countries. Fiscal devaluation and nominal wage restraint would help accelerate this rebalancing process. Reallocation across sectors could be supported by more active policies at the central EU level, including by targeting investment and leveraging the common resource pools.

REFERENCES

Allard, C., L. Everaert, with A. Annett, A. Chopra, J. Escolano, D. Hardy, M. Mülheisen, and B. Yontcheva, "Lifting Euro Area Growth: Priorities for Structural Reforms and Governance," IMF Staff Position Note No. 10/19 (Washington: International Monetary Fund).

Annett, A., "Lessons from Successful Labor Market Reformers in Europe," IMF Policy Discussion Paper No. 07/1 (Washington: International Monetary Fund).

Ball, L., D. Leigh, and P. Loungani, 2012, "Okun's Law: Fit at 50?" IMF Working Paper *forthcoming*.

Bassinini, A. and D. Venn, 2008, "The Impact of Labour Market Policies on Productivity in OECD Countries," *International Productivity Monitor,* Vol. 17, pp. 3-15.

Berger, H. and S. Danninger, 2007, "The Employment Effects of Labor and Product Market Deregulation and Their Implications for Structural Reform," IMF Working Paper No. 06/137 (Washington: International Monetary Fund) *IMF Staff Papers,* Vol. 54, pp. 591–619.

Bernal-Verdugo, L. D. Furceri, and D. Guillaume, 2012, "Crises, Labor Market Policy, and Unemployment", IMF Working Paper No. 12/65 (Washington: International Monetary Fund).

Blanchard, O. and F. Giavazzi, 2003, "Macroeconomic Effects of Regulation and Deregulation in Goods and Product Markets" *The Quarterly Journal of Economics*, pp. 879-906.

Blanchard, O. and J. Wolfers, 2000, "The Role of Shocks and Institutions in the Rise of European Unemployment: The Aggregate Evidence" *The Economic Journal,* Vol. 110, pp. 1-33.

Bouis, R. and R. Duval, 2011, "Raising Potential Growth After the Crisis: A Quantitative Assessment of the Potential Gains from Various Structural Reforms in the OECD Area and Beyond," OECD Economics Department Working Papers, No. 835, OECD Publishing, Paris.

De Mooji, R. and M. Keen, 2012, "Fiscal Devaluation and Fiscal Consolidation: The VAT in Troubled Times," NBER Working Paper No. 17913.

Everaert, L. and W. Schule, 2006, "Structural Reforms in the Euro Area: Economic Impact and Role of Synchronization across Markets and Countries," IMF Working Paper No. 06/137 (Washington: International Monetary Fund).

Fitoussi, J., D. Jestaz, D. Phelps, and E. Zoega, 2000, "Roots of the Recent Recoveries: Labor Reforms or Private Sector Forces?" *Brookings Papers on Economic Activity,* Vol. 1, pp. 237–312.

Fialová, K. and O. Schneider, 2008, "Labor Market Institutions and Their Effect on Labor Market Performance in the New EU Member Countries," *CESifo Working paper Series,* No. 2421.

Fiori, G., G. Nicoletti, S. Scarpetta, and F. Schiantarelli, "Employment Effects of Product and Labour Market Reforms: Are There Synergies? *The Economic Journal,* Vol. 122, pp. 79–104.

Goldman Sachs, 2012, "Our 2011 GES: A Sharper Signal for Growth," Goldman Sachs Global Economics, Commodities and Strategy Research.

Gomes, S., P. Jacquinot, M. Mohr, and M. Pisani, 2011, "Structural Reforms and Macroeconomic Performance in the Euro Area Countries, A Model-Based Assessment," ECB Working Paper No. 1323 (Frankfurt, European Central Bank).

IMF, 2012a, "Greece: Request for Extended Arrangement under the Extended Fund Facility," Country Report No. 12/57 (Washington: International Monetary Fund).

IMF, 2012b, "Fiscal Monitor: Caution Advised Amid Improving Fiscal Outlook," (Washington: International Monetary Fund).

IMF, 2011, Fiscal Monitor, Appendix 1: "Fiscal Devaluation": What is it-and Does It Work? (Washington: International Monetary Fund).

IMF, 2010, "Cross-Cutting Themes in Employment Experiences during the Crisis," IMF Staff Position Note, SPN/10/18 (Washington: International Monetary Fund).

Jaumotte, F. 2011, "The Spanish Labor Market in a Cross Country Perspective," IMF Working Paper No. 11/11 (Washington: International Monetary Fund).

Mourre, G., 2006, "Did the pattern of Aggregate Employment Growth Change in the Euro Area in the Late 1990s?" *Applied Economics,* Vol. 38, pp. 1783-1807.

