

The political economy of labour market reform

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The high and persistent unemployment in most Western European countries has provoked an intensive discussion of possible cures. By and large, there seems to have emerged a fair amount of consensus among economists. It is widely agreed that unemployment is mainly structural and that no single policy measure is likely to solve the problem. Instead, a *broad programme* that encompasses several measures seems to be required (see, for example, Alogoskoufis et al., 1995; Lindbeck, 1996; Calmfors et al., 1997; Calmfors, Manning and Saint-Paul, 1998; and Modigliani et al., 1998). Such “multi-handed” labour market reforms are likely to include both “deregulations” (for example, less generous unemployment insurance, liberalisation of employment protection legislation and lower minimum wages at least for some groups), and “soft policies” (for example, better training of the labour force, activation of the long-term unemployed and tax cuts to increase work incentives especially for low-income groups). To the extent that such supply-side policies make labour markets more flexible, the scope for more expansive monetary and fiscal policy is increased, as inflationary pressures become smaller.

Although recommendations of the above type have become standard, not least from organisations such as the OECD and the IMF (see, e. g., OECD, 1994), few Western European countries have embarked on broad reform programmes. And very little has been achieved in terms of reducing unemployment in countries such as Belgium, France, Germany, Italy, Spain, and Sweden. Effective measures to combat unemployment have so far proved to be politically impossible in these countries.

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So it is not enough to analyse the economic consequences of various employment policies if one wants to understand the causes of unemployment and find effective cures. It is as important to understand the political preconditions for successful employment policy. This is the theme of the *political economy* of unemployment. This line of research analyses the conflicts between, on the one hand, the goal of high employment and, on the other hand, goals such as an even income distribution, income insurance, job protection, etc. It usually stresses how employed insiders may oppose labour market reform, because this might reduce their real wages (e. g., Saint-Paul, 1996). The focus is on issues such as the preconditions for achieving popular support for employment programmes, the appropriate timing and sequencing of various policies regarding both business-cycle conditions and elections, and how various policies can be combined to minimise goal conflicts and maximise the chances of success.

The articles in the volume

This volume of the *Swedish Economic Policy Review* contains four papers that were presented at the *Economic Council of Sweden's* conference on "The Political Economy of Labour Market Reform" in Stockholm on May 25, 1998. The papers deal with these four main issues:

- The actual experiences of employment policies in various OECD countries
- The extent to which high unemployment in itself leads to self-reinforcing political mechanisms that make it more difficult to fight unemployment
- The extent to which various economic and political complementarities exist, i.e., whether the economic effects of various policies reinforce each other and therefore may increase the chances of gaining political acceptance for reforms
- How supply-side and demand-side policies to fight unemployment are likely to interact with each other

A few OECD countries have managed to reduce unemployment substantially, although most have failed to do so. An analysis of the actual experiences of employment policies in various countries is therefore a natural starting point for a discussion of the political economy of labour market reform. In their article "Key lessons for labour market reforms: evidence from OECD countries' experi-

ences”, **Jørgen Elmeskov**, **John Martin** and **Stefano Scarpetta** from the OECD examine the track record of the *successes* and the *failures* and discuss the policy implications. The OECD's policy recommendations are often influential and invariably receive a lot of attention in the member countries. So the contribution by Elmeskov, Martin and Scarpetta serves also as an illustration of the research methodology behind the OECD's recommendations.

The article contains a classification of the OECD countries based on the development of the *non-accelerating wage rate of unemployment* (NAWRU), i. e., the rate of unemployment at which wage inflation remains constant, during the 1990s. The countries were split into three groups: (1) countries where structural unemployment, as proxied by the NAWRU, has significantly increased; (2) countries where structural unemployment has remained basically the same; and (3) countries that show a significant decrease in structural unemployment. By pooling time-series and cross-country data, the authors carry out an econometric analysis of the determinants of actual unemployment. According to the results, the generosity of unemployment benefits, the size of the tax wedge, the strictness of employment protection legislation and institutional factors, such as the extent to which wage bargaining is co-ordinated, appear to be important determinants of unemployment, whereas there is more of a question over spending on active labour market policies.

