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Evidence-based policy making

Unemployment and the role of supranational policies

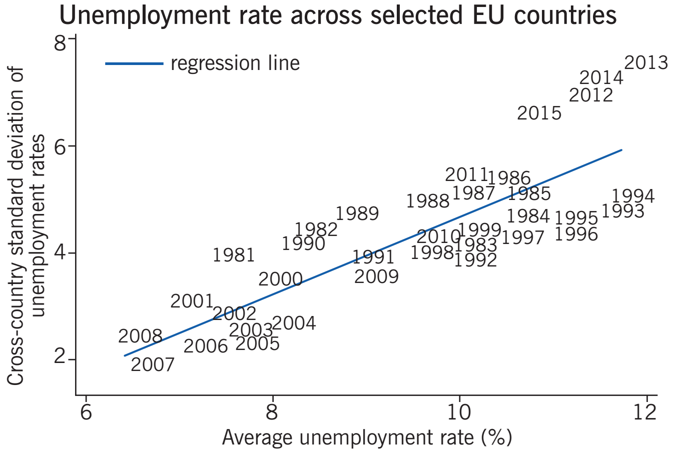
EU supranational policies should be more active at promoting institutional reforms that reduce unemployment

Keywords: unemployment, labor market institutions, employment policies, structural reforms

ELEVATOR PITCH

Unemployment in Europe is excessively high on average, and is divergent across countries and population groups within countries. On the one hand, over the past decades, national governments have implemented incomplete institutional reforms to amend dysfunctional labor markets. On the other hand, EU supranational policies—those that transcend national boundaries and governments—have offered only limited financial support for active labor market policies, instead of promoting structural reforms aimed at improving the functioning of European labor markets. Better coordination and a wider scope of EU supranational policies is needed to fight unemployment more effectively.

Unemployment rate across selected EU countries



Note: Countries included: BE, DE, DK, ES, FI, FR, GB, IE, IT, NL, PT, and SW.
Source: [1].

KEY FINDINGS

Pros

- Some EU countries have effective institutional setups in place for handling shocks while avoiding high unemployment, indicating that best practices do exist.
- Improvements in the EU coordination framework for employment policies could promote reforms to reduce unemployment.
- A significant step forward would be the establishment of an EU unemployment insurance program and introduction of wage subsidies partially financed by EU funds and implemented using individual accounts.

Cons

- Key reforms were not undertaken during the recent crisis, leaving many EU countries with semi-reformed labor markets that are still not fully capable of handling negative shocks.
- The EU has lost credibility regarding its ability to coordinate policy, stabilize member economies, and promote efficient structural reforms.
- EU supranational initiatives are often seen as a means of imposing unwarranted reforms that may not benefit specific member countries.

AUTHOR'S MAIN MESSAGE

During the Great Recession and the European debt crisis, the EU framework for policy coordination failed to provide either sufficient economic stabilization or clear guidelines for structural reforms. As a result, unemployment in Europe remains high, as does its dispersion across countries and population groups. Dysfunctional labor markets still prevail in many countries and, because of reform fatigue and strong insider resistance, progress in structural reforms seems highly unlikely. Improvements in the coordination of economic, social, and employment policies, and, in particular, new EU labor market programs are needed to promote successful structural reforms.

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MOTIVATION

Unemployment in Europe is not only unbearably high, but also insupportably different across nations belonging to an economic and monetary union. Failure to cope with this situation may lead to the collapse of the common EU institutional architecture.

Unemployment differentials have never been as marked as they are today. As of 2014, the top four (Portugal, Croatia, Greece, and Spain) and bottom four (Austria, Luxembourg, Germany, and the Netherlands) national unemployment rates in the EU28 differed by a factor of almost four. In the US by contrast, the corresponding figure for the top five (Michigan, California, Illinois, Rhode Island, and Nevada) and bottom five states (South Dakota, North Dakota, Nebraska, Utah, and Vermont) was only 2.4. Clearly, talking about "European unemployment" or, even more so, of a "European structural unemployment problem" is highly misleading. Moreover, reducing this divergence among unemployment rates is a prerequisite for the smooth functioning of the economic and monetary union.

