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# Lessons from Successful Labor Market Reformers in Europe

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## Abstract



Welfare states can be reformed successfully, and popular support for reforms can be maintained. But this requires an internally consistent package of labor market, fiscal, and product market reforms, including some kind of buy-in, through, for example, tax cuts. Empirical analysis combined with a select number of case studies—comprising Ireland, Denmark, the Netherlands, and the United Kingdom—reveals that successful reformers focused on increasing labor supply through benefit reform, lowering tax wedges, and lowering government consumption. At the same time, greater labor supply translated into employment growth more effectively in the presence of liberal labor and product markets.

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## I. Introduction

The goal of this short paper is straightforward: to illuminate the broad factors driving successful labor market reform in European countries and to derive a road map for emulation.[1] In the wake of adverse global supply shocks in the 1970s and early 1980s, often compounded by domestic policy mistakes, unemployment rose precipitously in many European countries. In some cases, it remains high to this day. But other countries have witnessed a remarkable turnaround, experiencing dramatic declines in unemployment rates, and corresponding sharp increases in employment rates. This paper discusses some of the successful policy responses to these shocks over the past two decades, including the political economy context. The primary approach is to focus on a number of concrete case studies, and four countries are singled out for special treatment—Denmark, Ireland, the Netherlands, and the United Kingdom. To complement the case study analysis, and to encompass a greater number of reform experiences, empirical techniques (event studies and econometric analysis) will also be utilized.

The four chosen countries stand out in terms of successful labor market performance over this period. In the European Union today, they boast four of the five lowest unemployment rates, and they have also achieved the greatest reduction over two decades (Table 1). Their employment gains have been equally impressive, with Ireland and the Netherlands also boasting large increases in participation[2] (Figures 1 and 2). In Denmark, the reforms started in earnest only in the early 1990s, and this is when employment began to turn

[1] A more detailed version of this paper can be found in *Euro Area Policies—Selected Issues*, IMF Country Report No. 06/288, June 2006.

[2] Including government employment makes the United Kingdom look somewhat better.

around. The same broad pattern is broadly true when looking at total hours worked. However, the case study evidence does not suggest that the return on reforms is immediate; frequently, the employment gains arrived many years after the initiation of the reform program. Also, there is an element of arbitrariness in the choice of cases, as other countries reach the top echelon using different performance benchmarks. This underscores the importance of the complementary empirical analysis.