Mourre, G., 2009, "What Explains the Differences in Income and Labor Utilization and Drives Labor and Economic Growth in Europe? A GDP Accounting Perspective," European Economy Economic Papers No. 354, (Brussels, European Commission).

Nickell, S., L. Nunziata, and W. Ochel, 2005, "Unemployment in the OECD since the 1960s: What Do We Know," *The Economic Journal,* Vol. 115, pp. 1-27.

Organization for Economic Co-operation and Development, 2012, "OECD Economic Surveys Euro Area," Paris.

Ostry, J., A. Spilimbergo, and A. Prati, 2009, "Structural Reforms and Economic Performance in Advance and Developing Countries," IMF Occasional Paper (Washington: International Monetary Fund).

Pérez, E., and Y. Yao (2012), "Can Institutional Reform Reduce Job Destruction and Unemployment Duration? Yes It Can," IMF Working Paper No. 12/54 (Washington: International Monetary Fund).

Santos, I., 2008, "Is Structural Spending on a Solid Foundation?" Bruegel Policy Brief 2008/02, February 2008.Sutherland, D., P. Hoeller, and R. Merola, 2012, "Fiscal Consolidation: How Much, How Fast and by What Means?" OECD Economic Policy Papers No. 01 (Paris: Organization for Economic Co-operation and Development).

Tiffin, A., forthcoming, "Potential Growth Prospects in Euro-area Program Countries," IMF Working Paper (Washington: International Monetary Fund).

World Bank, 2012, "Golden Growth—Restoring the Luster of the European Economic Model," (Washington).

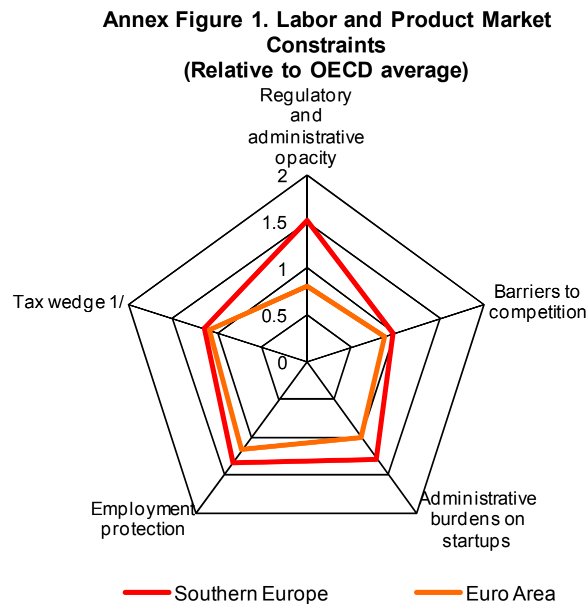
ANNEX I. KEY GAPS IN STRUCTURAL POLICIES—CROSS-COUNTRY COMPARISONS

Identifying country-specific gaps can help focus on reforms that yield larger gains. The European social model has delivered strong outcomes combining periods of sustained growth with relatively low income inequality. But weak growth prospects imply a need to adjust institutions, focusing on areas with more scope for reform and hence larger potential gains. A cross-country comparison of structural characteristics can help identify those areas, though such an approach also has shortcomings. Institutional features are complex and difficult to measure, and defining the frontier or best practice will involve a judgment of which institutional characteristics yield favorable economic outcomes (specifically, the indicators are generally geared toward growth, not other considerations such as equity), to which the empirical evidence does not often provide a clear-cut answer. These short-comings need to be overcome by an in-depth country-specific analysis.

What do surveys and ratings show?

Regulations and administrative burdens are higher in Europe relative to its OECD peers (Annex Figure 1). Europe's work model features stronger security for those with jobs, more generous benefits for those without work, and easier pension eligibility. European enterprises also face more administrative burdens, less competition and higher employment tax burden than its OECD peers. These features limit labor participation, incentivize fewer working hours, and smaller enterprises, making Europe less productive and less prepared to face the aging challenge. The Southern euro area is more encumbered with administrative and regulatory burdens than the rest of the euro area. While several countries in the Northern euro area pursued strong labor market reforms in the 1990s and 2000s that allowed businesses to take advantage of a more integrated Europe and the pan-European value chain, the Southern euro area remained more regulated and protected, missing out on the trade and investment train.