EU unemployment divergence has its roots in institutional differences. Moreover, EU policy coordination and conditionality during the crisis did very little to improve employment policies or to make labor markets more resilient to shocks in countries with high unemployment (mostly in southern European countries). Additionally, EU employment policies, notably EU conditionality for countries involved in rescue programs, failed to account for the cyclical nature of economic conditions, and did not put enough emphasis on productivity-enhancing structural reforms. Learning from these mistakes is essential to improving the economic policy coordination framework in Europe. Completing Europe's Economic and Monetary Union, as called for by the "Five Presidents' Report" [2], will not be possible without a more decisive intervention of supranational polices in structural reforms.

DISCUSSION OF PROS AND CONS

Diagnosis

Figure 1 provides the mean unemployment rates and their standard deviations (both aggregate and by age groups) in a sample of EU countries during the 1984–2015 period (the corresponding annual series are plotted in Figure 2). There were two main recessions during this period, one in the early 1990s, and the double-dip recession during the aftermath of the Great Recession and the European debt crisis (in bold).

Looking at these developments, the performance of European labor markets during the Great Recession and the European debt crisis could be characterized by a number of observations set out in the following paragraphs.

First, unemployment in Europe is not only unbearably high, but also increasingly divergent across countries. During the 2009–2013 crisis, both the unemployment rate and its cross-country dispersion (in the sample of 13 countries considered) were higher than in the previous recession, regardless of the population age group considered. The fact that the aggregate unemployment rate was lower in 2009–2013 than in 1992–1993, while the corresponding rates for separate age groups were higher, is obviously due to

Figure 1. Unemployment rates, overall and by age groups, across time

	Mean					Standard deviation				
	All	Over 30	15–29	15–24	25–29	All	Over 30	15–29	15–24	25–29
1984–1991	9.5	6.0	15.1	18.7	10.9	4.6	2.8	8.4	10.1	5.9
1992–1993	**10.6**	**7.5**	**16.7**	**20.8**	**12.8**	**4.2**	**3.0**	**7.5**	**9.2**	**5.7**
1994–2008	8.5	6.5	14.1	18.0	10.4	3.1	2.5	5.9	7.9	4.8
2009–2013	**10.2**	**8.0**	**18.6**	**24.2**	**13.6**	**5.4**	**4.6**	**9.2**	**12.3**	**7.9**
2014–2015	10.9	8.8	19.6	25.2	14.9	6.7	6.0	11.6	14.9	10.3

Note: Countries included: Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain, Sweden, and the UK. Means and standard deviations are non-weighted. Bold formatting refers to recession periods.

Source: OECD.Stat. Online at: https://stats.oecd.org/

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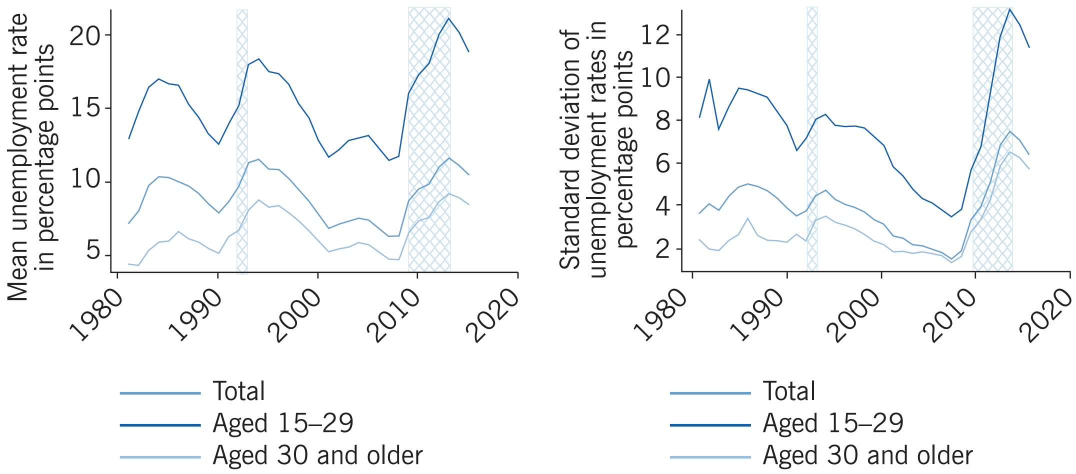
Figure 2. Mean and standard deviation of unemployment rates in a sample of EU countries



Note: Countries included: Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain, Sweden, and the UK. Shaded areas between vertical lines indicate recession periods.