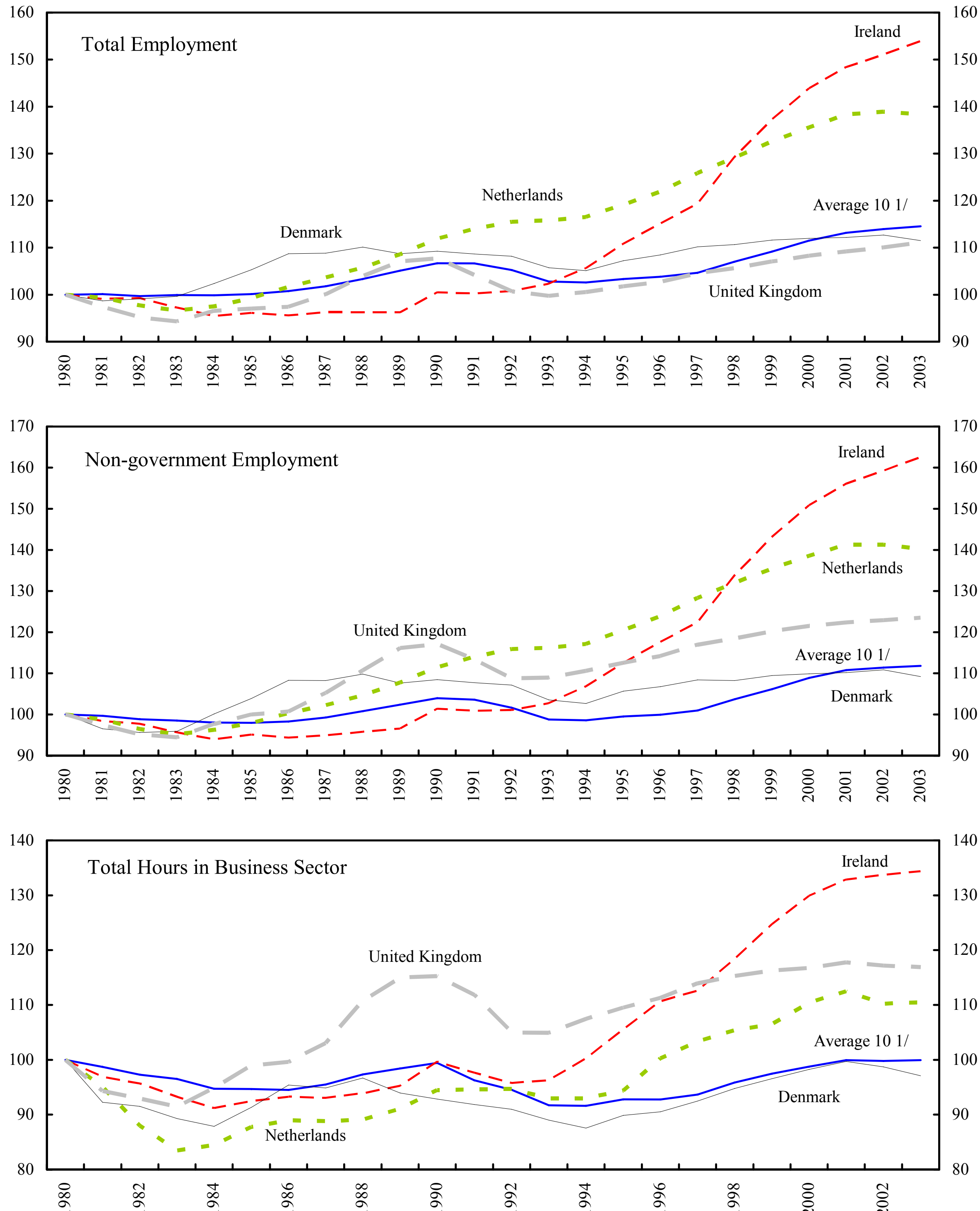
Table 1: Unemployment in the EU-15

| Rate, in percent (average 2000-04) | | Change, in percentage points (from average 1980-84 to average 2000-04) | |
|---|---|---|---|
| **Netherlands** | 3.1 | **Ireland** | -7.6 |
| **Ireland** | 4.3 | **Netherlands** | -4.6 |
| Sweden | 4.6 | **United Kingdom** | -4.2 |
| **Denmark** | 4.9 | Portugal | -3.0 |
| **United Kingdom** | 5.1 | **Denmark** | -2.5 |
| Austria | 5.2 | Belgium | -2.0 |
| Portugal | 5.2 | Spain | -1.3 |
| Belgium | 7.3 | France | 1.2 |
| Germany | 8.2 | Sweden | 1.8 |
| Finland | 9.2 | Germany | 2.3 |
| Italy | 9.3 | Italy | 2.3 |
| France | 9.4 | Austria | 2.6 |
| Greece | 11.0 | Finland | 4.0 |
| Spain | 11.1 | Greece | 5.3 |

Source: OECD Economic Outlook.

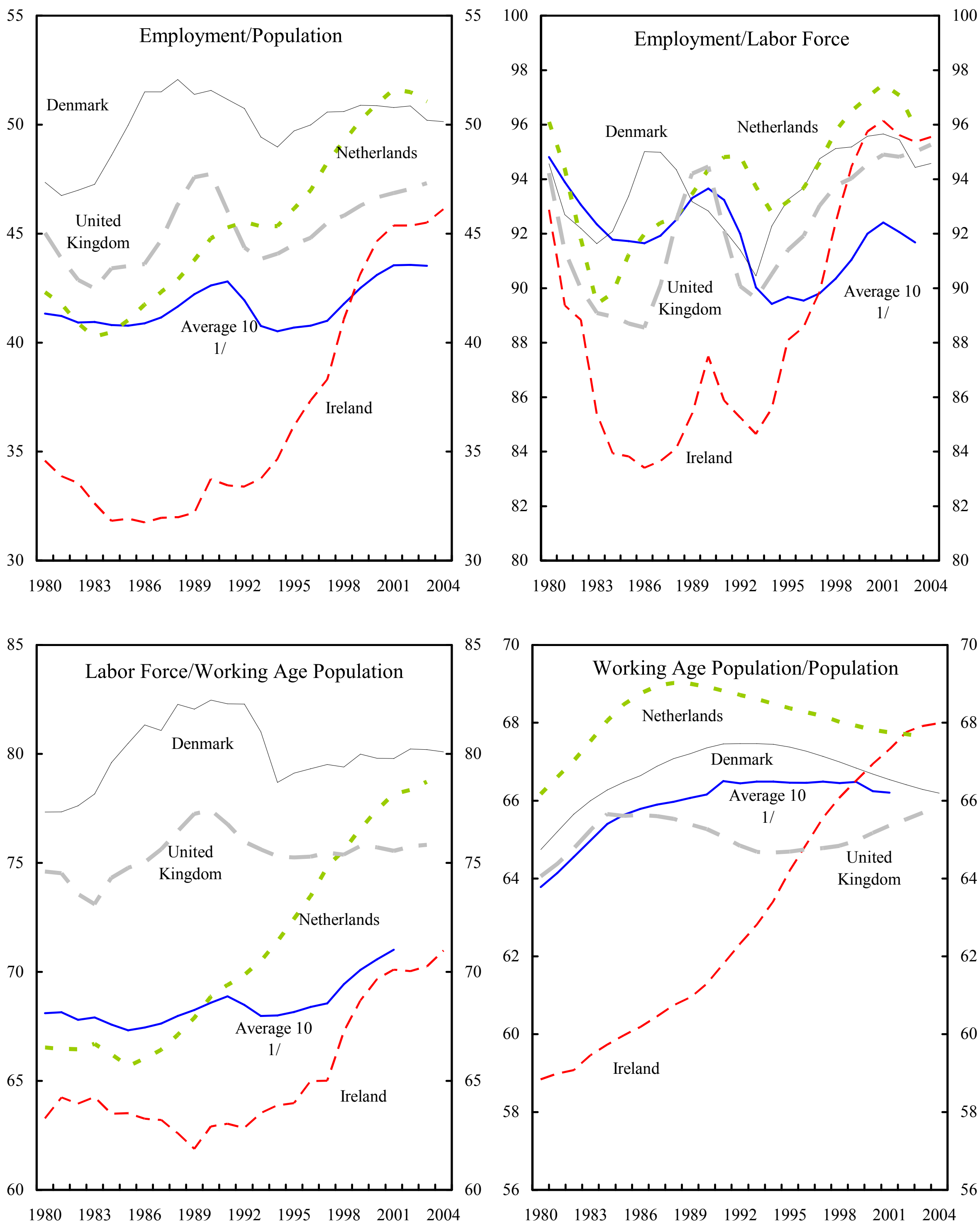
The paper centers on broad reform programs that are associated with increases in labor supply. Section II provides an overview of the basic reform experiences, focusing in particular on union behavior, welfare reform, and the inter-relationship between fiscal and structural policies. Following this, the next two sections provide brief overviews of the political economy and social contexts of the reform programs. Section V concludes.

