

PRESS POINTS FOR CHAPTER 3: TIME FOR A SUPPLY-SIDE BOOST? THE MACROECONOMIC EFFECTS OF LABOR AND PRODUCT MARKET REFORMS IN ADVANCED ECONOMIES
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Key Points

- Now is an opportune time to push for additional product and labor market reforms in many advanced economies: there is a strong need and substantial scope for reform, the political environment is conducive, and such reforms can raise potential output and employment levels over the medium term.
- Product market reforms deliver gains in the short term, while the impact of labor market reforms varies across types of reforms and depends on economic conditions. Reductions in labor taxes and increases in spending on active labor market policies have larger effects during periods of economic slack, while reforms to employment protection arrangements and unemployment benefit systems are beneficial in economic good times but can have detrimental effects when the economy is weak.
- Careful prioritization and sequencing of reforms, as well as supportive macroeconomic policies, are needed to maximize the short-term payoff of reforms in the current environment of persistent slack in most advanced economies. Reforms that entail fiscal stimulus will be the most valuable, including reducing labor tax wedges and increasing public spending on active labor market policies. Product market reforms should also be prioritized.

The continued weakness of growth and shrinking macroeconomic policy space in many advanced economies have led policymakers to emphasize structural reforms. High on the agenda are several reforms designed to strengthen the functioning of product and labor markets—including, depending on countries' specific circumstances, reducing barriers to entry in services sectors, strengthening active labor market policies and/or revising unemployment benefit provisions, streamlining and harmonizing employment protection legislation for permanent and temporary workers, cutting labor taxes, and implementing targeted policies to boost the labor market participation of youth, women, and older workers.

These product and labor market reforms have the potential to boost growth and jobs in many advanced economies over the medium term. They therefore warrant further effort. Their contributions are likely to be modest in the short term, however, because it takes time for the benefits to materialize, particularly where economic conditions remain weak.

Product market reforms have some expansionary effect even in the short term, and this effect does not depend markedly on overall economic conditions. For example, the

widespread deregulation of air transport and telecommunications that took place in many advanced economies mostly during the 1990s led to large increases in output, productivity, and quality of services.

In contrast, the impact of labor market reforms depends on overall economic conditions:

- Fiscal structural reforms in the labor market area, such as reduced labor taxes and increased public spending on active labor market policies, have larger effects under weak macroeconomic conditions, in part because they usually entail some degree of fiscal stimulus.
- In contrast, reforms to employment protection arrangements and unemployment benefit systems have positive effects in good times, but can weaken aggregate demand and become contractionary in bad times.

Table 3.1. Effect of Product and Labor Market Reforms on Macroeconomic Outcomes

The effects of structural reforms depend on the type of reform, overall economic conditions, and the horizon considered.

Area of Reforms	Normal Economic Conditions		Weak Economic Conditions		Strong Economic Conditions	
	Short Term	Medium Term	Short Term	Medium Term	Short Term	Medium Term
Product Market	+	++		+	+	++
Employment Protection Legislation			-	--	+	++
Unemployment Benefits	+	++	-		+	++
Labor Taxes	++	++	++	++		
Active Labor Market Policies	++	++	++	++		

Source: IMF staff estimates.

Note: The macroeconomic outcomes are output and/or employment; + (-) indicates positive (negative) effect; the number of "+" ("–") signs denotes the strength of the effect. The effect of labor tax cuts and increases in spending on active labor market policies is smaller but remains positive when these measures are implemented in a budget-neutral way.

Complementary policies can enhance the short-term payoff from structural reforms.

Supportive macroeconomic policies—including fiscal stimulus where space is available and a strong medium-term fiscal framework is in place—can offset the short-term costs of some labor market reforms. Intensified efforts to address weaknesses in bank and corporate balance sheets can strengthen the impact of product market deregulation on private investment.

Prioritizing and sequencing reforms can also strengthen their impact in the current environment of persistent slack in most advanced economies. Reforms that entail fiscal stimulus will be the most valuable, including reducing labor tax wedges and increasing public spending on active labor market policies. Product market reforms should also be prioritized because they boost output regardless of overall economic conditions.