››› Euro area labour markets: reform successes are a good signal for employment

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The labour markets in the euro area perform an important function. In the absence of national exchange rates, they need to absorb a large part of the pressure of adjusting to asymmetric shocks. Well-functioning labour markets ensure that these adjustments run smoothly, and the less coordination and equalisation exists between the members of the union, the more crucial they are to the success of the euro area.

An international comparison of developed economies shows that the labour markets of the large euro area economies are highly regulated. They are characterised by extensive dismissal protection, little flexibility at employer level, and dual structures. France, Italy and Spain, in particular, have charted the right course and addressed weaknesses through their reforms between 2012 and 2016. Initial successes are already visible. But many measures require more time to be able to become fully effective, and weak points also remain. So it is too early for them to rest on their laurels.

Functioning of labour markets

The role of labour markets in a currency union

In the euro area, labour markets play an important role. Asymmetric shocks will occur here from time to time, such as crises that appear suddenly and affect only parts of the currency union. The introduction of the euro eliminated national exchange rates as a mechanism for adjusting to such shocks. Prices, wages and working hours therefore have to respond to changes in economic conditions even more strongly than before.

However, wages in particular tend to exhibit inertia, that is, they respond more slowly to a changed economic environment. This strengthens social cohesion but delays necessary adjustment processes when regulations on working hours are not sufficiently flexible. Dismissal is then often the only option. Well-functioning labour markets in the member states of a currency union are therefore important to enable adjustments to regional distortions with little friction and limit increases in unemployment. At the same time, economic policy has to meet various needs. After all, efficiency cannot be the sole objective in the European system of values. Appropriate social protection must also be ensured for those whose incomes decrease or whose job search remains unsuccessful.

Rigid labour markets in the euro area

Compared with the OECD overall, the labour markets in the four largest euro area economies – Germany, France, Italy and Spain – are highly regulated. For example, employees enjoy above-average dismissal protection. The OECD quantifies this with the aid of its "strictness of employment protection index". It evaluates legal norms and collective agreements and measures the cost of firing employees. The most recent available value for 2013 is 2.45 across the average of the large euro area countries compared with 2.04 for the OECD, where high values reflect pronounced dismissal protection. The value for the very flexible US labour market, in turn, is a mere 0.26.

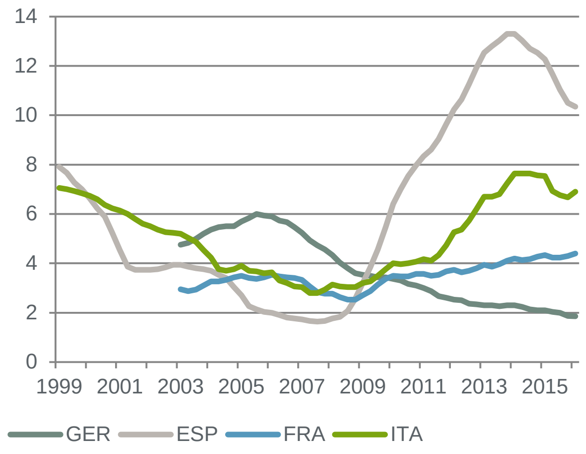
Dismissal protection benefits employees as a form of insurance and is desirable from a social-policy perspective. At the same time, it prevents rapid mass layoffs in times of crisis and thereby contributes to preserving human capital. Far-reaching dismissal protection also has negative economic consequences, however, because it raises the barriers for new hiring. In the recovery phase after a crisis it may cause businesses to be more careful in creating jobs, and a positive cyclical development may take longer to show on the labour market. In this way, firms and economies lose part of their flexibility and cannot respond as effectively to changing conditions.