Figure 1. Employment Growth Since 1980
(1980=100)




Source: OECD Economic Outlook.
1/ Average of other EU-15 members, excluding Luxembourg.

Figure 2. Breakdown of Employment (Total)




Source: OECD Economic Outlook.
1/ Average of other EU-15 members, excluding Luxembourg.

## II. Reform Experiences

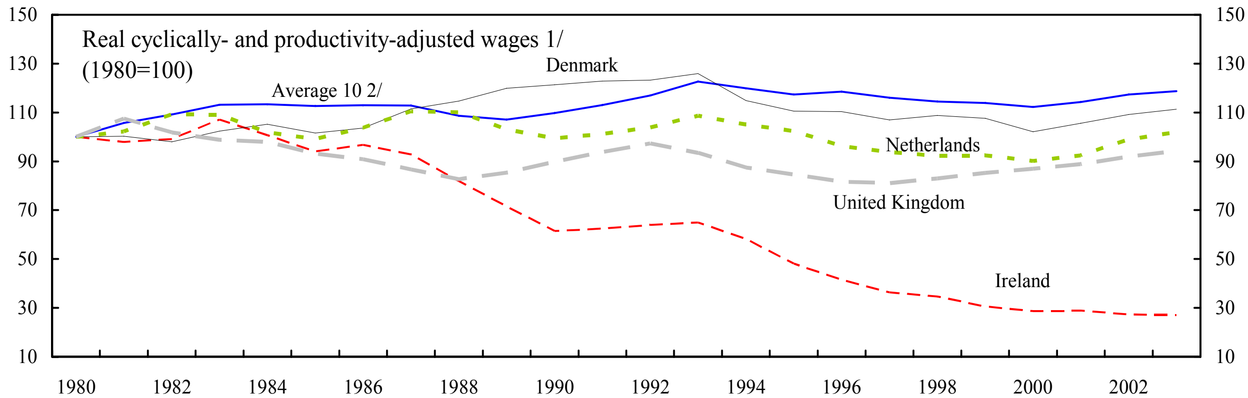
The literature on the relationship between labor market institutions and outcomes is a broad one, especially when it comes to explaining the divergence in performance across Europe. Some believe that governments responded to adverse shocks by using institutions to protect workers, a trend that was only partially reversed after the 1980s (Blanchard, 2005). Although there is little consensus on the particular institutions most likely to stifle employment growth or keep unemployment elevated, attention has centered on such natural candidates as generous unemployment benefits with long duration, high tax wedges, restrictive employment protection legislation (EPL), and union power. Different researchers often emphasize different factors. In a fairly representative result, Nickell, Nunziata, and Ochel (2005) argue that institutions can explain slightly more than half of the increase in European unemployment between the 1960s and 1990s, with a division between unemployment benefits (39 percent), labor taxes (26 percent), union power (19 percent), and EPLs (16 percent). Likewise, a recent study by Bassanini and Duval (2006) lays the blame for high structural unemployment on high and long-lasting unemployment benefits, high tax wedges, and stringent product market regulation. While the results from this literature are generally consistent with those of this paper, the latter takes a slightly different tack and looks at reform experiences through a more holistic lens, focusing on the broad fiscal and labor market strategies undergirding reform efforts.

In a plethora of different ways, reforms centered on reforming labor market institutions, with the goal of boosting labor supply. Based on a model whereby unions and employers bargain over wages, this overarching policy goal implies an outward shift in the labor supply (or wage) curve—more supply at a given wage or a lower wage at a given supply. The wage variable under consideration is the productivity- and cyclically-adjusted real hourly compensation rate.[3] A number of factors can lead to such wage moderation: (i) changes in the attitudes of unions and workers, placing a greater emphasis on employment; (ii) falling labor taxation, allowing workers to accept lower gross wages for the same net wage; (iii) unemployment benefit reform, reducing the reservation wage of union members; and (iv) lower government employment or government wages, also reducing reservation wages, given that government employment is an alternative to private employment.

From this perspective, wage moderation was a basic outcome of the reform strategies. In the context of the present paper, the case studies, the event study, and the econometric analysis all springboard from this fundamental observation. Looking across the two decade horizon, the countries exhibiting the largest shifts in labor supply included Ireland, the United Kingdom, and the Netherlands (see Figure 3); in Denmark, the trend became pronounced only after the early 1990s. In terms of other countries, Finland and Sweden also stand out, while more countries joined the wage moderation group in the late 1990s and early 2000s, including Italy, Spain, and Germany.

[3] More technically, the hourly compensation rate in the business sector is deflated by the private consumption deflator and an index of labor-augmenting technical progress. But since changes in wages may reflect cyclical changes in unemployment, or movements along the "Blanchflower-Oswald" wage (labor supply) curve without any change in workers' underlying stance, the growth in wages is also adjusted for the change in the unemployment rate, based on an assumed elasticity of wage costs to unemployment of 0.1, a standard assumption in the wage curve literature. For details, see, for example, Decressin and others (2001), and Estevao (2005).

Figure 3. Wage Moderation 1/




Source: Author's calculations based on OECD Economic Outlook.
1/ See text, footnote 3, for definition.
2/ Average of other EU-15 members, excluding Luxembourg.