The authors point out that most of the countries that have managed to significantly reduce structural unemployment (Australia, Denmark, Ireland, the Netherlands, New Zealand, and the UK) have implemented broad policy packages that involve most of the above areas, whereas the failures (among them Belgium, Finland, France, Germany, Italy and Sweden) have not. They also discuss the political contexts in which labour market reforms have been possible. The analysis suggests that comprehensiveness of reforms may help to compensate the losers from individual policy measures and this way make reforms politically more acceptable.

A key question is which political mechanisms tend to block labour market reform. In “The political consequences of unemployment”, **Gilles Saint-Paul** argues that unemployment is self-reinforcing, because high unemployment increases the political support for rigidities in the labour market.

Saint-Paul discusses three channels through which badly functioning labour markets may lead to unfavourable political decisions.

- Unemployment may weaken the mechanisms for transmitting productivity gains into wage growth. This gives incumbent employees (the insiders) stronger incentives to use collective action to ensure that the rents from productivity increases accrue to them. The prediction is that labour should be more willing to engage in political conflict to protect the institutions that support high real wages (minimum-wage provisions, employment protection legislation, collective agreements) in times of high unemployment.
- Supply-side shocks to the economy, for example, more aggressive unions, higher minimum wages or stricter hiring and firing regulations, will not only raise unemployment, but also the rents that accrue to the employed insiders. These higher rents will in turn increase the interest of labour in defending the institutions that uphold them. So changes in labour market institutions that raise unemployment will, in this way, tend to create constituencies dedicated to preserving them.
- High unemployment also creates stronger incentives for labour to block changes in policy that generate job re-allocation across sectors. The explanation is that high aggregate unemployment means larger unemployment risks for workers who are laid off in stagnating sectors. This argument may apply especially to reductions of the size of the public sector.

Saint-Paul also argues that the incentives for a large public sector as a “soft” employment policy will be much stronger in economies with rigid labour markets (such as Denmark, France, Germany, and Sweden) than in economies with flexible labour markets (such as Japan, New Zealand, Switzerland, the UK, and the US).

As noted above, a common characteristic among the OECD countries that have been successful in reducing unemployment is the comprehensiveness of labour market reforms. In their article “Anatomy of policy complementarities”, **Mike Orszag** and **Dennis Snower** attempt to explain why broad-based reform programmes may be more effective than isolated measures against unemployment. The analysis suggests that there are important economic and political *complementarities* between various types of labour market reform.

Economic complementarities imply that the effectiveness of a particular policy depends on the implementation of other policies. Orszag and Snower focus on the interaction between tax policy and

unemployment benefit reform. They stress the implications for both workers' and employers' search behaviour. A tax cut will reduce unemployment to the extent that employers find it more profitable to provide jobs, while the unemployed gain more from search because the probability of finding a job goes up. A reduction in the unemployment benefit will increase the rewards from job search. When the unemployed search more, vacancies will be filled at a faster rate. Shorter vacancy durations reduce hiring costs, which in turn stimulate employers to post more vacancies. The main argument in the Orszag and Snower article is that the unemployment-reducing effect of a given tax cut will be larger in the presence of a cut in unemployment benefits, and vice versa. The explanation is that "the firms' search for workers reinforces the workers' search for jobs, and vice versa". The authors also argue that similar complementarities between benefit and tax cuts may work via their effects on employees' work effort and employers' retention decisions.

A key point in the paper is that the economic complementarities may also lead to political complementarities. If attempts at reform are piecemeal, there are likely to be large groups of losers who will oppose the reforms. But with broad reform programmes that exploit the economic complementarities, the possibilities to compensate potential losers increase. This may make reform politically feasible.

