European Job Growth Hinges on Deeper Labor Market Reform

A substantial reduction in European unemployment—it now stands at between 11 and 12 percent of the workforce—will require deeper labor market reforms across a broader range of complementary policies and institutions than have so far been undertaken. A coherent reform program that emphasizes such complementarities among different policies—while simultaneously addressing distributional concerns more effectively—could help generate a stronger constituency in favor of more broad-based, and potentially more effective, labor market reforms. These are the main conclusions of an IMF Working Paper, *Policy Complementarities: The Case for Fundamental Labor Market Reform*, by David T. Coe and Dennis J. Snower.

The Current Situation

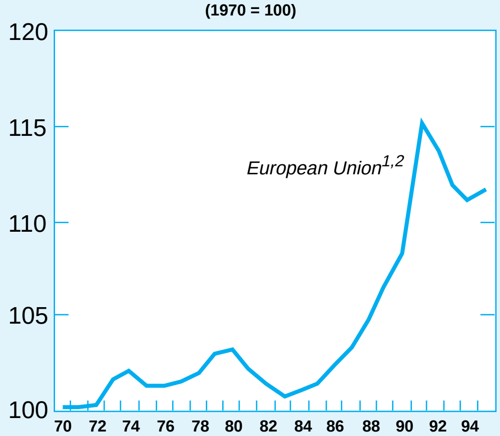
Since 1970, employment in Europe has grown far more slowly than the labor force: the total labor force increased by 22 percent from 1970 to 1995, while total employment expanded by only 11 percent, with the increase in private sector employment increasing by an even more modest 5 percent. As a consequence, joblessness climbed steadily over this period: from a little more than 2 percent in the early 1970s to 11–12 percent in 1995—ranging from 7.2 percent in the United Kingdom to about 22 percent in Spain. IMF staff estimates of natural rates of unemployment—the rate of unemployment that is compatible with stable inflation—are currently on the order of 8–10 percent for Germany, France, and Italy. Current projections for the year 2000 foresee only modest declines in unemployment in most European countries.

Current Policies. The twin problems of high unemployment and low job growth are a serious concern for European countries. Total spending on labor market programs has been equivalent to 3.5 percent of European GDP on average in recent years. Only one-third of this outlay has been used for active policies, such as job training, mobility, and placement. The remainder has been used to provide passive income support, such as disability payments or unemployment insurance. Some progress has been made in increasing labor market flexibility over the past decade. This includes provisions for more fixed-term contract workers in Germany, France, and Spain; less stringent rules for shift work in France and Finland; and easing of conditions for layoffs in France. Initiatives are under way to reduce the generous unemployment benefits that have become the norm in Europe since the end of World War II.

These labor market reforms, however, have done little to reduce Europe's high level of unemployment over the past decade or so. This failure, according to the authors, may reflect that only partial and incremental reforms have been implemented and that these reforms have not taken into account complementarities among unemployment policies. The authors also argue that an important group of labor market reform policies are complementary, in the sense that the effect of each policy reform is greater when implemented in conjunction with other reforms than in isolation.

Root Causes. While supply-side shocks and tight macroeconomic policies bear some responsibility for Europe's high rate of joblessness, the underlying cause derives from labor market rigidities. Such rigidities include job security legislation that makes it difficult to replace workers, barriers limiting the number of people who may qualify for certain professions, and high wages in a number of declining sectors. These and many other practices, maintain Coe and Snower, discourage the unemployed from seeking new positions and make employers equally disinclined to hire them. European labor market institutions insulate incumbent workers from the forces of supply and demand, with the result that the unemployed end up being effectively disenfranchised from the wage bargaining system. All of these tend, in turn, to make wages even less responsive to market

European Employment Trends
(1970 = 100)



[1] Excluding Greece, Luxembourg, and Portugal. Real GDP, capital stocks, and real compensation are calculated using purchasing power parity-based weights.
[2] The increase in employment in 1991 is due largely to the unification of Germany.

Data: OECD, *Analytical Data Bank*; and IMF staff estimates forces. In addition to these difficulties, strict seniority rules and other such barriers place formidable obstacles in the way of job creation and prolong unemployment, according to the IMF study.

Coe and Snower cite the following examples where European labor market reforms have been ineffective, or may even have made matters worse because of the absence of reforms linked to complementary policies:

• In the Netherlands, the statutory minimum wage was reduced or frozen in 1994 to increase employment among lower-skilled workers. This action was largely nullified, however, because the government did not curtail the automatic extension of wage agreements between unions and employers to cover other workers. As a result, real wages of lower-paid employees in the Netherlands continued to increase at about the same pace as the private sector average, even though their unemployment level was roughly twice the overall rate.

• In 1984, Spain attempted to promote greater wage flexibility by introducing fixed-term labor contracts, including provisions that lowered the costs of laying off workers. Such steps might have helped Spanish firms, which face some of the strictest job security regulations in Europe, adjust more rapidly to changes in market demand—but only if the move to more flexible, fixed-term contracts had been matched by similar efforts to loosen the stringent job security guarantees protecting people with permanent contracts. This did not happen. Failure to undertake both actions simultaneously, say Coe and Snower, had the "perverse effect" of contributing to less wage flexibility and higher rates of unemployment in Spain.

• In the late 1980s, Sweden initiated a program to accelerate the re-entry of the unemployed into the workforce through a combination of reduced benefits and job counseling and training. These efforts were largely frustrated because the government did not implement parallel regulations preventing people from filing for new unemployment benefits at the expiration of state-supported job training programs. Such institutional barriers help explain why Swedish unemployment grew so rapidly after the adverse shocks of the early 1990s and why it has remained high since then.

Throughout Europe, ad hoc, uncoordinated efforts to restructure passive income support or disability programs have yielded only modest results. These programs and other welfare-state benefits often function as alternatives to, or extensions of, unemployment benefits. Thus, reforming one program—such as unemployment insurance—while leaving another intact—such as disability benefits—will do little to encourage job search or reduce long-term dependency, Coe and Snower conclude.

A Comprehensive Approach

In place of these ad hoc, isolated approaches, the IMF study encourages European countries to adopt a more comprehensive strategy to reduce European unemployment—that is, reforms that are simultaneously broad (covering a wide range of complementary policies) and deep (of substantial magnitude).

Distributional Consequences. The authors emphasize that broad-based labor market reforms will be politically feasible only if they incorporate measures to address the equity or income distribution objectives that may have been the initial rationale for many current labor market policies. They argue that a negative income tax, made conditional on employment or job search requirements, is a more efficient means of achieving governments' equity objectives than the current system of labor market regulations and passive income support. Although there is clearly no one-size-fits-all labor market reform, a hypothetical program relevant to many European countries might consist of the following elements:

• Replace passive income support measures with a negative income tax that is conditional on employment or job search to achieve distributional objectives—with fewer adverse effects on incentives and employment; such a tax could be coupled with a substantial scaling back of existing measures of passive income support.

• Cut payroll taxes, particularly for low-wage employees.

• Liberalize job security laws to encourage the hiring of workers while easing conditions for layoffs.

• Reduce wage rigidities.

• Increase incentives for the acquisition and provision of training, including rules that will allow the unemployed to transfer benefits for training vouchers.

• Lower search costs by increasing job mobility and pension transferability.

Copies of IMF Working Paper 96/93, *Policy Complementarities: The Case for Fundamental Labor Market Reform*, by David T. Coe and Dennis J. Snower, are available for $7.00 from Publication Services, Box XS600, IMF, Washington, DC 20431 U.S.A. Telephone: (202) 623-7430; fax: (202) 623-7201; Internet: publications@imf.org