The case study, event study, and econometric analyses all deliver the same basic messages. Of course, the methodologies differ: while the empirical analysis focuses on a few key variables, the case studies adopt a more holistic approach. The event study analysis complements the case studies by isolating large labor supply increases/wage moderation episodes over the past two decades. Such periods are defined (somewhat arbitrarily) as periods during which real productivity- and unemployment-adjusted hourly compensation rate in the business sector declined by at least 3 percent a year, for at least two consecutive years. This yields 17 periods between 1980–2003.[4, 5] The behavior of a number of relevant variables—including growth, the output gap, the fiscal balance, government expenditure, and labor taxes—is examined around each particular episode—during the period, the average of

[4] The events are as follows: Denmark, 1994–97; Denmark, 1999–00; Finland, 1993–00; Greece, 1985–86; Ireland, 1984–85; Ireland, 1987–90; Ireland, 1994–00; Italy, 1994–95; Netherlands, 1983–85; Netherlands, 1988–90; Netherlands, 1994–98; Portugal, 1985–89; Sweden, 1982–88; Sweden, 1992–95; Sweden, 1997–99; United Kingdom, 1982–88; and United Kingdom, 1993–97.

[5] In the original paper, a second event study was defined around instances of non-government employment booms. The conclusions are similar.

three years before, and the average of three years afterwards (Table 2). More formally, the econometric analysis—using annual data spanning 1980–2003 for 14 countries—examines the relationship between labor supply shifts and government expenditure and the tax wedge, and between product and labor market regulation and employment (Box 1).

Table 2. Results of Wage Moderation Event Study

(annual average over period)

| | Before | During | After |
|---|---|---|---|
| Change in real productivity and unemployment-adjusted wage | 3.0 | -5.0 | 1.1 |
| | | | |
| Real GDP growth | 0.8 | 3.7 | 2.4 |
| Output gap | -2.4 | -1.5 | 0.0 |
| Change in output gap | -1.6 | 1.2 | -0.5 |
| Change in savings rate | 0.5 | -0.7 | -0.1 |
| | | | |
| Change in overall balance | -0.4 | 0.7 | 0.1 |
| Change in cyclically-adjusted primary balance | 0.4 | 0.3 | 0.0 |
| Change in social expenditure | 0.7 | -0.3 | 0.1 |
| Change in wage government consumption | 0.2 | -0.4 | 0.1 |
| Change in taxes on labor | 0.3 | -0.3 | 0.0 |

Source: Author's calculations based on OECD Economic Outlook.

### *Union Behavior*

Wage moderation was abetted in Ireland and the Netherlands by coordinated agreements between social partners, while the United Kingdom focused on reducing the power of unions.[6] At the core of the Dutch and Irish programs was the strategy to mitigate the effects of lower nominal wage growth with labor tax cuts. The seminal *Wassenaar* agreement

[6] For in-depth case studies, see Honohan and Walsh (2002) for Ireland; Bakker and Halikias (1999) for the Netherlands; Andersen (2003) and Gaard and Kieler (2004) for Denmark; and Blanchflower and Freeman (1993) as well as Nickell and Quintini (2002) for the United Kingdom. For comparative studies, see Barrell and Genre (1999) for Denmark and the Netherlands, and Nickell and van Ours (2000) for the Netherlands and the United Kingdom.

## Box 1. Econometric Evidence

**A simple econometric analysis supports the key conclusions of the paper**. Two equations are estimated, in differences: the first explores the fiscal determinants of labor supply shocks, defined as the change in the cyclically- and productivity-adjusted real hourly compensation, while the second relates the growth in the non-government employment rate to wage moderation and other institutional factors. In all cases, an OLS model is estimated for 14 countries (EU15 excluding Luxembourg) between 1980–2003, incorporating lagged dependent variables, country fixed effects and year dummies capturing common excluded variables. 1/ The basic results are as follows:

- ***Labor supply shocks are influenced by fiscal policy parameters***. What appears to matter most for wage behavior is not the stance of fiscal policy in itself, but its composition, in terms of revenue and expenditure. Higher social expenditure, government wages, and tax wedges all lead to higher wages, and a concurrent negative labor supply shock—a vicious circle.

- ***The feedback from labor supply shifts to employment growth depends on the degree of product and labor market regulation***. While there is indeed a negative relationship between wages and non-government employment, the interactive terms suggest that this effect is smaller in countries with heavily regulated product and labor markets (see Estevao, 2005, for a discussion of this effect as it pertains to product markets). 2/ Thus the benefits of wage moderation are greater in countries with more liberal product and labor market regulation; in this context, it may be no accident that the four case study countries are among the most liberal in Europe in this regard.

1/ In terms of sources, data on employment, wages, and fiscal policy are from the OECD Economic Outlook database (for construction of the wage variable, see footnote 3 in main text). Social expenditure is from the OECD Social Expenditure Database. The tax wedge is from the OECD *Taxing Wages* database. EPLs and product market regulation indices hail from OECD (2004) and Conway and Nicoletti (2006) respectively.

2/ Results change little when estimating the second equation using instrumental variables, treating real wages as endogenous, using its own first lag and the fiscal variables from the first equation as instruments.