A pronounced insider-outsider problem

Dismissal protection also involves what is referred to as the "insider-outsider problem". Legislation protects persons who are successfully established on the labour market while it discriminates against persons without access to the labour market. This contributes to structural unemployment. The development of the long-term unemployment rate, that is, the rate of job-seekers who have been without employment for at least one year as a percentage of the total workforce, shows how protracted the process of reducing this structural unemployment can be – especially in Germany and Italy (Figure 1). Thus, the long-term unemployment rate in Germany did not start to drop significantly until 2007, when the economic cycle was already at its peak and the financial crisis was imminent. The financial crisis had hit the Spanish economy particularly hard, leading to a massive increase in the long-term unemployment rate. The trend did not reverse until 2014, when the economy began to recover and a labour market reform was introduced.

Figure 1: High long-term unemployment rate in Spain

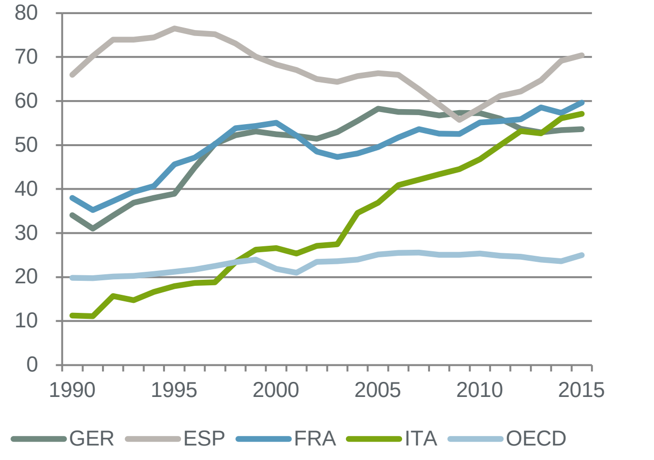
Smoothed long-term unemployment rate (>1 year), in per cent



Source: Eurostat

Figure 2: More temporary jobs than the OECD average

Persons in temporary employment as a percentage of all workers, 15–24 years



Source: OECD

Businesses respond to the reduced flexibility imposed by rigid labour market regulation by hiring workers on temporary contracts. This benefits unemployed workers while businesses preserve part of their flexibility. But at the same time, this practice merely places the obstacles in front of the temporary employees who continue struggling to move into permanent employment. Temporary employees also have less long-term planning certainty and less incentive to undertake professional development and build company- and occupation-specific human capital. The consequence is weak productivity growth.

The proportion of temporary employees among younger workers is particularly high in the four large euro area countries. Across the average of the OECD member states, one in four of the 15 to 24-year-olds are on temporary employment contracts, while in the euro area countries that quota is now between 55 % and 70 %, and rising (Figure 2).[1] The lower proportion of permanent employment relations is in line with the above-average employment protection in these countries. The correlation coefficient between the “strictness of employment protection index” and the proportion of temporary employment contracts is 0.57 in the OECD countries.

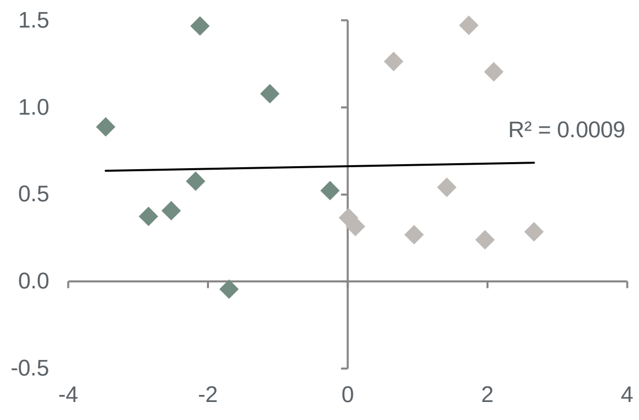
Wages do not respond to cyclical movements

Where businesses lack the flexibility to respond to a changed economic situation by laying off and hiring workers, wages might help them to adjust. But these, too, are rigid on the European labour markets and contribute little to prevent a rise in unemployment during times of crisis, for example. Wage development in the euro area is virtually unresponsive to cyclical changes. Real wages per employee fell in only a single year between 1999 and 2015. Measured by the output gap, on the other hand, the cyclical situation was poor during a period of eight years, for example consistently since 2009 (dark points in Figure 3). The complete absence of a correlation between economic output and wages additionally hampers adjustment on the European labour markets. At the same time. rules on working hours are very inflexible and cannot facilitate necessary corrections either.