Annex Figure 1. Labor and Product Market Constraints (Relative to OECD average)

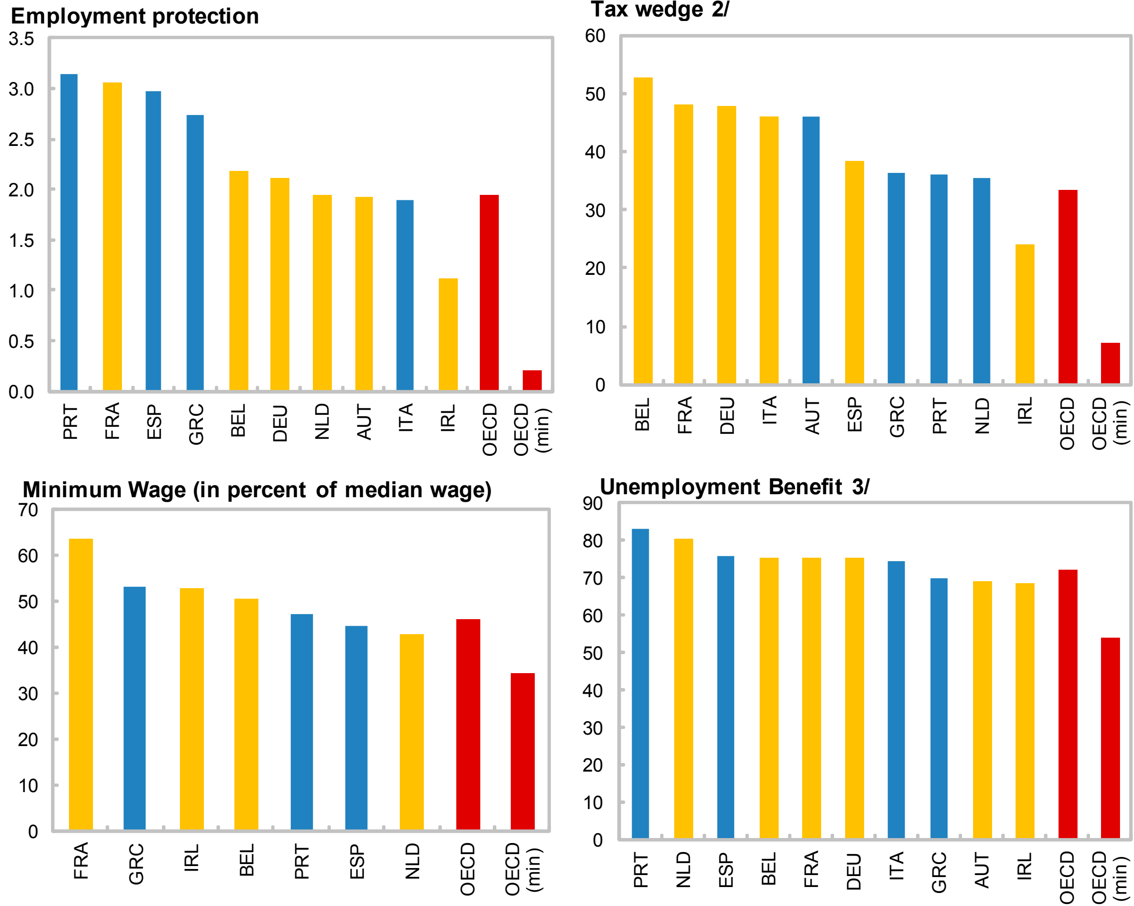


Southern Europe consists of Greece, Italy, Portugal and Spain.
1/ Average tax wedge on labor; average of two income situations (67% and 100% of average earnings).
Source: OECD and Staff calcualtions.

Specific structural gaps vary considerably across euro area countries, and are reflected in different reform priorities. All euro area countries have structural gaps with respect to the OECD benchmark, as shown by the orange flags (a rating below average) and the red flags (a rating more than one standard deviation below average) in Annex Table 1. The South stands out as a region with larger structural reforms gaps across the board, including with regards to institutions and contract enforcement, education, business regulation, and innovation capacity. To respond to the most urgent priorities, most euro area countries, in particular in the South, have put in place comprehensive reforms in the past years, which are not captured in these backward-looking indicators, and more are in the pipeline (Annex II). Nevertheless, IMF recommendations on reform priorities for each country indicate that further measures are needed, in particular to improve the functioning of labor markets, increase labor force participation, and reduce barriers to competition, which should help enhance competitiveness and dampen the negative impact of aging.