Table: Basic Econometric Results

| Dependent variable: change in cyclically and productivity-adjusted real wages | | Dependent variable: change in non-government employment-population ratio | |
|---|---|---|---|
| Lagged dependent variable | 0.28***<br>(0.06) | Lagged dependent variable | 0.43***<br>(0.06) |
| Change in social expenditure | 0.71**<br>(0.33) | Change in cyclically and productivity-adjusted real wages | -0.14***<br>(0.03) |
| Change in government wage bill | 3.18***<br>(0.67) | Change in cyclically-adjusted primary balance | 0.05**<br>(0.02) |
| Change in tax wedge | 0.60***<br>(0.22) | Product market regulation | 0.11<br>(0.09) |
| | | Change in cyclically and productivity-adjusted real wages * product market regulation | 0.02**<br>(0.01) |
| | | Employment protection legislation | -0.13<br>(0.13) |
| | | Change in cyclically and productivity-adjusted real wages * employment protection legislation | 0.01*<br>(0.007) |
| N | 269 | N | 260 |
| $R^2$ | 0.53 | $R^2$ | 0.61 |

Standard errors in parentheses. ***, **, and * denote significance at the 1 percent, 5 percent, and 10 percent levels respectively.

in the Netherlands was signed in 1982 between the leading labor federation and the employer's federation, trading wage restraint for less-than-offsetting working hour reductions, alongside government commitments to reduce labor taxes and social security contributions. Ireland adopted a similar strategy in 1987, without the emphasis on sharing work through lower hours. Although the wage agreements applied only explicitly to the unionized sector, they acted as a *de facto* benchmark for wage expectations. Given its success, this strategy has continued unabated in both countries. The United Kingdom took a different tack, progressively reducing union power throughout the 1980s. But even there, the effect on after-tax wages was mitigated by lowering the tax burden on labor. The Danish governments also initially adopted a confrontational approach with unions, which led to industrial unrest and ultimately failed to restrain wage growth. Following this, the wage bargaining system became increasingly decentralized over the 1990s, and the government shifted gears and focused instead on reforming labor market institutions.

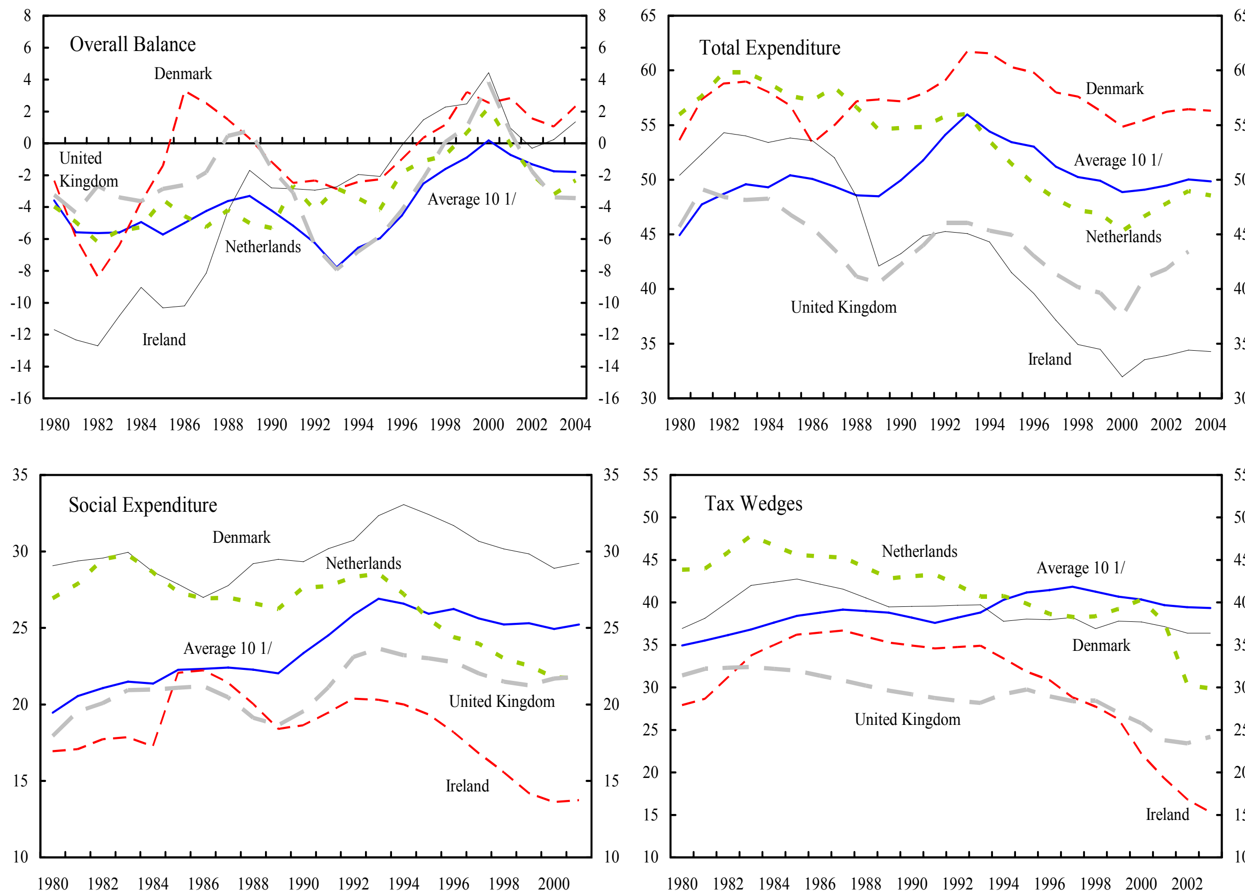
***Reduction in tax wedges***

A common factor among the four case study countries was a steady reduction in tax wedges, contributing to wage moderation. The overall tax wedge on labor income declined markedly over two decades in Ireland, the Netherlands, and the United Kingdom and modestly in Denmark (Figure 4).[7] This was not a common trend, as the wedge actually rose in half of the EU countries at this time. Econometrically, higher tax wedges are associated with higher wages, and a concurrent negative labor supply shock (Box 1). And the event

[7] The tax wedge is defined as employees' and employers' social security contributions and personal income tax less transfer payments as percent of gross labor costs, averaged between single and married workers.

study confirms the role of lower tax wedges in abetting wage moderation, as labor taxes declined during wage moderation episodes (Table 2).