Source: OECD.Stat. Online at: https://stats.oecd.org/

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the composition effect arising from the aging labor force. During the mild recovery of 2014–2015, mean unemployment rates and their cross-country dispersion continued to rise, both at the aggregate level and for each age-specific group.

Second, youth unemployment (for the 15–24 age group) climbed above (often well above) 40% in southern Europe, while remaining mostly unchanged in Austria and Germany. As shown in one study, the rise in unemployment was due both to a youth hiring freeze and to heavy destruction of those jobs held by young people [3]. Since 2009, alongside low educational attainment and lack of skills, younger age has been associated with higher probability of losing a job and lower likelihood of moving from unemployment to employment, especially in countries where the rise in unemployment has been highest.

Third, the rise in unemployment is associated with decreasing GDP. The shocks driving the crisis (for example, the presence and magnitude of housing bubbles in the pre-crisis period and the poor resilience of financial markets), and challenges related to the policy responses to it (for example, fiscal and external financing problems and bail-out issues), explain a great deal of the cross-country dispersion in both GDP growth and unemployment.

However, about half of the cross-country variation in unemployment is not explained by GDP, but instead seems to be associated with labor market institutions and employment policies. For example, the change in unemployment per point of variation in GDP growth turned out to be significantly higher in countries where dual employment protection legislation (EPL) leads to strong segmentation between employees with full-time, regular contracts, and those with atypical contracts (part-time, temporary, or seasonal).

Finally, microeconomic evidence shows that firms followed a variety of strategies to adjust to the shocks, using different combinations of employment, wages, hours worked, and other adjustment mechanisms, and that these strategies were to some extent conditioned by the labor market institutional framework prevailing in each country [4]. Thus, while some countries had the proper institutions in place to deal with shocks, others were in more difficult positions. These countries lacked the appropriate institutions to accommodate the large reallocation of resources needed given the nature of the shocks.

Functional and dysfunctional labor market institutions

The above observations show that some countries allowed several margins of adjustment to their labor market institutions that accommodated the crisis's negative shocks. In others, labor market institutions amplified the negative consequences of the shocks. The most evident examples are:

- *Subsidizing reductions in working hours.* Some countries (most notably Germany) activated a variety of instruments to concentrate the adjustment to the Great Recession on the intensive margin (i.e. a reduction of working hours). First, the scope of subsidized short-time work was increased. Second, German firms made heavy use of working time accounts (essentially a scheme allowing firms to borrow from their employees: rather than being paid for overtime work, employees had the right to work fewer hours at a later date). Third, the introduction of mini-jobs increased the scope of multiple job holdings, which helped prevent outright unemployment for many workers who lost their primary (or secondary) jobs.
- *Decentralized bargaining.* There has been a clear trend toward decentralized wage-setting in some EU countries since the early 1990s. This is the case in Germany, which has been a pioneer in the introduction of so-called "exit clauses." These clauses allow firms to use plant-level "pacts for employment and competitiveness," which enable wage reductions rather than collective dismissals. In contrast, until at least 2012, collective bargaining institutions in Spain imposed wages established at "higher" (provincial or sectoral) levels that included very limited exit clauses. This prevented firms from being able to trade wage concessions with their workers for more employment security, as was the case in Germany.
- *Dual employment.* The coexistence of two different segments in the labor market (employees with open-ended contracts and employees with temporary contracts) generated larger fluctuations in employment than those observed in fully flexible

labor markets. Countries with a higher level of contractual dualism display a stronger responsiveness of unemployment to output changes. Since dismissing temporary workers is much less expensive than firing permanent employees, employment adjustments are mostly concentrated on those in temporary employment, which insulates workers holding permanent contracts from the consequences of negative shocks. Thus, large job losses among temporary workers may well coexist alongside wage rises among those employed under permanent contracts.

