

INTERNATIONAL EXPERIENCES ON LABOR MARKET REFORMS

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Introduction

It is only recently that the institutional characteristics of an economy and, particularly, institutional features of the labor market have been recognized as potentially important determinants of labor market outcomes. Paul Krugman, for instance, suggested in 1993 that “the level of employment is a macroeconomic issue, depending in the short run on aggregate demand and depending in the long run on the natural rate of unemployment, with microeconomic policies like tariffs having little net effect”.

In the meantime, such a view has lost practically all its currency. New developments in microeconomic theory and particularly in the theory of the labor market (e.g. incorporating matching, searching, signaling, shirking), as well as a large number of empirical studies, have shown that institutional (sometimes called ‘structural’) features of the economy and the labor market are key determinants – or at least important co-determinants – of economic growth and satisfactory labor market outcomes.

This article looks at the effects of labor market institutions and their reforms on employment outcomes by reviewing the results of systematic international empirical studies, mainly about European countries. The last section summarizes the main findings and draws conclusions for a Croatian labor market reform policy.

International comparisons of labor market institutions and their reforms

The following section presents stylized facts about the findings of econometric studies conducted in the past

10 years, including two meta studies. The meta studies comprise the results of altogether more than 100 country-comparative econometric studies.

General institutional reforms and employment outcomes

The most important determinants of per capita growth are general institutional characteristics – such as political stability, respect of property rights and administrative quality. The system and rates of individual and corporate taxation also play an important role.

General structural reforms which clearly define and increase the range of options market participants have at their disposal, combined with specific reforms of labor market institutions, lead to positive outcomes also in the labor market. Empirical evidence does not support the view that such reforms result in an overall destruction of jobs, higher inequality and more poverty. Quite the contrary. One reason is that simultaneously implemented general and labor market reforms reinforce each other’s positive effects. Another reason is that institutional reforms of the labor market impact not only directly but also indirectly (*via* the effects of the reforms on economic growth) on labor market outcomes.

Labor market institutions and their reforms: effects on employment outcomes

A large majority of the empirical studies analyzed come to the conclusion that employment, job creation and job re-allocation are negatively associated with the size of the tax wedge, the size of unemployment benefits, the duration of benefits, the level of the minimum wage and a dominance of open-ended contracts. Higher labor market flexibility turns out to be advantageous for the workers and the economy, at least in the medium- and long-run, but not necessarily in the short-run, particularly during a crisis.

The between-countries difference in the flexibility of labor market institutions suggests that a higher labor market flexibility is associated – at least after a period of adjustment – with a significantly better response of



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labor markets when the economy is hit by external shocks. By contrast, lower labor market flexibility is associated not only with higher unemployment but also with a less labor-intensive production and a higher ‘employment threshold’ (i.e. a higher rate of economic growth needed to keep employment at least stable).

In order to assess the impact of external shocks on labor market performance it is also important to differentiate between the short- and the medium- to long-run perspective. The short-term negative impact of external shocks on employment is larger in countries with more flexible labor markets, while the medium-term effect is larger in countries with more rigid labor markets. Labor market rigidity tends to leave young workers unemployed in relatively greater numbers than older workers. This implies that an increase in labor market flexibility favors younger workers relative to older workers.

While the effects of a flexible labor market have been practically unanimously found to be positive for labor market outcomes, the evidence for the effects of union density and the degree of centralization of the wage setting process on labor market results is less clear. The reason is that both highly decentralized and of highly centralized wage settings can produce socially efficient results. An efficiency problem often arises in the intermediate situation where (small) unions have the power to protect their own workers but are not large enough to take account of the wider economic and social consequences of their actions.

A politically viable reform of the labor market is often characterized by the notion of ‘flexicurity’. It consists of a combination, on the one hand, of a liberal employment protection legislation (*flexible*, i.e. not much individual protection against dismissal) and a policy of generous unemployment benefits (*secure*) with strong activating labor market policies on the other hand. This type of ‘smart’ policy reduces political opposition from the direct and short-run losers of reform by offering them generous benefits and a better reemployment outlook.

Two-tier reforms of employment protection

While the empirical evidence about the effects of labor market institutions suggests that increasing the share of fixed-term contracts and reducing that of open-ended contracts finally leads to more, not less employ-

ment, it is politically difficult to implement such a reform due to the impact on incumbent employees who work under open-ended contracts.

A solution for this problem has been found in a less radical procedure which is called a ‘two-tier’ reform. Such a reform of employment protection legislation enables firms to offer fixed-term instead of open-ended contracts – but only to additional workers, leaving the position of incumbent workers with open-ended contracts unchanged (a reform on the margin, and not on the core of existing contracts). Political resistance against a full-fledged reform of employment protection (liberalizing the core, i.e. the existing open-ended contracts) has led many European governments to pursue such a more limited aim.