Figure 4. Fiscal Developments
(in percent of GDP)




Source: OECD Economic Outlook; OECD Social Expenditure Database; OECD *Taxing Wages* Database.
1/ Average of other EU-15 members, excluding Luxembourg.

### *Benefit reform*

The case study countries all engaged in some aspect of welfare reform, reducing the level of unemployment benefits, or their duration, or strengthening eligibility requirements. Reforms led to less generous benefits in the United Kingdom and the Netherlands in particular (the latter focused on sickness and disability as well as unemployment), while in

Ireland, benefits failed to keep pace with after-pay income. Denmark and the Netherlands also cut the maximum duration of unemployment benefits, while three of the four countries (bar Ireland) tightened up eligibility requirements. In Denmark, policies deliberately allowed for generous benefits in the face of shorter duration and tougher eligibility conditions, alongside increasingly stringent "activation" requirements. Indeed, by 2002, the requirement to partake in Active Labor Market Policies (ALMP) kicked in after one year, so that the activation period constituted 75 percent of the benefit duration period.[8] As the institutional reform of benefits is notoriously difficult to quantify, the effects of these reforms do not show up clearly in either the event study or the econometric analysis; instead, the data indicate a negative relationship between growth in transfers and wage moderation (see below).

***Twinning expenditure and labor tax cuts***

Another common factor was that the successful reformers tended to reduce both government expenditure and taxation on labor. The four countries in question undertook substantial adjustment during various phases over the past two decades, and three of four (excluding Denmark, which moved only relative to the early 1990s) reduced the size of government substantially, both on the expenditure and revenue fronts (Figure 4). The case-study evidence points clearly to the success of expenditure-based consolidation, especially based on pruning transfers and government wages. Attempts to resort to labor tax-based budget deficit reduction tended to backfire, as demonstrated by early attempts at such consolidation by Denmark and Ireland. The event studies back up this basic pattern, showing

[8] Estevao (2007) finds evidence that ALMP can foster wage moderation.

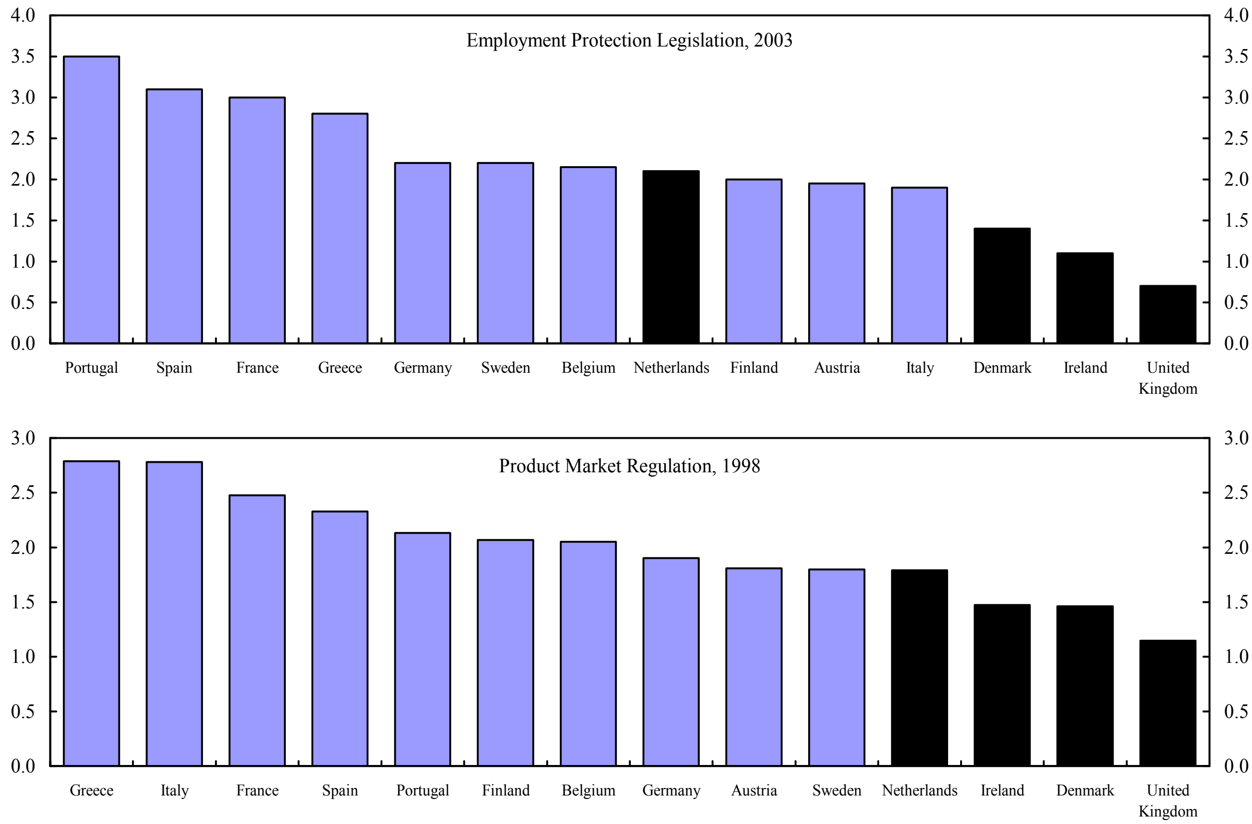
that fiscal policy and labor supply improvements are intimately entwined—increases in labor supply were associated with an improving fiscal balance and discretionary fiscal adjustment, especially on social expenditure and government wages (see Table 2). And while revenue increased prior to the reform period, it fell during the labor supply shift itself, reflecting declining labor taxation. The econometric evidence concurs, highlighting the positive association between wages and social spending, the government wage bill, and tax wedges (Box 1).