Labor market institutions represent a key reform priority, but reform should take into account different work models. It is notable that the German labor market, which is found to have significant gaps compared to their OECD benchmarks (Annex Figure 2), produced favorable employment outcomes during the crisis. Episodes of successful labor market reforms in various European countries during the last three decades show that wage moderation is a basic ingredient in ensuring large shifts in labor and output growth. This was achieved through agreements between social partners in exchange for higher job security (Ireland and Netherlands, see Box 1), and with cuts in labor tax (Denmark and Ireland). Collective bargaining systems that are more favorable to employment than wage increases, which typically requires strong coordination or strong decentralization as opposed to intermediate coordination (a feature in several Southern countries), seemed to have worked better. Most reform episodes also took place in conjunction with reduction in government wages and transfers highlighting the complementarity of institutional reform and fiscal policy elements (Annett, 2007).

Annex Figure 2. Cross-Country Differences in Labor Market Institutions: Euro Area 1/



Source: Organization for Economic Cooperation and Development.
1/ 2008 for EPL and minimum wage; 2009 for unemployment benefit; and 2011 for tax wedge.
2/ Average tax wedge on labor; average of two income situations (67 percent and 100 percent of average worker earnings). Data for Greece are from 2010.
3/ Average of net replace rates for six family types and two earning levels (67 percent and 100 percent of average worker earnings).

Annex Table 1. Structural Reform Gaps in Selected Euro Area Economies: A Heatmap 1/

	Austria	Belgium	France	Germany	Greece	Ireland	Italy	Netherlands	Portugal	Spain
Institutions and contracts										
Institutions (WEF)										
Extent of public ownership (OECD)										
Legal system and property rights (IEF)										
Enforcing Contracts (WB)										
Infrastructure										
Infrastructure (WEF)										
Sectoral regulation in transport (OECD)										
Human capital										
Health and primary education (WEF)										
Higher education and training (WEF)										
Average PISA score (OECD)	..									
Employment protection (OECD)										
Business regulation										
Goods market efficiency (WEF)										
Business regulations (IEF)										
Starting a business (WB)										
Product market regulation (OECD)										
Openness to trade and FDI										
Market size (WEF)										
Freedom to trade (IEF)										
Barriers to FDI (OECD)										
Trading across borders (WB)										
Credit market rigidity										
Financial market development (WEF)										
Credit market regulations (IEF)										
Getting credit (WB)										
Innovation										
Technological readiness (WEF)										
Business sophistication (WEF)										
Innovation (WEF)										
Financial support for R&D (OECD)										

Sources: OECD Going for Growth 2012; Fraser Institute Index of Economic Freedom 2011; WEF Global Competitiveness Report 2011-12; WB Doing Business 2012.

1/ See IMF (2010) for a description of the methodology. The indicators reflect the most recent data available from the sources, and do not always capture the most recent reforms implemented.

Annex II. Euro area: Country-Specific Structural Reform Recommendations

Country	Area of reform priority	Progress since 2010	Ongoing reforms	Recommendations
Austria	Increase labor market participation of low-skilled, older, and female workers	Recent policy focus has been on ad-hoc measures in the pension area (such as containment of pension increases) and on selective measures to increase the effective retirement age (which is the second lowest in the OECD).	Pension reform	Close all avenues to early labor market exit without actuarially fair benefit reductions (including by fully abolishing the specific early retirement scheme for long-time insured, so-called "Hacklerregelung") Further tighten the eligibility for disability pensions (including by broadening the scope of alternative occupations against which disability is assessed) Revenue-neutrally reduce the high effective tax wedge (social security contributions) for low-skilled workers.
	Strengthen human capital formation in the education system closing the achievement gap for immigrant and first generation children in primary and secondary education			Introduce entrance admission tests to avoid overcrowding and high drop-out rates in tertiary education Attract more enrollments in engineering and natural sciences Institute measures to rise private funding for education.
Belgium	Raise the employment rate	New government reform program agreed in December 2011	Reform of eligibility of pre-pension and early retirement benefits, introduction of search requirements for older unemployed	Adjust early retirement benefits to actuarially neutral levels. Stepwise phasing out of unemployment benefits over duration of unemployment spells; reallocate active labor market policies towards intensified job search assistance. Allow greater geographic and sectoral wage flexibility; significantly reform automatic wage indexation mechanism.
	Increase competition in product and services sectors	The EU Services Directive has been fully transposed into national legislation.	Competition Authority study on retail price differentials across country borders and barriers to exit.	Implement EU Services Directive
	Increase competition and enhance supervision in energy sector	The energy regulator is studying measures to reduce monopoly rents.		Reduce barriers to entry and strengthen regulatory oversight to limit any rents and bring energy prices closer to the levels in neighboring countries.
Cyprus	Improve the functioning of labor market and the business environment		Abolition of 1200 redundant positions, limit 1 appointment per 4 retirements.	Reduce the size of the public sector. Simplify and shorten procedures to resolve court disputes and identify obstacles for technology adoption.
	Reform the national pension and civil servant pension scheme	Increased contribution of public sector to pensions from 0.8% to 5%. Introduced CPI indexation for benefits for civil service pensions.		Introduce early retirement penalties, increase gradually the retirement age to the same level in the national and civil service scheme. Align benefits closer to contribution and lifetime earnings.