Greater responsiveness of wages would mean that salaries would have to rise faster than before in strong business cycles in which there is greater scope for distribution. This would also permit a revival of consumption. Wage growth should be more moderate during weak business cycles. This could assist businesses in becoming more competitive and lead an economy more quickly out of recession.

Figure 3: Wages are unresponsive to crisis or recovery

X-axis: Output gap euro area 1999–2015, per cent of potential GDP
Y-axis: Real wage per euro area employee 1999–2015, in per cent yoy



Source: Ameco

Criteria for assessing labour markets

In addition to these empirical indications, various institutions assess and quantify the functioning and flexibility of labour markets. The most widespread is the approach used by the World Economic Forum.[2] It determines the competitiveness of economies around the world on the basis of twelve pillars in the “Global Competitiveness Index” (GCI). These include innovative capacity and quality of institutions as well as efficiency of labour markets, among others. Ten indicators were used in the most recent annual edition to assess the competitiveness of labour markets. They comprise directly measurable parameters such as the level of dismissal costs measured in weekly wages and labour market participation of women. But the core criteria for assessing labour markets include criteria that are difficult to quantify and often involve legal or behaviour-related aspects determined in surveys.[3] Among them are legal conditions for recruitment and dismissal, the willingness of employers and employees to cooperate with each other, flexibility in wage setting, the tax burden on labour, the relationship between pay and productivity, the level of nepotism, and difficulties in finding skilled employees on the one hand and attracting foreign labour on the other hand.

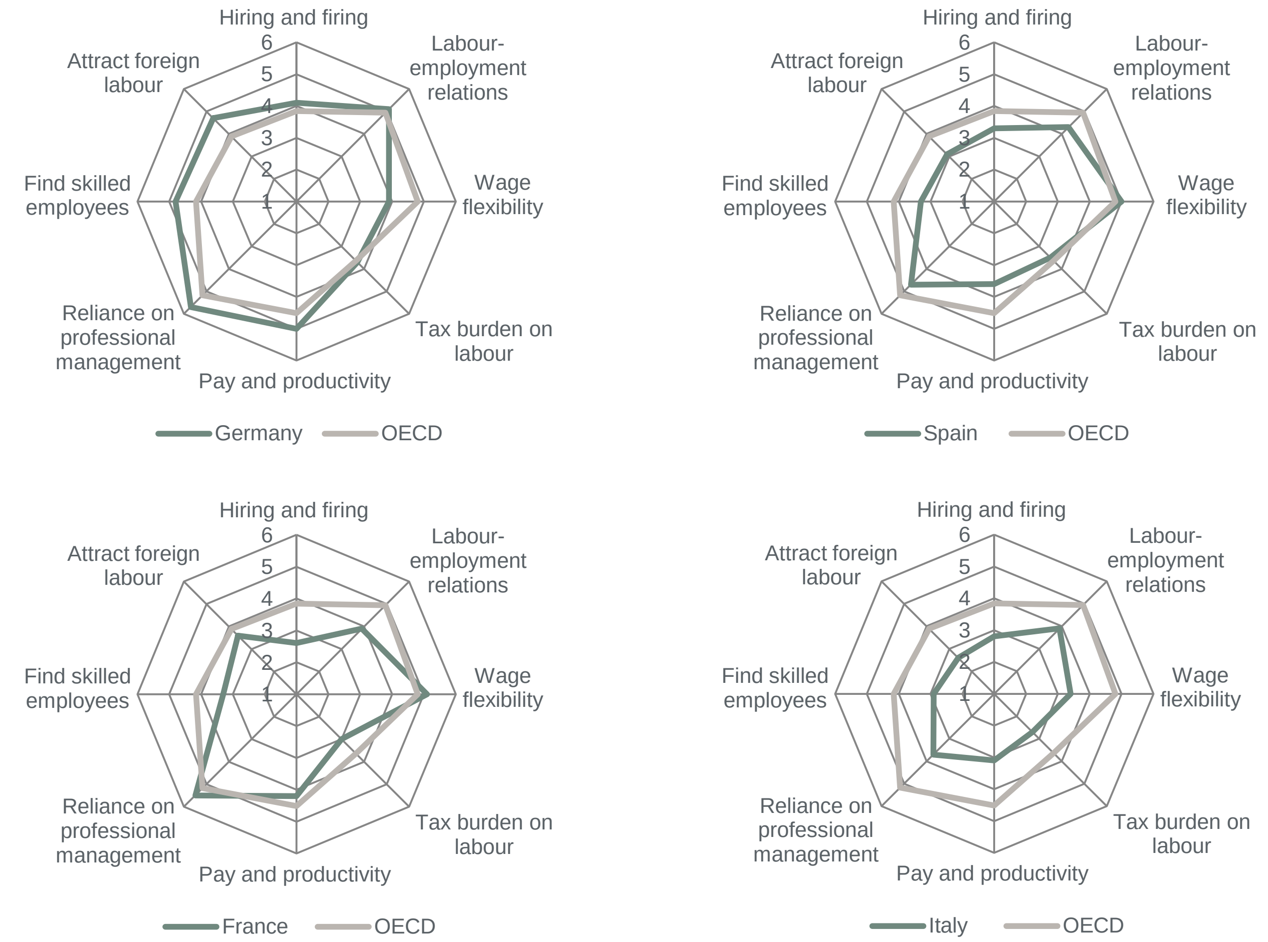
The results obtained for the four economies examined in this paper differ substantially. On the efficiency scale thus defined, according to the World Economic Forum the German labour market ranks 22nd worldwide, France 51st, Spain 69th and Italy 119th, which is far below the OECD average (Figure 4).