- *Active labor market policies (ALMPs)*. The effectiveness of ALMPs at reducing unemployment remains a controversial issue. Some surveys tend to conclude that, when taking into account deadweight, substitution, lock-in, and general equilibrium effects, ALMPs are not cost-effective at reducing unemployment [5]; others suggest that some programs, in particular those aimed at human capital accumulation, can have positive long-term effects on the employability of some targeted groups, especially in a recessionary climate [6]. In any case, the effectiveness of ALMPs seems to be rather dependent on the institutional framework in which they are implemented. Thus, human capital accumulation programs tend to be less effective in countries where dual EPL leads to job instability due to a high degree of worker turnover across short-term jobs. In sum, dysfunctional institutions not only lead to bad labor market performance, but also reduce the effectiveness of ALMPs.

The effects of labor market reforms throughout the business cycle

A huge literature on the effects of institutions on labor market outcomes offers insights into the long-term effects of institutional reforms [7]. The appropriate timing to implement labor market reforms is also an important topic for policy discussions. In principle, it seems that employment can be made more resilient to negative shocks by increasing wage flexibility during recessions, instead of increasing employment flexibility, which amplifies employment volatility, especially when done by promoting contract dualism.

Moreover, since the optimal level of unemployment benefits is lower when unemployment duration increases with benefits, generosity should be higher when the unemployment rate is high and be reduced during economic expansions [7], generosity should increase when the unemployment rate increases, and be reduced during economic expansions, although this raises the fiscal costs at the moment in which budgetary constraints are more binding. There are also conceptual reasons and empirical evidence to advocate that the counter-cyclicality of unemployment rates should be embedded in replacement rates (the ratio of benefits to past wages) rather than in duration entitlements.

Regarding ALMPs, there is some trade-off about their effectiveness and the resources available for financing them during the business cycle. In recessions, there are few job offers around, so even when some ALMPs are effective, the increase in the employment rate brought by these types of measures is small [7]. However, increasing employability during recessions is especially important to avoid hysteresis (that leads to cyclical rises in unemployment becoming permanent), and to stave off the decrease in the rate of people moving into employment due to long-term unemployment spells. On the other hand, public resources to upgrade ALMPs are scarcer in recessions. Hence, whether ALMPs should be conducted more intensively during recessions is, as with their overall effectiveness, a controversial issue. Increasing expenditures on ALMPs during downturns is politically challenging due to budgetary constraints, and, most often, these expenditures end up being pro-cyclical.

A similar trade-off also appears in pension reforms. Reforms that steeply raise the retirement age just when labor demand is declining may backfire. Employers may end up freezing new hires, preventing recessions from serving as labor market cleansing devices, especially in countries where young workers are better educated than incumbents. Instead, early retirement under actuarially neutral adjustment of pension benefits may be desirable, so as not to increase social costs in the long-term.

Summing up, there are three important policy lessons about the timing of structural reforms. First, their effects depend on cyclical conditions. Second, the employment policies needed during recessions involve higher public expenditures. Finally, precisely because employment policies during recessions may involve more public resources, it is important to design a sequential strategy taking into account intertemporal budget constraints—those constraints faced by a decision maker who is making choices for both the present and the future—which are especially relevant in the case of pension reforms. This sequential strategy is also needed because of political feasibility issues, which frequently lead to the implementation of most reforms during downturns (when they may be most harmful), and far fewer reforms in good times (when they would be most palatable).

The shortcomings of labor market reforms in Europe during the crisis

Although describing and assessing all labor market reforms implemented in EU countries since 2007 in detail is beyond the scope of this article, there are some key features that are important to highlight (for a summary list of labor market reforms in EU countries during this period, see [4]).

First, while some countries were able to accommodate negative shocks via their existing institutions and without a significant increase in unemployment (for example, Austria, Germany, and Belgium), others experienced a large increase in unemployment and implemented fundamental labor market reforms. In most cases, these reforms followed recommendations by international institutions to national governments that were either under formal rescue programs or were suffering severe macroeconomic imbalances (for example, Portugal, Greece, and Spain).

Second, labor market reforms essentially focused on (i) promoting wage moderation, (ii) implementing reductions in severance pay and, more broadly, the strictness of employment protection, and (iii) increasing statutory retirement age.

Third, not all recommendations from international institutions were closely followed (for these recommendations see [8], [9], [10]). The following were all overlooked and mostly absent from the reform agendas: the elimination of contractual dualism; the implementation of schemes inducing more adjustment along the intensive margin, such as short-time work or working time accounts; the introduction of productivity enhancing measures; exploiting complementarities between ALMPs and unemployment benefits by making the latter conditional on activation (as recommended, for instance, by the OECD); and the introduction of actuarial reductions to early retirement, rather than forcing a rapid increase in the retirement age.