Whether a reform on the margin can later be extended to a reform of the core seems to depend crucially on the relative proportion of workers with temporary and with open-ended contracts. In Europe, only Spain has so far been able to proceed from a marginal reform of employment contracts to a reform of their core, thanks mainly to the fact that the share of incumbent workers with open-ended contracts had over the years dropped to less than 50 percent of the total active population.

Effectiveness of active labor market programs

Active Labor Market Programs (ALMP) are generally associated with lower unemployment. However,

- program costs are often unknown and make even a crude cost-benefit analysis impossible;
- short-term effects of ALMP are often insignificant or even negative;
- many programs exhibit significantly positive effects only after two to three years; and
- significant effects of ALMP can be best expected from incentives and penalties.

Job-search assistance belongs to the least costly ALMP programs and has been found to be of significant impact on job-finding rates and on unemployment duration. By contrast, training – and particularly classroom training – has proven to be less effective, at least in the short term. Classroom and on-the-job training programs generate positive effects only after some years. Training most often has positive effects on re-employment and wage prospects, but the effects are of limited size. Training often is more effective when

provided within firms and in connection with counseling, start-up support and wage subsidies. A broadly-based vocational educational training is vital for the employability of young workers. Such systems, however, differ widely in Europe, making it difficult to provide easy orientation for a reform.

Public works programs seem to be the least effective type of ALMP in terms of increased long-term employment prospects. Still, during periods of mass unemployment, temporary works programs targeted to persons of low employability may be useful for mitigating income loss and maintaining a link to the labor market.

Conclusions

There is overwhelming evidence for significant effects of the institutional design of labor markets on labor market outcomes. The evidence comes both from theoretical insights and numerous empirical studies. Labor market reforms introducing more flexibility improve labor market outcomes, particularly in the medium- and long-run. However the interactions of the different elements of labor market institutions and the transmission channels from institutions to outcomes are complex and country-specific. Thus, there is no general blueprint for labor market reforms. The country-specific background and context is decisive for designing reforms of labor market institutions – and of other institutions as well. This is all the more so as economic policy reforms, and particularly reforms of the labor market, are politically highly sensitive.

A combination of policies – increasing labor and product market flexibility, as well as macroeconomic policies aimed at reducing macroeconomic volatility – has proved to be particularly efficient in enhancing employment responses to growing economic activity.

Policy proposals for labor market reforms in Croatia

Whenever a nominal currency devaluation to regain international competitiveness is politically unfeasible, an internal devaluation entailing a reduction of wages and prices in the whole economy becomes unavoidable. In such cases, it is best to start by cutting wages in the public sector and by enhancing productivity. Another, less painful, possibility is the prolongation of working time. This can take different forms: increase of daily, weekly or monthly working time, re-

duction of public holidays, or of days of annual paid leave.

To win public support, particularly during the difficult initial years of such a reform, such a program must be

- comprehensive, i.e. it must comprise measures on the macro level, on the micro level and in all sectors;
- socially justifiable, i.e. there should be no pure winners and no pure losers of the reform; unavoidable social hardship must be at least mitigated;
- pre-announced, so that workers, enterprises, banks and social funds can start early and adapt more quickly to the reforms.

Reforms of labor market institutions must be an important part of the reform package. Croatia's labor market institutions compare unfavorably with those of its peers, calling for their urgent reform. Reform packages of the labor market can aim to reduce political resistance through 'flexicurity' and by 'two-tier' reforms. Flexicurity combines a liberal (i.e. low) employment protection against dismissal with generous unemployment benefits. Two-tier means that firms are allowed to offer fixed-term contracts – but only to additional workers. The open-ended contracts of the incumbent workers are unaffected. Restrictions on fixed-term labor contracts should be eased. In the long-run, open ended and fixed-term contracts should be made more similar in terms of severance pay and duration. Chaining of fixed-term labor contracts should be permitted.

Labor disputes should be resolved not in the normal courts, but in a separate system of tribunals and arbitration. Tripartite agreements (government, unions, employers) can make more competitive (i.e. lower) wages politically easier, particularly when public sector wage cuts are carried out. Enterprises should have the right to opt out of centralized wage agreements. Wage subsidies should be preferred to an increase in minimum wages. Contractual wage scales should allow for suitable pay differences between young and more experienced workers.

Active labor market policies should be an integral part of a labor market reform program. The participation of unemployed workers in such measures should be obligatory. Job search assistance should be a preferred way of performing an ALMP, because it is cost-effective and has been found to have a significant impact

on job-finding rates and on unemployment duration. Training is often more effective when provided within-firm and in connection with counseling, start-up support, and wage subsidies. Temporary public jobs programs should be introduced during periods of mass unemployment, targeted to persons of low employability, since they are useful in mitigating income loss and maintaining the link to the labor market.

Reference

Krugman, P. (1993), "What Do Undergrads Need to Know about Trade?", *American Economic Review*, 83(29), 23–26.