Since the reforms of the last decade, Germany's labour market has exhibited several strengths. According to GCI surveys, the conditions for hiring and dismissals in particular have improved over a good ten years. But there are still weaknesses in Germany as well. The wage bargaining process, for example, is still excessively centralised in international comparison.

According to the World Economic Forum, potential for increasing labour market flexibility and efficiency remains, especially in France, Italy and Spain. In the following we focus on these countries also because they have taken measures and adapted their regulations since the financial crisis, while reforms in Germany date back some time. Table 1 at the end of this paper summarises the reform priorities of the relevant countries.[4]

Figure 4: Labour market efficiency differs widely

Assessment of labour market efficiency in 2016, qualitative categories, scores



Note: Scores range from 1 (poorest) to 7 (best)

Source: World Economic Forum

Labour market reforms

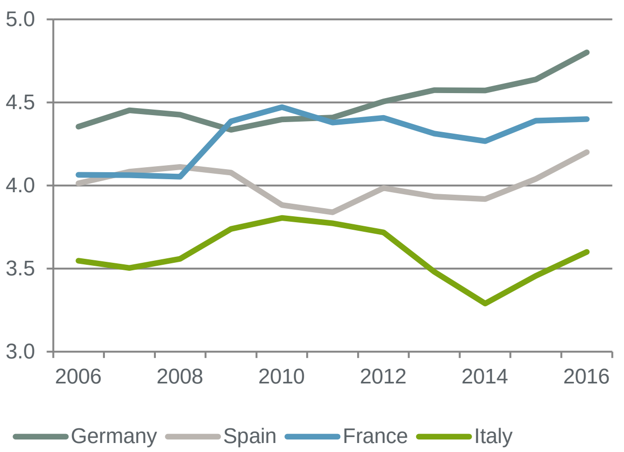
Strategic focus: flexibility and worker protection

The reforms that followed the financial crisis were primarily directed at increasing businesses' flexibility while securing adequate worker protection ("flexicurity"). Countries often increase flexibility by decentralising wage bargaining and regulations on working hours and loosening dismissal protection. Thus, reforms are successful primarily when businesses use their higher influence responsibly and help to ease the situation on the labour markets. The conflict with the goal of protecting workers can be solved, for example, by making temporary positions more costly than permanent positions as a way of reducing labour market segmentation.