Country	Area of reform priority	Progress since 2010	Ongoing reforms	Recommendations
Cyprus (cont)	Ensure wage moderation and reduce wage rigidity to strengthen competitiveness	Cost of living adjustment (COLA) will remain frozen for 2 years (2012 and 2013), implying a temporary public wage freeze. A review of the COLA indexation mechanism was also agreed. Entry salaries for new public servants were cut by 10 percent.		Eliminate or reform the COLA wage indexation mechanism and link wage increases to productivity developments at the firm level. Reduce wage increases in the public sector and more generally abolish automatic increments in public sector wages.
Estonia	Enhancing attractiveness for FDI		Measures to boost infrastructure and promote FDI, especially in traded goods	Improving R&D capability and education in technical fields.
	Addressing emerging labor market tensions	Cut unemployment insurance contributions from 2013, introduced targeted wage subsidies for problem labor market segments, doubled per capita amount for voucher training program, introduced new IT platform for enhancing one-stop job matching process	Measures to raise labor force skills and increase inclusiveness, gradual shift from direct (labor) to indirect taxes	Addressing growing labor market tensions (long-term unemployed, skills mismatches) by harmonizing vocational education with labor market needs, increasing voucher training programs, improving job-matching through new one-stop IT platform. Lower labor market taxes.
	Enhance Estonia's already business-friendly environment			
Finland	Increase labor participation	Part-time pension age limit has been increased to 60.	Social guarantee to offer young people a job, training, studies, or rehabilitation within 3 months of unemployment (Budget 2012).	Tighten unemployment and disability pipelines to early retirement and strengthen work incentives. Strengthen activation requirements for sickness and disability benefits.
	Make the education system more efficient			Refocus R&D expenditure on academic research and adjust incentives to reward academic quality. Speed the transition from secondary to tertiary education, in particular by introducing tuition fees with a means-tested loan system, to better direct students to areas of labor market demand.
	Promote competition in the retail sector			Open the service sector to more competition, particularly retail trade, not least by relaxing excessive municipal zoning restrictions.

Country	Area of reform priority	Progress since 2010	Ongoing reforms	Recommendations
France	Improve the functioning of labor markets to re-absorb the unemployed and increase labor force participation	A pension reform was adopted and is being implemented. Labor market reforms to facilitate employment of senior, young and low-skilled workers.	In 2011, approval of measures to accelerate pension reform implementation. In 2012, approval of measures to further promote alternating work-study schemes.	Achieve minimum wage moderation and reduce inactivity traps for young and low-skilled workers (easing the high employment protection, and reducing the duration of unemployment benefits or lowering the benefit level over time). Better support the unemployed in their job search by further strengthening activation policies and the unified job placement agency and strictly enforcing job-search requirements.
	Increase competition in service sectors	Steps have been taken to increase competition in the electricity, telecommunications, and retail sectors	G20 commitment to adopt a law to increase competition in retail, energy, telecommunication and real estate by end-2011.	Foster more competition in growth-critical services to increase potential growth by reducing regulatory barriers (notably for professional services), focusing the activities of the Competition Authority on areas where progress has been limited. Liberalize services sectors by implementing the EU Services Directive.
	Undertake a tax reform		In 2012, Parliament approved a reduction in the labor tax wedge by increasing the VAT rate.	Undertake a growth friendly tax reform that supports the fiscal consolidation by reducing tax rates (reducing labor tax wedge and the statutory corporate tax rate), broadening the tax base and improving compliance and removing the least efficient tax expenditures.
Germany	Increase labor force participation	Some progress in extending the provision of child care Recognition of qualifications earned abroad has been improved	Authorities are contemplating reduction of tax rates and/or social contributions to reduce the labor wedge	Lower the tax wedge, in particular for secondary, low skilled and low income earners through targeted tax measures. Improve quality and availability of early childhood education, including child care facilities.
	Increase investment	Corporate tax reform of 2008 improved Germany's tax competitiveness		Abolish trade tax. Remove debt bias in corporate financing.
	Increase productivity, in particular in the services sector	Additional allocation to research and development in the 2012/13 budgets, initiatives to improve the use of ICT in Germany's High Tech Strategy and Europe's Agenda 2020		Raise incentives to invest in higher risk, higher growth sectors. Promote widespread use of ICT.
Greece	Improve labor market flexibility	Major labor market reforms were undertaken, which: (i) reduce entry-exit costs; (ii) promote firm-level bargaining and suspend automatic extension of sectoral agreements to firms not-represented in negotiations; (iii) reduce rigidities in collective bargaining, (iv) lower the minimum wage by 22 percent		Achieve a 5 percentage point reduction in the labor tax wedge (employer's social security contribution rate) in a budget-neutral way. Take additional measures as necessary to achieve a 15 percent reduction in unit labor costs over 3 years. Simplify the minimum-wage framework.