Orszag and Snower illustrate their reasoning by examining the potential conflict of interest between employed insiders and unemployed outsiders as regards unemployment benefits: in general, the former prefer lower unemployment benefits and thus also lower taxes than the latter. But although lower benefits would benefit the political majority of insiders, the minority of unemployed outsiders may be able to block such a change because of the value attached to consensus in most democratic societies. However, expanding the programme of reform to more areas, for example, by introducing hiring subsidies might break the political deadlock, because they represent a welfare gain for the unemployed—a greater chance of employment—which can compensate for the benefit reduction. At the same time, hiring subsidies may increase the gains for the employed, because taxes can be reduced more when hirings increase and the expenditures on unemployment benefits thus fall.

Charles Bean applies a broad macroeconomic perspective in his article "The interaction of aggregate-demand policies and labour market reform". His analysis suggests that the feasibility of supply-

side labour market reforms depends on the fiscal and monetary policy environment. For example, a change in the macroeconomic policy regime, e. g., the introduction of the euro, is likely to affect the possibility of labour market reform.

Bean argues that mildly accommodating monetary and/or fiscal policy is the most suitable macroeconomic environment for labour market reform. The reason is the real-wage reductions that labour market reform will ultimately entail may take a long time to achieve in a situation with *very low inflation or deflation*: to the extent that the money-wage level (or money-wage growth) is rigid downward, the speed of real-wage adjustments becomes lower when real wages cannot be reduced through price increases. So demand policy must see to it that inflation does not become too low.

Bean focuses on how participation in the EMU is likely to affect the chances of labour market reform. He distinguishes between the *economic incentives* to undertake reforms and their *political feasibility*. As to the economic incentives for reform, Bean concludes that arguments run both ways. On the one hand, the loss of domestic monetary policy as a stabilisation policy tool may strengthen the incentives for labour market deregulations in order to increase money-wage flexibility. And to the extent that monetary integration increases competition, the location of firms' activities is likely to become more sensitive to wage-cost differences between countries. This will also create more pressure for labour market reform. But on the other hand, there may be a smaller probability of reform inside the EMU than outside, because each country has a weaker incentive to lower structural unemployment in order to reduce the temptation to inflate when there is a common monetary policy.¹ Moreover, the pressures for labour market reform in order to help fiscal consolidation may subside once the EMU has started.

Although Bean remains rather agnostic regarding the effect of the EMU on the economic incentives for reform, he argues that monetary union will make it politically more difficult to achieve reform.

¹ This is the hypothesis of Sibert and Sutherland (1997) and Calmfors (1998), who employ a Barro-Gordon (1983) model, in which the temptation to inflate in order to reduce unemployment is greater the higher equilibrium (structural) unemployment is. The argument is that labour market reform in each country has only a small effect on equilibrium unemployment in the euro area and hence on the temptation of the European Central Bank to inflate. In contrast, labour market reform in an individual country may have a large effect on the propensity to inflate when monetary policy is national.

The reason is that one can no longer co-ordinate national labour market reform with monetary policy when the latter is decided by the European Central Bank. Co-ordination of labour market reform and monetary policy in the EMU requires a common European employment policy as well, which does not appear likely. So reform will take a longer time to produce significant reductions of unemployment inside than outside the EMU. This is likely to make it more difficult to gain political acceptance for supply-side reform, because losers from it cannot then be compensated already in the short run through more job creation when monetary policy is eased. In addition, the demand for social protection may increase in the EMU when monetary policy can no longer help stabilise asymmetric shocks.

Areas for future research

Although the articles in this volume help illuminate several important political-economy issues, they also highlight our insufficient understanding of many other issues where there is a need for future research.