Measured by the relevant overall assessment arrived at in the surveys of the World Economic Forum, the reforms have made the labour markets more efficient in the past years (Figure 5). This is particularly true of Spain and Italy from the year 2014. The most important reform in France was not adopted until 2016, so that it will take a few years for its effects to appear.

Figure 5: Labour markets in Spain and Italy more efficient

Assessment of overall labour market efficiency, scores



Source: World Economic Forum

France – labour market reform on the final sprint to the presidential election

Some months ago, France adopted one of the most comprehensive labour market reforms of the past years. Referred to as the 'El Khomri law' after the minister of labour, the reform addresses fundamental problems of France's labour market regulations.[5] The 35-hour work week remains as a benchmark. However, enterprises are allowed to deviate from collective agreements if they are agreed with at least 50 % of their workforce – requiring only a simple majority in a referendum among employees if necessary. For example, firms can modify the number of maximum daily or weekly working hours for specific periods or reduce pay increases for extra hours. In addition, the legislator has specified the legal requirements for operational redundancies, creating planning certainty for enterprises. The procedure for mass layoffs has also been simplified and abbreviated.

Reform provides more flexibility for enterprises, but in a watered down form

The El Khomri Law provides enterprises with more legal security and flexibility and allows them to respond more effectively to changes in the economic environment. According to the GCI survey, France already scores well on wage flexibility. But the cooperation between trade unions and employers is not working well and labour disputes are common. France's labour market is particularly hampered by the social partners' lack of willingness to cooperate.[6] The new law expands the employers' scope of influence and could allow the strained relationship between trade unions and employers to recede into the background.

The original draft reform, however, had to be watered down following hefty protests. The main casualty of this watering down was the previously planned capping of severance payments determined by employment tribunals in cases of wrongful dismissals. Instead of maximum limits there is now merely a non-binding orientation for the level of these payments. This arrangement limits the planning certainty for enterprises and is a missed opportunity for eliminating additional obstacles to permanent employment contracts.[7]

Further reforms in the future are conceivable

France's labour market reform addresses the right issues. The rigid dismissal protection hampers business activity. According to the GCI, France ranked second but last among the OECD countries with regard to the legal conditions for hiring and firing. From an economic perspective the reform could have gone further. The IMF, for example, recommends enhancing work incentives for recipients of transfer incomes.[8] France is among the countries with the most generous support for unemployed persons, in terms of amounts disbursed as well as entitlement periods. The survey conducted by the World Economic Forum identified labour market regulation as the prime obstacle to the competitiveness of France's economy. Reforms should therefore remain on France's economic policy agenda in future.

Italy – dual labour market hampers productivity

Italy's labour market is characterised by particularly strong segmentation. Numerous forms of atypical employment relations and temporary contracts with weakened dismissal protection have established themselves here since the 1990s (see Figure 2). Particularly for younger workers, this tends to lead to shorter lengths of service, less investment in human capital and a focus on simple work. On the other hand, employees with permanent contracts enjoy high dismissal protection and dismissed workers can fight for reinstatement before employment tribunals under certain conditions.[9] The primary cause for Italy's structural economic weakness is seen in factors such as an excessive tax burden and inefficient administration. However, it is also because of labour market segmentation that Italy has recorded only minimal productivity growth in the last 20 years.[10]