Country	Area of reform priority	Progress since 2010	Ongoing reforms	Recommendations
Greece (cont.)	Improve labor market flexibility (cont.)	(for youth by 32 percent) and freeze it for the next three years; and (v) legislate a gradual reduction in the labor tax wedge.		
	Foster competition in service and product markets	Legislation was adopted liberalizing restricted professions, transportation services and energy		Finalize implementation of the law liberalizing closed professions by end-2012 by liberalizing professions gradually, in order of priority. Define an action plan to tackle remaining rigidities in product markets.
	Improve the business environment	Legislation to improve the business environment by simplifying the process to start up a business and licensing procedures, and simplifying judicial procedures.		Facilitate investments by extending and simplifying the fast-track investment framework. Simplify export legislation and streamline export and customs procedures by implementing an electronic export widow and e-customs system by end-2012 Finalize implementation of new licensing laws by end-2012. Continue judicial reforms aimed at reducing the large case backlog in courts, speeding up court proceedings, and defining steps to reform the Code of Civil Procedures and to set up a performance framework for courts.
Ireland	Labor market reform	Drafted law reforming sectoral wage-setting agreements, with a reduction in the number of sectoral agreements and wages, and strengthening of the “inability to pay” clause, which allows firms to derogate from the set wages in times of financial difficulty. Expanded number of activation places (Jobs Initiative).	Address shortcomings found in the job search assistance and monitoring (Pathways to work).	Reform the sectoral wage setting agreements in order to facilitate labor reallocation from the distressed sectors of the economy (particularly construction), to increase the responsiveness of wage-setting to economic conditions, and exclude employment conditions which are protected by other legislation. Strengthen labor activation and training policies for the unemployed. Reform structure of unemployment benefits to reduce the share of unemployed facing high replacement rates and address sources of unemployment traps. Reduce the relatively high minimum wage.
	Increase efficiency and competitiveness of the overall economy	Introduced to parliament amendments to the Competition Bill to enhance the competition law framework. Designed a strategy to reform the water sector regulator and introduce water metering.		Implement an ambitious program of state assets disposals through an orderly process including associated regulatory reforms especially in the gas and electricity sectors. Reform sheltered sectors, including legal and medical professions, to better align the costs of these services with state of the economy. Strengthen competition law enforcement.

Country	Area of reform priority	Progress since 2010	Ongoing reforms	Recommendations
Italy	Make labor market work better	June 2011 agreement signed by social partners modified the rules on representation and contract enforceability to foster wage bargaining decentralization; August 2011 fiscal package allowed firm-level contracts to derogate from national contracts and labor law; In April 2012, the government submitted to the parliament a labor market reform proposal.	Labor market reform is to be approved by the parliament.	Decentralize wage bargaining to take into account regional differences in productivity and the cost of living and to better link wages to productivity to increase competition. Introduce regional differentiation in public sector wages, and revisit the system of tax incentives for second-level wage bargaining. Relax job protection on standard contracts and harmonize/reduce the number of labor contracts. Reorganize social safety net to make the coverage more uniform (within the overall fiscal constraints). Increase effectiveness of activation policies to raise labor participation and workforce skills. Reduce tax wedge on labor income (combining with unions' commitment to wage moderation at national level) by shifting taxation toward indirect taxes.
	Boost product market competition	Reforms in the areas of product market liberalization, infrastructure investment, and administrative simplification have been introduced.	Liberalization measures are to be implemented, including adopting follow-up regulations; administrative simplification reform to lower the cost of doing business is also underway.	Implement the liberalization package, including to separate ownership of the main energy company from gas distribution activity to encourage competition, streamline the authorization process for strategic infrastructure projects, establish an independent transport authority to ensure an adequate regulatory framework, abolish all tariffs for professional services and reforming professional orders, strengthen enforcement of competition rules for providing local public services and requiring competitive tendering. Enhance further the role of competition bodies, such as by raising the statutory cap on authorized personnel level of the Antitrust Authority (low compared to peer countries); regularly present and adopt the Annual Competition law. Encourage privatization, both at the central and local government levels, to curb state involvement in the economy, promote more productive use of state assets, and reduce debt. Enhance the efficiency of the judiciary system.
Luxembourg	Increase labor market flexibility	An agreement has been reached to delay automatic wage increases and limit these to once a year.		Drop food and fuel prices from the reference index, with a view of eliminate automatic backward-looking wage indexation in the medium term. Review employment and income support schemes and eliminating those no longer needed and better targeting schemes the rest to minimize adverse work incentives.