Thus, labor market reforms implemented by national governments were not fully rooted in key lessons from international experience. They did not adequately account for the differences in labor market responses to shocks in the euro area [4], nor for the counterproductive effects of labor market reforms under major recessions. As a result, the EU countries most affected by the rise in unemployment did not find any fiscal space to accommodate negative shocks, and were forced to undergo internal devaluation processes that turned out to be excessively costly in terms of employment losses. Although some of the measures implemented in those countries may have been desirable in normal times, incompleteness, lack of coherence, and bad implementation of the reform packages have left these countries in not much better positions compared to where they were prior to the crisis, with dysfunctional institutional labor market configurations.

Toward a new approach of EU supranational policies

The recent negative experience of structural reforms during the European crisis period suggests that the coordination framework and the conditionality principle behind EU supranational policies have not delivered a more efficient institutional framework, especially regarding European labor markets. Increasing cross-country divergence in unemployment is the result of the contrast between countries with an adequate combination of labor market institutions and those with dysfunctional policies. In the former, negative shocks were accommodated without a rise in unemployment, while in the latter, unemployment surged. Although reforms implemented during the crisis period in the latter countries moved their institutional frameworks in the right direction by promoting wage and employment flexibility, they failed to anticipate some negative consequences during downturns and did not address all the institutional drawbacks prevalent in these countries.

This sequence of events has two negative consequences. One is reform fatigue, especially in countries that implemented reforms during the crisis. The other is the lack of credibility of the EU framework for policy coordination, economic stabilization, and promotion of efficient structural reforms. National governments have difficulties introducing best practice institutions, and EU supranational initiatives in this respect are seen as instruments to impose unwarranted reforms or, in the less adverse case, to support the status quo.

Insisting on conditionality and imposing reforms from abroad are likely to present further barriers for efficient structural reforms. If national governments do not take full ownership of their own reforms, the most likely result will continue to be the implementation of incomplete policy packages that do not fully address the roots of dysfunctional labor markets. Similarly, if supranational institutions do not take full ownership of the policies that they recommend, implementation at the national level will most likely be inefficient.

Moreover, since reforms may have strong effects on income distribution, and may thus require compensating losers, there is a need for greater funding of employment programs. Supranational funding, if well-designed, could lessen the institutional shortcomings of some countries, while at the same time playing a stabilizing role across the eurozone. Admittedly, there are limitations to the financial resources that an EU budget can provide.

However, the EU budget will have to be upgraded to meet the challenges of "completing Europe's Economic and Monetary Union." Additionally, the available resources already devoted to improving "competitiveness for growth and jobs" and "economic, social and territorial cohesion" (about €113.3 billion in 2016, amounting to around 73% of the total EU budget) could surely be more effectively spent in meeting some of these challenges.

There are ways to change this undesirable state of affairs by using EU supranational policies to promote efficient labor market reforms, while, at the same time, meeting some desirable criteria, namely, (i) not harming the subsidiarity principle—the belief that decisions should be made at the local level, if possible , (ii) keeping conditionality, and (iii) being financially feasible under reasonable budget constraints.

For instance, one study advocates "positive conditionality," a concept based on the following four principles [1]:

(i) EU supranational policies should be complementary to national programs, not substitutes for them. The sole competence for employment policy should remain with the member states.

(ii) EU supranational policies should implement measures that neither involve large expenditures (given the EU budget constraints) nor deliver permanent transfers across countries.

(iii) EU supranational policies should empower people as opposed to national governments, by providing fully portable benefits across national jurisdictions in the form of EU-wide entitlements. These benefits could also contribute to reducing some barriers to transitory labor mobility, which could play a stabilizing role in case of asymmetric shocks.

(iv) Access to the benefits of EU supranational policies should be conditional on national governments accepting best practice institutional changes. National governments should be free to choose either to accept EU benefits, and thereby implement the required institutional reforms, or to retain their status quo institutional framework, but without gaining access to the EU benefits.

A useful instrument to achieve the above goals is the gradual introduction of individual accounts, which could make transfers involved in EU supranational policies to European citizens easily implementable, more visible, flexible, and better targeted to the most disadvantaged population groups.