Overall, fiscal adjustment and labor supply reforms tend to be complementary, especially when the adjustment is expenditure-based. Fiscal and structural adjustment moved in one direction, as periods of extensive fiscal consolidation coincided with labor supply shifts, with no evident trade-offs. The labor market channel stands out, as reducing both government wages and transfers, as well as cutting labor taxes, encourages unions to accept lower wages, which in turn leads to higher profitability and higher employment and growth (Ardagna, 2004; Alesina and others, 2002). Granting tax cuts also neuters potential opposition to labor supply reforms. Hauptmeier, Heipertz, and Schuknecht (2006), also adopting a case study approach, find that countries typically enjoyed high growth and employment in the wake of substantial expenditure reform, especially in the context of a broader reform package.

***Flexible product and labor markets***

A further common element is that the case study countries had legacies of relatively liberal labor and product markets (Figure 5). In the early 2000s, the four countries clustered around the bottom of the group in terms of EPLs, with highly liberalized labor markets in

Figure 5. Labor and Product Market Rigidities




Source: OECD (2004); Conway and others (2005).

Ireland and the United Kingdom in particular.[9] Based on indices of economy-wide product market regulation compiled by the OECD, the four case study countries were also shown to be the least regulated in the sample in 1998, and in the top five in 2003.[10] The econometric evidence shows that positive labor supply shocks are more likely to lead to higher

[9] The OECD index relates to the strictness of EPLs, considering such factors as difficulty of dismissal, notice and severance pay provisions, specific requirements for collective dismissals, and regulation of temporary employment. A high value denotes a stricter EPL. See OECD (2004).

[10] The index is computed based on a detailed questionnaire of general and sectoral regulatory policies in each country (including state control, barriers to entrepreneurship, and barriers to trade and investment. A higher value denotes more regulation. See Conway and others (2005) for details.

employment in these circumstances, as wage moderation feeds through to jobs rather than rents (Box 1)—see also Estevao (2005) and Berger and Danninger (2005).[11]

## III. The Political Economy Dimension

While crisis spurred the initial reform, the continuation of reforms was contingent on a growth rebound. In terms of average growth performance between 1980–82, three of the countries—Denmark, the Netherlands, and the United Kingdom—were among the worst four performers (Greece was the other). And Ireland chalked up the second worst average fiscal deficit, and the third worst average inflation performance at this time. Thus policymakers could make the case that reform was of the essence, requiring a fresh start. In the case study countries, the initial reforms were implemented by a new government, in a decisive break with the past. At the same time, successful reforms heralded strong growth, and provided space for the reforms to continue, suggesting a positive feedback between the intensity of internally-consistent reforms and growth after the initial crisis. The broader event study analysis paints a similar picture—following sluggish growth in the immediate pre-reform period, positive labor supply shifts generally coincided with good times, as measured by high growth rates and an improving output gap (Table 2). At the same time, households savings declined during reform periods, after increasing beforehand, possibly reflecting the absence of adverse confidence effects.

To garner support for reforms, policymakers often neutralized the opposition by granting various vested interests a stake in the process. The type of political system does not

[11] For time series purposes, the only available data on product market regulation conveys information on regulatory conditions in seven non-manufacturing sectors: airlines, telecoms, electricity, gas, post, rail, and road freight. See Conway and Nicoletti (2006) for details.

matter for success, as evidenced by the political variation among the case study countries.[12] While strong stable governments can push through a reform agenda with vigor, this does not preclude weaker governments from seizing the reform mantle, particularly if they allow different groups to "buy into" the process (Castanheira and others, 2006). Indeed, the case study countries went down this route to varying degrees as seen by the trade-offs between wage moderation and tax cuts in Ireland and the Netherlands, and the Danish policy of guaranteeing high benefits in return for a tougher system. Governments in the Netherlands found it useful to put together detailed coalition agreements in advance, typically centering on fiscal policy goals, to avoid any later conflicts. Ireland later adopted this practice with considerable success. Also in Denmark, institutional reforms reduced the ability of parliament to attack individual budgetary measures (Hallerberg, 2004). Importantly, governments tended to win re-election following reforms. And successful reforms tended to be emulated by different governments, even those of a different ideological hue.