Country	Area of reform priority	Progress since 2010	Ongoing reforms	Recommendations
Luxembourg (cont.)	Old age pension reform	Introduced “pension a la carte” that when fully in force in 40 years, will reduce pension benefits for those choosing to retire at the current effective retirement age but maintain benefits for those choosing to work three more years.		Gradually increase statutory retirement age in line with life expectancy. Modify benefit indexation from wage increases to cost-of-living adjustment. Eliminate complementary periods.
Malta	Make labor market work better	Encourage female labor market participation, through fiscal incentives for part-time and flexible work arrangements, training programs and affordable childcare services.	Revision of a new productivity-linked indexation mechanism	Maintain the reform momentum and ensure a cautious settlement of wage negotiations at the firm-level to better align wage and productivity developments. Improve the quality of human capital through education targeted on labor market needs, continue encouraging female labor participation, and adopt productivity-enhancing measures (training and R&D).
	Reform the pension system	Implementation of the remaining 2007 pension reform measures		Implement recommendations of the Pensions Working Group: indexing the retirement age to longevity; and introducing a mandatory privately funded second pillar and voluntary third pillar. Consider introducing a notional defined contribution first pension and to accelerating the gradual increase in the retirement age to 65.
	Improve business environment and efficiency		Air Malta restructuring	Reduce state involvement in the economy, implement restructuring plans of Air Malta and EneMalta and agree on strategic plans, and permit professional independent management to lead these entities subject to sound governance and performance targets; promote energy-efficiency reforms.
Netherlands	Make labor market work better with a view to lifting the employment rate, especially for women (including hours worked), older workers and low-skilled young workers	(i) Introduction of the Work Capacity Act , (ii) increase of the statutory retirement age to 66 in 2020 and linking it to life expectancy (iii) introduction of the vitality scheme to stimulate participation of elderly workers as well as workability in general.		Selectively reduce labor taxes for hiring unemployed workers over 50, phase in the income-based tax credit to make it attractive for low-earning partners with children, and increase statutory retirement age from 65 to 67 while providing financial incentives for workers to continue working after minimum retirement age. Relax the strict employment protection legislation for regular contracts by simplifying the dismissal system--including appeal procedures-- and making it more predictable, clarifying the rules governing layoffs, reducing severance payments to older workers to the level of those for other workers, expanding the range of "appropriate work" that must be accepted by unemployed, and reducing the duration of unemployment benefits and tapering off its generosity over time.

Country	Area of reform priority	Progress since 2010	Ongoing reforms	Recommendations
Netherlands (cont.)	Promote competition in retail sector			Ease restrictions on shop opening hours, large scale outlets and zoning regulations
	Increase infrastructure			Increasing infrastructure investment, introduce road pricing system, relax the strict zoning regulations and open up the transportation sector to more competition.
Portugal	Make labor market work better	Implemented "organized decentralization" and reduced the firm threshold size to 150 workers for unions to delegate power to words councils to conclude collective agreements. Automatic extensions have been suspended. Severance payments have been reduced. Draft Labor Code revisions currently with Parliament relax constraints to using more flexible working time arrangements.	The government will assess the effects of measures, and if needed, prepare an action plan to ensure more firm-level wage bargaining. Mechanism being redesigned to disallow extensions of agreements that do not represent at least 50 percent of workers in a sector. Draft law with Parliament aligns the severance pay of current employees with that under new contracts. Severance payments under all contracts will be reduced further to the EU average level (8-12 days).	Promote firm level wage bargaining to allow companies to opt-out from industry-wide arrangements. Promote less automatic extension of collective bargaining agreements. Reduce severance payments (which area above EU average level) both for fair and unfair dismissals. Relax employment protection for regular workers with a view to reducing protection gap with temporary workers. Relax working time regulations to help reduce cyclical employment losses.
	Improve competition framework	Competition Law and Public Procurement Code have been revised; State special rights in companies ("Golden Shares") have been abolished.		
	Reduce costs in regulated network sectors (notably electricity)	Progress has been made in telecommunications, for example in lowering high mobile termination rates.	Renegotiation of excessive rents in electricity is in progress; so is the elimination of incentives with weak economic underpinning.	Streamline licensing processes for businesses and more generally accelerate the implementation of the authorities' SIMPLEX program
	Further improve the business environment	New Corporate Insolvency Law approved by Parliament in March 2012. Full implementation of Services Directive is in progress. Privatization of two companies in energy sector.	Backlog of court cases is being reduced, roadmap for streamlining court structure is being developed. Privatization agenda has been expanded; SOEs have specific operational targets to largely achieve operational balance by end-2012.	Reform the judicial system, improving efficiency, and promoting better out-of-court dispute resolution. Reform insolvency regime for corporates. Expedite the revision of existing legislation to make it compatible with the EU Service Directive Resume the privatization process and expand performance monitoring of state-owned enterprises