The following discussion offers an example of how these principles could be put into practice by creating a specific program aimed at providing hiring incentives, unemployment insurance, and support for pension entitlements, all at once.

Inadequate EPL and contract dualism are the major sources of inefficient worker turnover and job instability, and act as a barrier to human capital accumulation and productivity growth. To combat this, the EU could create a "European Employment Contract for Equal Opportunity," which would be an open-ended contract with severance pay gradually increasing along with worker tenure [11], as included in the new open-ended contract introduced in Italy and effective since March 2015. The contract comes with individual savings accounts that accumulate contributions by employers (as created in the Austrian system via reforms of severance pay implemented in 2003 [12]) and by a new European Fund (which could be constituted through the combination of resources from Structural Funds and the European Social Fund). The European contributions would play the role of hiring subsidies, since employers would benefit from the reduction in labor costs resulting from the EU contributions to individual accounts. Only if national governments implemented this contract, with the attached EPL provisions, could newly hired workers under the new European contract benefit from the contributions of the European Fund. In this way, national governments would have an incentive to implement the needed EPL reform.

Upon dismissal, workers could use the funds accumulated in their individual accounts to either finance training or complement unemployment benefits paid by national insurance programs. As such, this measure embeds the embryo of a complementary "European Unemployment Insurance Program," which introduces some automatic stabilizers at the EU level while promoting solidarity and social and economic cohesion among member states, an explicitly stated goal of the European Treaties. By doing so, this policy could deliver both a smoother absorption of asymmetric shocks and more economic convergence [13]. As suggested in another study, the presence of an experience rating in the financing of unemployment benefits (under which employers with higher firings contribute more to the funding of unemployment benefits) provided by national governments under this contract would also be convenient, and could be a required condition for EU funding [11].

Workers not dismissed could use the funds accumulated in their individual accounts to complement pension entitlements. Introducing some pre-funding of pension entitlements under defined contribution schemes could help promote actuarial neutrality and the portability of pension rights across jurisdictions. Greater information transparency about future pension rights and intertemporal budget constraints, both at the aggregate and the individual levels, is needed to improve flexibility in retirement age, which would soften the cost of adjustment to macroeconomic shocks while also rejuvenating the workforce. Moreover, generalizing actuarially neutral adjustments to pension entitlements enables the full and sustainable portability of pension rights across jurisdictions, and forces intra-EU bilateral agreements among social security administrations to be more transparent.

LIMITATIONS AND GAPS

Calls for more active involvement of EU supranational policies in the institutional reform of EU member countries and for larger funding of EU employment programs typically face both economic and political objections. The economic objection generally has three layers. The first deals with the nature of externalities and spillovers across countries that would justify strong intervention by supranational institutions in national labor markets. The second is the lack of consensus about the diagnosis and treatment of the causes of dysfunctional labor markets. Finally, there is the issue of the limited EU budget available to fund employment policies with positive conditionality. The main political objection is that these policies could potentially generate cross-country transfers and pressures to increase the EU budget. As argued above, these objections could be overcome by moving toward a new approach to designing and implementing EU supranational policies.

SUMMARY AND POLICY ADVICE

Dysfunctional labor markets remain prevalent in multiple EU countries despite the reforms implemented during the recent crisis. These reforms were incomplete and, in some cases, counterproductive, as they were introduced without sufficient consideration of their consequences during downturns. Unemployment is becoming increasingly divergent across EU member countries and national governments seem incapable of delivering a complete package of efficient structural reforms. Reform fatigue, insiders' resistance to alter the status quo, and the lack of scope of EU supranational policies make it very likely that the current unfortunate state of affairs will persist. Under this scenario, with this combination of policy failures at the national and supranational levels, it is difficult to foresee a bright future for a united Europe.

EU supranational policies should be reconsidered in a bid to change this situation. New EU programs with positive conditionality, rather than recommendations and guidelines either suggested or imposed under rescue programs, should be the norm rather than the exception. They could give national governments the necessary incentives to implement institutional changes based on best practices. Moreover, by empowering European citizens rather than national governments, these programs would make EU policies more credible, and, at the same time, more transparent and socially acceptable.

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Competing interests

The IZA World of Labor project is committed to the *IZA Guiding Principles of Research Integrity*. The authors declare to have observed these principles.

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Further reading

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