Structural labour market reforms in Europe: timing matters

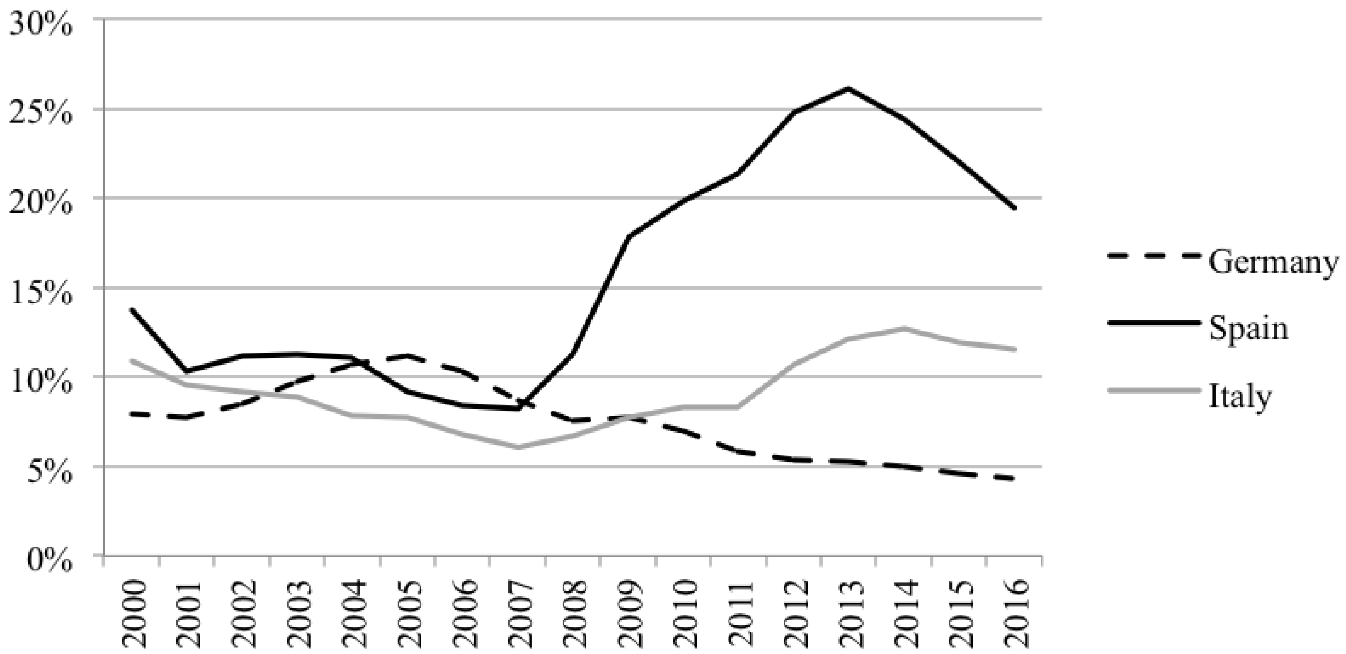
The German government implemented large-scale structural labour market reforms in the years 2003 to 2005 to fight high and upward trending unemployment rates (see Figure 1). The reforms aimed at increasing labour market flexibility, improving the matching of unemployed workers and job vacancies, and decreasing unemployment benefits and their duration. Ever since, the unemployment rate in Germany has almost steadily been falling, as also illustrated in Figure 1. Even the Great Recession, which led to an enormous decline in output, hardly affected the labour market in an adverse way.

In contrast, the labour markets in Italy and Spain experienced a very different development. Until the mid 2000s, unemployment rates were at similar levels compared to Germany. However, the trend in Italy and Spain was decreasing (see Figure 1), whereas unemployment was increasing in Germany at that time. Yet after the Great Recession hit, unemployment rates in Italy and Spain started to rise tremendously.

In Spain, unemployment peaked at more than 25 per cent in 2013. In Italy, unemployment rates have remained higher than 10 per cent from 2012 onward. In response, both Spain and Italy also implemented large-scale labour market reforms. The Spanish reforms in 2010 and 2012 flexibilised wage setting and reduced employment protection. Similarly, in Italy in 2012 and 2014/2015, employment protection was substantially reduced.

However, as of today the reforms in Spain and Italy were not followed by as positive effects on the labour markets as the German reforms. Unemployment remains high in these countries relative to pre-crisis levels. For a review of the reforms and their effects see among others the 2012 study by Samuel Bentolila et al. for Spain, the 2015 OECD study for Italy, and the 2016 studies by Sabine Klinger and Enzo Weber and Andrey Launov and Klaus Wälde for Germany.