Country	Area of reform priority	Progress since 2010	Ongoing reforms	Recommendations
Slovak Republic	Increase employment to raise income and reduce unemployment particularly in less developed regions	Reformed the labor code, which reduced firing and hiring costs, streamlined administrative burdens, and enhanced flexibility of wage negotiations.		Reduce employment disincentives for lower income workers by limiting the pace of phasing out income support. Consider differentiating minimum wages by skill level and by region according to cost of living. Better target and monitor active labor market policies, in part by improving their regional focus, expanding training opportunities for unemployed youth, and targeting job creation subsidies to long-term unemployed.
	Improve effectiveness of the tertiary and vocational education system			Enhance the funding and quality of tertiary education, by introducing tuition fees for full-time tertiary students along with means-tested grants and loans, and giving greater autonomy to tertiary education institutions, along with stronger performance-based management. Promote better vocational and professional training to align skills with labor market needs, by developing more occupationally-oriented curricula at the tertiary level, with a stronger involvement of employers.
Slovenia	Reform the pension system to encourage labor market participation	Pension reform with partial implementation of staff recommendations was planned in 2011. However, it was defeated in a public referendum.		Increase the penalty for early retirement to 6-7 percent per year to increase the effective retirement age to 65, move gradually to full CPI indexation from wage indexation, adjust the retirement age by life expectancy at retirement once the effective retirement age reaches 65, and expand the private pillar to compensate for cuts in public benefits while ensuring benefit portability
	Increase the flexibility of labor markets	The Act on Minijobs, an employment act, and revised Labor Market Regulation was drafted addressing partially some of staff concerns. However, the Acts were defeated by public referendum		Reduce employment protection by reducing notice periods, severance payments, and restrictions for dismissals, eliminate wage supplements for years of service to reduce the cost of older workers, avoid any further indexation of the minimum wage after a binding 23 percent increase in 2010, reform legislation related to student work restricting its possible use to prevent abuse and institute limited social security and pension contributions for students instead of full exemption to limit distortions.
	Improve the business environment to enhance FDI attractiveness.	Creation of one stop shops for establishing new companies		Accelerate bankruptcy procedures and introduce a cap on social security contributions compensating any potential revenue loss.

Country	Area of reform priority	Progress since 2010	Ongoing reforms	Recommendations
Spain	Improve the functioning of the labor market	The Feb. 2012 labor reform reduces severance payments for unfair dismissals of new permanent workers, and eases the use of fair dismissals with low severance costs for firms in distress, gives priority to firm level agreements over collective agreements, eases the opt out clauses from wide collective agreements for firms in distress, and allows distressed firms to modify wages, working time, and temporarily suspend contracts. In addition, the reform includes subsidies and tax incentives to promote hiring of young and long-term unemployed with permanent contracts, as well as to foster in job training.	The reform was introduced as a decree-law, entering into force immediately, but it was also submitted to Parliament for its enactment as an ordinary law, allowing for discussion and amendments.	Ensure that the recent labor reform is well implemented in practice and achieves the goals of reducing dualism, increasing firm's internal flexibility, raising wage flexibility, and fostering permanent hires. Further reduce severance pay on permanent contracts for unfair dismissals to at least EU average levels. Introduce a single open ended contract with gradually increasing severance payments in the early years of tenure. Further decentralize wage setting (for example by moving to an "opt-in" rather than "opt-out" system for collective bargaining) and eliminate automatic indexation. Strengthen retraining of the unemployed.
	Further reform in the service and product markets		Service and product market reforms ongoing.	Ensure an ambitious implementation of the EU Services Directives, especially to lower entry barriers in the area of retail trade imposed at the local and regional levels. Eliminate restrictions on professional services, in particular by narrowing qualification requirements and reducing existing regulatory differences across regions. Relax restrictions in the rental market, such as landlords' obligation to automatically renew lease for the first five years and the cap on rent increases to CPI inflation. Simplify product market regulations and reduce regulatory barriers to competition.