According to the GCI survey, Italy is trailing behind other

OECD countries especially in regard to wage flexibility and the responsiveness of wages to productivity. Centrally negotiated wages fail to adequately account for regional differences in productivity, which are pronounced given Italy's north-south divide. The consequence is that unemployment in the south is significantly above the national average. At the same time, wage development in the public sector is not covered by adequate productivity gains and personal relations play too big a role in filling management openings.[11]

Labour market liberalisation in the years 2012 and 2014
The last two labour market reforms in Italy took place in 2012 and, in particular, in 2014. Both reforms aimed to bring about broader participation in economic recovery, eliminate labour market segmentation and contain abuses with temporary contracts. Both reforms were intended to flexibilise the rigid labour market by loosening dismissal protection and, at the same time, improving social safeguards for employees. Hence, in 2012 the possibilities for redundancies on economic grounds were expanded and broader, uniform unemployment support with longer periods of entitlement to transfer incomes was introduced. Policymakers tightened the legal conditions for certain types of temporary contracts and imposed higher social security contributions on temporary employment – subject to reimbursement in case of subsequent conversion into permanent employment.

The comprehensive labour market reform of 2014, referred to as the "Jobs Act", went one step further. It loosened employment protection by banning the court-ordered reinstatement of workers who had been dismissed for economic reasons or after a restructuring. This gives enterprises considerably more legal certainty. The Jobs Act introduced a new standard employment contract with a generally lower severance payment graduated by length of service. This measure was accompanied by a further expansion of unemployment benefits. At the same time, the use of certain temporary contracts was simplified in order to lower the access barriers to the labour market and, in particular, to reduce the rate of youth unemployment which had risen sharply after the crisis.

Italy's Jobs Act needs more time
Since the Jobs Act was implemented in 2015, the unemployment rate has dropped only moderately. The quota of limited employment contracts in new appointments remains high despite grants for permanent positions (see below). One reason for this is that the loosened dismissal protection applies only to the newly introduced standard contract. Existing contracts remain subject to previous labour law. The reform therefore needs time to become fully effective.

In 2015 policymakers provided fiscal incentives to quickly spread the use of the new standard contract. Companies were entitled to an exemption for newly hired as well as temporary employees upgraded to permanent status, from approx. EUR 8,000 in social security contributions for a period of three years. This measure was extended in 2016, but on a lower level. The development of permanent employment remains sluggish nevertheless, in large part owing to the worsening economy in Italy. The reforms should become effective and the situation on the labour market should gradually ease when the economy recovers. The surveys conducted under the GCI already show progress for 2015 and 2016 (see Figure 5).

Spain – reform prioritises decentralised wage bargaining
In Spain the labour market is segmented to a similar extent as in Italy. Temporary employment contracts among young employees are nearly three times as common as the OECD average. At the same time, youth unemployment is as high as in Greece and significantly above the euro area average. Roughly half of all job-seekers have been out of work for at least one year. The high overall unemployment rate and the loss of skills and knowledge resulting from long phases of unemployment reduce the country's long-term growth potential.

Spain undertook its labour market reforms in 2010 and especially in 2012. Both reforms had a similar focus and instruments. First, policymakers strengthened decentralised wage bargaining. Company agreements were given priority over wage agreements at industry or regional level. Besides, businesses were empowered to modify wages and working hours temporarily and unilaterally on "objective grounds", e.g. for economic or organisational reasons. The move has given employers more flexibility and alternative ways of responding to economic shocks apart from dismissals. This secures employment in times of crisis.

Spain's reforms also loosened the protection against dismissal for permanent employment contracts. First, employers no longer have to demonstrate that a dismissal significantly affects their future profitability. Declines in turnover in consecutive quarters are sufficient grounds. Second, severance payments imposed on wrongful dismissals have been cut almost in half.[12] Moreover, collective dismissals no longer require prior authorisation by the administration and a new employment contract with a one-year probation period has been introduced for employees in small and medium-sized enterprises. These reliefs are intended to make it easier to hire new employees.