- Elmeskov, Martin and Scarpetta argue that economic crisis, such as a major hike in unemployment or exchange-rate pressures, may have created the preconditions for embarking on a path of broad reform in some countries. They also note that reform has often been associated with a change in government. But the authors are careful to point out that very similar conditions have prevailed in other countries that have not adopted reform programmes. So although we may have learned something about the *necessary* conditions for reform, we certainly have learned much less about the *sufficient* conditions.
- The idea that reform programmes should exploit *economic complementarities* between different policy measures, which is expounded by Orszag and Snower, has recently received a lot of attention. But as pointed out by Bertil Holmlund in his comment, the empirical support for the importance of such complementarities is very limited so far, although Elmeskov, Martin and Scarpetta produce some results suggesting that complementarities do matter. So it is very hard to evaluate how important economic (and thus also political) complementarities in fact are. It is also clear that identifying complementarities (i. e., that the effect on unemployment of a change in one policy variable is magnified by the change in another policy variable) is much more demanding on a

theory than just identifying in which direction a change in a certain policy variable will move unemployment.

- Bean provides an interesting discussion about the appropriate *timing* of various reforms in order to minimise political resistance. He argues that the generosity of unemployment benefits should be reduced at the bottom of a recession (because fiscal pressures for reform are greatest then and employed insiders are less concerned about unemployment benefits when unemployment begins to fall). Reductions in job security should be made during an upswing, when the rate of job destruction is at its lowest and the rate of job creation is at its highest. Reforms of wage-setting institutions should be made toward the end of an upswing (when market forces drive up wages anyway) or in an early downswing (when those in work are most threatened by the possibility of layoff). It is an intriguing question how these considerations go together with the argument that reform must be comprehensive so as to allow losers from individual measures to be compensated and the public to be convinced that the policy changes will have a considerable effect. Pursuing one reform at a time may also use up “political capital”: because politicians have a limited ability to handle many issues within a given time period, it may be more efficient to try to gain support for a broad reform programme at one occasion rather than to try to gain support sequentially for many smaller reform steps.
- The start of the EMU raises the question of whether co-ordinated employment policies at the EU level are desirable and feasible. One argument in favour of such co-ordinated reform is that inflation would be reduced in the entire euro area and thus make it possible for the ECB to support the reform programme through easier monetary policy. However, there are also many other aspects to consider. It could be that agreements on the European level might represent a “commitment technology” that makes it easier for policy makers to take a long-term view regarding employment policies. But it might also be the case that the decision-making process inside the EU introduces new distortions. For instance, governments may see EU agreements on employment policy mainly as a way to get international approval of the policies pursued domestically. If so, political blockings may be reinforced rather than mitigated on the EU level.

- A larger role for the EU in employment policy would also make it less clear to voters where the responsibility for labour market outcomes lies. This could weaken the incentives of governments to reduce unemployment. Moreover, there is the risk that attempts to co-ordinate reforms on the EU level will mean that too little attention is paid to the specific institutional conditions of individual countries. In a situation with great uncertainty about the appropriate mix of various measures against unemployment, it would also be a disadvantage if attempts at co-ordination would result in smaller possibilities of experimenting with different policies in different countries.

The central question in this volume is how large the possibilities are for politicians to fight unemployment in an effective way despite all the political constraints. Here, economists are a bit schizophrenic.

On the one hand, there is a tendency in the political economy of unemployment to view bad labour market outcomes as the necessary consequence of rational decision-making within the present system of political institutions. The upshot is that more successful employment policy would also require reform of political institutions, for example, longer election periods, to allow a greater role for more long-term considerations (although it is not clear why political resistance to such constitutional changes with the aim of making certain policies more viable should be less than to the policies themselves).

On the other hand, economists, such as those represented in this volume, expend a lot of effort in convincing policy-makers that they should choose certain strategies rather than others, because they are both economically and politically more viable. This does reflect a belief that well-informed and determined politicians can fight unemployment and deal with the present political constraints much more effectively than now. It is certainly true that politicians in most Western European countries could do much better than today in assessing the various policy options on the basis of available evidence, in trying to explain the trade-offs to the public, and in arguing for measures which they believe have favourable long-term effects even though they may have short-run costs.

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