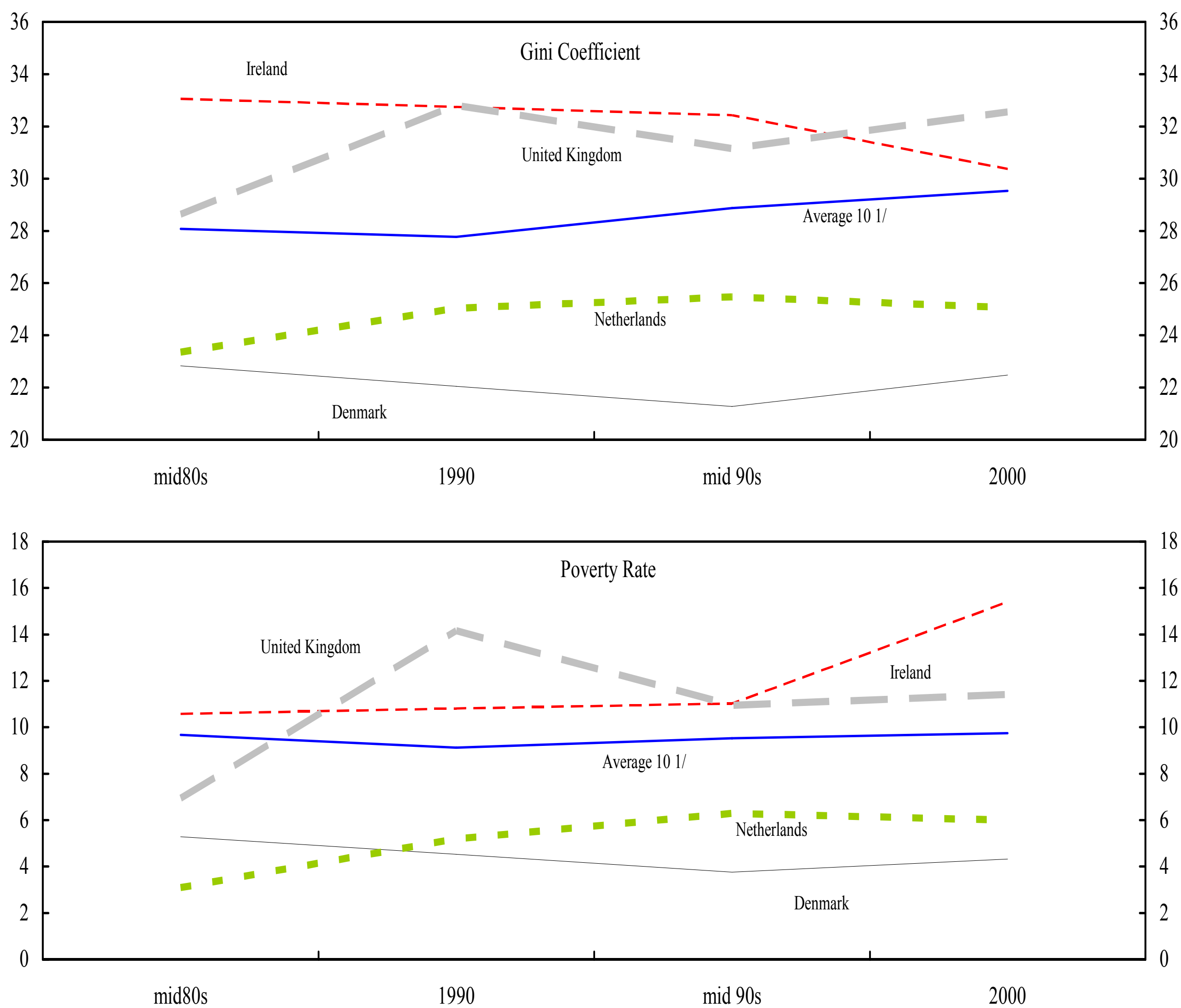
## IV. The Social Dimension

The case study evidence suggests that twin goals of efficiency and equity are not incompatible. A number of recent commentators have pointed out that high employment can go hand-in-hand with low inequality and poverty rates (Sapir, 2005; De Groot, Nahuis, and Tang, 2004). In this regard, countries like Denmark and the Netherlands have consistently outperformed other European countries when it comes to these social indicators like inequality and poverty, and continue to do so. And although the United Kingdom and Ireland

[12] Denmark has a history of minority coalition governments. Ireland has oscillated between single party and majority coalition governments. With a single national electoral district, the Netherlands has the most proportional electoral system in Europe, and multiparty majority coalitions are the norm. And with a majoritarian electoral system, single-party majority governments are standard in the United Kingdom.

are located at the other end of the scale, they still score better than countries like Greece, Italy, Portugal, or Spain. Where a country lies on this scale is largely a product of societal preferences, especially related to the size of social spending, but these preferences need not lead to less employment (see Figure 6).

Figure 6. Social Indicators




Source: Forster and d'Ercole (2005).
1/ Average of other EU-15 members, excluding Luxembourg.

At the same time, reform need not require social cohesion to be sacrificed. Denmark and the Netherlands retained their relatively favorable positions after their reforms. And while inequality nudged up in the United Kingdom following the onset of reforms, it was stable in Ireland throughout the adjustment period, and even declined a little. Also, the uptick in inequality over the 1990s was a widespread phenomenon, common to some reformers and non-reformers alike. Some have argued that the unfavorable effects of expenditure reform on income distribution can be mitigated by faster growth and better targeting of public spending (Tanzi and Schuknecht, 2005).

## V. Conclusion

The key lesson for policymakers is that successful reform programs consist of internally consistent mixtures of labor market, fiscal, and product market reforms that complement and reinforce each other. Policymakers can also maintain popular support for the reform agenda. Looking at past experiences, policies tended to be consistent over time, with little backtracking. In some of the most successful cases, countries embarked on a strategy of simultaneously cutting government spending and labor taxes, which boosted labor supply. In turn, low levels of product and labor market regulation allowed the wage moderation to kindle vigorous employment growth. And higher employment generated further revenue which paved the way for further tax cuts and continued wage moderation—a virtuous circle. Governments maintained support for ambitious reform strategies by giving the different vested interests a stake in the process, such as by rewarding responsible wage-setting behavior by unions with labor tax cuts or by guaranteeing high benefits in the face of a strict regime and little employment protection. Newer governments were more likely to initiate reforms during their honeymoon period. And governments were often able to secure reelection on the heels of a successful reform strategy. Finally, there is no need to sacrifice equity to gain higher employment.

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