Flexibilisation works, segmentation remains
According to the OECD, the decentralisation of wage negotiations has contributed to wage restraint in Spain and brought about an improved balance between wages and productivity.[13] Given the cyclical volatility of the past years – renewed recession after the financial crisis up to 2013, strong recovery from 2014 – additional flexibility at employer level is particularly valuable for Spain. The training and education programmes for long-term unemployed persons and young jobseekers, some of which were expanded in 2014, are also helpful for preserving human capital. Labour market segmentation, on the other hand, has hardly been affected yet by the reform. The share of temporary jobs in new hiring remains steady at around 90 %.[14] This is the area with the largest scope for improvement.

Table 1: Priorities of labour market reforms

	Decentralisation	Dismissal protection	Labour market segmentation
France	X	X	
Italy		X	X
Spain	X	X	X

Source: own rendition

Conclusion: the need for efficient labour markets in the euro area is greater than ever

After the internet crisis the unemployment rate in the euro area, which usually responds to cyclical variations with a time lag, had reached its peak of 9.3 % in 2004. During the upswing before the financial crisis, the rate dropped to a low of 7.2 % in 2008. In the financial crisis and the subsequent debt crisis, the unemployment rate rose to 12.1 % in 2013 before it fell over the following four years to now 9.8 %. This comparison shows that unemployment has recently fallen roughly as fast as during the previous recovery phase. However, unemployment in the euro area had risen to a record level in 2013. At the peak of the business cycle before the financial crisis, 11.5 million people were out of work. Today this figure is still 16 million. In other words, the euro area needs to create more employment than before.

At the same time, the debt crisis brought to light the specific demands on a currency union that has inadequate international equalisation mechanisms. So long as the euro area fails to evolve further towards closer coordination between member states, flexibility on national markets remains all the more urgent. A flexibilisation of labour markets helps strengthen the structures of the currency union. Against this backdrop, the reform successes deserve special recognition – and they are an incentive to continue on this promising path. ■

[1] This difference is partly due to the system of vocational training with temporary contracts of apprentices in some European countries. However, the share of workers with temporary employment contracts is also disproportionately high in relation to the overall population in all four countries and more than twice as high in Spain as in the OECD overall.

[2] Other approaches include, among others, the Labor Market Regulations Index of the Fraser Institute or the World Competitiveness Yearbook of the International Institute for Management Development.

[3] Approx. 14,000 managers of small, medium-sized and large enterprises from around 140 countries were surveyed.

[4] The relevant reforms obviously consist of complex sets of legislation that cannot always be unequivocally assigned to one of the categories. The table should therefore be understood as a heavily simplified description.

[5] Parts of the El Khomri law of 2016 are a further development of previous reforms with a similar focus (Job Security Act 2013). The reform is supported by fiscal relief in the form of lower labour costs via tax credits for enterprises and reductions in social security contributions (CICE and Responsibility and Solidarity Pact).

[6] Cf. Commerzbank 2016, France: more than a cyclical recovery?, Economic Research, Economic Insight.

[7] Cf. Barclays 2016, France: The labour law and its ramifications, Economics Research, Euro Themes.

[8] Cf. IWF 2016, France: Article IV consultation, IMF Country Report No. 16/227.

[9] Cf. Fana, M., Guarascio, D. and V. Cirillo 2015, Labour market reforms in Italy: evaluating the effects of the Jobs Act, ISI Growth Working Paper.

[10] Cf. Ehmer, P. 2016, Labour productivity of large euro area countries drifts apart – Italy falling behind, Focus on Economics No. 134, July 2016.

[11] Cf. IWF 2016, Italy: Article IV consultation, IMF Country Report No. 16/222.

[12] In an OECD comparison, however, severance payments remain on a high level of 24 monthly wages, cf. OECD 2014, The 2012 labour market reform in Spain: A preliminary assessment, OECD publishing.

[13] Cf. ibid.

[14] Cf. IWF 2015, Recent labor market reforms: A preliminary assessment, Spain: selected issues, IMF Country Report No. 15/233.