Figure 1. Development of ILO unemployment rates (in %) in Germany, Italy and Spain from 2000 to 2016



***Source:* [*International Labor Organization*]**

Our recent study (chapter 5) shows that these different reform experiences can be attributed to the particular timing of the reforms. Labour market reforms that are implemented in times of economic crisis while demand is low have weaker short-run expansionary effects compared to reforms that are implemented when the economy is booming. Reforming during recessions may entail short-term costs even though the long-run effects are positive.

We obtain these results from an empirical time series model that identifies the effects of labour market reforms in good and bad states of the business cycle. There are two key types of structural reforms: components that affect the matching of unemployed workers and firms with job vacancies, and components that foster job creation at the firm level. Intuitively, the first component captures reforms connected to labour supply, whereas the second component relates more to labour demand. The econometric model framework is specified with regard to the established search and matching theory. Intuitively, we interpret the components not explained by the business cycle and by direct economic relationships in terms of unemployment, vacancies, productivity and wages as the impact of policy, i.e., reforms.

The case of Germany offers a unique setting for the study: First, Germany has experienced large labour market restructuring in recent years. Second, Germany provides very detailed and high-quality labour market data. The results on German data for the last 30 years show that reforms that improve the matching process have indeed substantially weaker effects in recessions than in expansions. In extreme cases, the positive effects of structural labour market reforms are completely offset in the short run if implemented in recessions. For reforms in job creation, the dampening is less pronounced. Notably, the results are not specific to Germany. Estimates on data for Spain confirm that comparable asymmetries exist in the Spanish labour market. This similarity is remarkable given that the aggregate performance of the Spanish economy in terms of up- and downturns and the development of the unemployment rate was very different compared to Germany. In Spain, the dampened reform effect in recessions turns out to be more pronounced in terms of job creation intensity.

An alternative approach to measuring reforms is by using observed indicators of labour market regulation. Examples include replacement rates in case of unemployment benefit receipt, or indices of employment protection legislation. While these indicators have the advantage of clear interpretability, our new identification resolves some of the difficulties connected to them (e.g., measurement of the strength of the reform and timing). Further, the indicators capture only a limited part of legislation. In contrast, our new identification of reforms provide a big picture of reforms. Nevertheless, when comparing the unobserved reform components to observed indicators we find considerable co-movement. Reforms in matching efficiency and job creation intensity occurred in periods when substantial structural changes as measured by the employment protection indices or the replacement rates of the OECD took place.

The results of our empirical study establish a strong interaction of the business cycle and structural labour market reforms: Reforms affecting labour market mechanisms turn out to be less effective in recessions. Interestingly, the optimal timing of labour market reforms is thus the opposite compared to what is often found for fiscal policy. Expansionary government spending or tax cuts directly stabilise demand in economic downturns and can be more beneficial in recessions. Britta Gehrke and Brigitte Hochmuth document the same in the context of the labour market policy short-time work.

In contrast, implementing reforms to alleviate crises turns out to be a costly policy. Even though long-run effects of structural reforms are beneficial, the short-run costs may erode the public support for such reforms and even worsen the crisis. From a political economy point of view, these findings provide both a negative and a positive conclusion. On the negative side, they explain the reluctance of governments in crisis countries to conduct reforms. The adverse short- to medium-run effects disincentivise such a strategy. However, the results also show that outside recessions, positive reform effects may materialise much quicker and can encourage public support of unpopular reforms.

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Notes:

- *This blog post is based on the author's article "Reforming the Labor Market in Good and Bad Times: Any Differences" in N. Campos, P. De Grauwe and Y. Ji (eds) The Political Economy of Structural Reforms in Europe, Oxford University Press, 2018.*
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Britta Gehrke is assistant professor of macroeconomics and labour market research at the Friedrich-Alexander University Erlangen-Nürnberg (FAU), and the Institute for Employment Research (IAB). Her research interests are applied quantitative macroeconomics and econometrics; business cycles, fiscal and monetary policy; and labour economics.

Enzo Weber holds the chair of empirical economics, in particular macroeconometrics and the labour market, at the University of Regensburg. He is head of the research department's forecasts and macroeconomic analyses at the Institute for Employment Research (IAB). He is also a research fellow at the Institute for East and Southeast European Studies (IOS), as well as a consultant and research affiliate of BE Berlin Economics.