Structural reform policies: New OECD report reveals vanishing confidence among governments about reform impact

TUAC Secretariat Comments on the Going for Growth 2015 Publication

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Going for Growth 2015 (GfG 2015), the new issue of OECD's flagship publication on recent structural policy developments and reform priorities for the current year has been launched in Istanbul on 9 February 2015. One of its key findings is that the pace of structural reforms has been slowing in the majority of advanced economies. This suggests that governments have increasingly lost confidence in the alleged benefits of implementing structural reforms. This finding, which is causing great disappointment among the report's authors and advocates of structural reforms, may reflect a slight relief for many workers in the countries concerned. They have all too often been affected by adverse effects of structural reforms, in particular by those on labour markets. In this respect, the report acknowledges that "in the short run, several reforms entail transitional costs, especially if introduced under unfavourable macroeconomic conditions and limited room for counter-cyclical macroeconomic policy or flanking measures to protect the poor." More specifically, the report points out that in some cases the hoped-for long-term growth gains "can be preceded by short-run losses" and that "growth benefits may take more time to materialise in a downturn." [1] Thus, some reforms may hit the most vulnerable in the short run, even if such negative effects are allegedly overturned by the benefits of reform in the medium run.

Although slightly more nuanced than previous issues, *Going for Growth 2015* fails to take adverse effects of structural reforms sufficiently into account

It is interesting to note that the report openly displays difficulties many governments are facing in their efforts to push for reforms in a context of weak aggregate demand, high unemployment and the adverse effects of reforms implemented. As examples for adverse effects of structural labour market reforms, *GfG 2015* refers to social protection reforms aimed at encouraging jobseekers' return to work through a tightening of conditions for receiving unemployment benefits in a context of severe labour market slack, which can

[1] OECD, ECONOMIC POLICY REFORMS 2015: GOING FOR GROWTH; Paris 2015, p. 21

temporarily depress overall employment. The editorial of *GfG 2015*, signed by *OECD Chef Economist*, *Catherine Mann*, is particularly frank in this respect. It notes that in “some of the countries hardest-hit by the crisis, substantial labour market reforms aimed at restoring competitiveness have been introduced without commensurate and parallel efforts in product markets and without the availability of fiscal resources to cushion the social impact. The result has been severe job and income losses, hurting young people the most.” [2]

In a nutshell: In line with previous research, *GfG 2015* not only confirms that regulatory reform and institutional change contributed to unemployment, it also confirms the legitimate concerns regarding adverse employment effects of implementing labour market reforms in times of weak aggregate demand and high unemployment; concerns repeatedly expressed by trade unions and a number of economists looking at labour markets without blinders. [3]Against this backdrop, it is welcome that *GfG 2015* emphasizes that “postponing such (labour market) reforms until the labour market shows clear signs of recovery is legitimate in economies still facing weak demand.” [4]

Continuously subject of reforms: Protective labour market institutions

Regrettably, however, the recommendations for structural reform suggested by *GfG 2015* fail to take that into account. Instead, the section on labour market regulation and collective wage agreements laments subsequent to a period of a substantive reduction of the alleged strictness of employment protection, which mostly focussed on easing regulations governing individual and collective dismissals that OECD countries have started to show signs of a pause in further reforms of protective labour market institutions. Consequently, *GfG 2015* calls upon 8 member countries to further weaken employment protection legislation on regular workers, namely Chile, France, Germany, Italy, Japan, Korea, Spain and Sweden. At the same time, *GfG 2015* urges France, Luxembourg, the Netherlands, Spain and Turkey to lower the notice period for dismissals or severance pay. Moreover, Belgium, Portugal and Spain are requested to reduce or eliminate administrative extensions of collective wage agreements and to promote wage bargaining at the firm level.

In view of the heavy criticism directed to the recommendations made in previous issues of *GfG,* in particular with regard to adverse employment and income effects, it is unsurprising to note that the current issue comprises a particular chapter discussing the effect of pro-growth structural reforms on income inequality. In this respect, it is much less surprising that, while conceding that income inequality has increased in a majority of OECD countries since the mid-1990s, *GfG 2015* in the section summarising the main findings of the chapter firmly asserts that many reform recommendations made by previous issues of *Going for Growth* “have little or no impact on income inequality among households, even when they widen the wage dispersion.” [5] It is obvious, as this is an effort to underpin the legitimacy and appropriateness of structural reform policies, the assertion cannot be taken at face value. It is

[2] OECD, p. 4
[3] Modigliani , F. et. Al., An Economist's Manifesto on Unemployment in the European Union; BNL Quarterly Review, no. 206 September 1998
[4] OECD, p. 21
[5] OECD, p. 76

in a striking contrast to recent OECD research on causes and drivers of the increase in income inequality. This research revealed that many dimensions of regulatory reform and institutional change contributed to an increase in wage inequality. The summary also misrepresents findings stemming from research of the OECD's Economics department and summarised in the same chapter. In doing so, the chapter states that "for example, lowering the minimum wage or reducing the unemployment benefit replacement rate as well as easing the stringency of employment protection may lead to higher wage dispersion by reducing the reservation wage and by increasing the creation of low-paid jobs." [6]

How such 'reforms' can be characterised as having "little or no impact on income inequality" remains the secret of the authors. The same applies to the message conveyed that implementing structural reforms can boost demand - "which is crucial to preventing the development of a vicious circle whereby weak demand and growing inequalities undermine potential growth and confidence, possibly leading to persistent stagnation," as OECD Secretary-General Angel Gurría said during the launch event in Istanbul.

Quantifying the impact of structural reform policies: Lost in estimation

The final chapter of *GfG 2015* provides an overview of reform activity since the early 2000s. It claims that overall "*structural reforms implemented since the early 2000s have contributed to raising the level of potential gross domestic product (GDP) per capita by around 5%*" and that "*further reform towards best practice could further raise potential GDP per capita by up to 10% on average across OECD countries, depending on the degree of their ambitions.*" [7] These are bold and puzzling statements. The estimated output gap across the OECD in 2014 on average was about 2.3% of GDP, while countries like Ireland, Italy, Portugal and Spain were struggling with output gaps of around 6% and Greece with a gap of about 12%. GDP per capita in Greece, Spain, and Ireland is predicted to remain below pre-crisis levels until at least 2019. It seems that the quantitative effects of structural reforms in raising GDP-per-capita as outlined by *GfG 2015* are overly optimistic and thus in need of a serious revision.

They are ways beyond the effects of ambitious and comprehensive structural reforms in Europe as quantified by the IMF. The IMF recently reported that labour market reforms in Europe could have a positive but modest impact on real GDP of 1½ percent after five years.[8] However, in the light of a joint IMF-OECD effort of '*Quantifying the Impact of G-20 Members' Growth Strategies*' even this result seems to be fairly optimistic: The commitments made by the G20 members to raise the level of their combined GDP by 2 percent by 2018 relative to the levels in October 2013 are being carried out under the estimation that labour market reforms would contribute to GDP growth over the period by less than 0.5%.

Going for Growth 2015 – a further effort towards institutional convergence

First published in 2005 with the objective to provide an overview of structural policy developments in OECD countries from a comparative perspective, the annual *Going for*

[6] OECD, p. 80
[7] OECD, p. 104
[8] Schindler, M.; Berger, H., Jobs and Growth: Supporting the European Recovery, Washington 2014; chapter 7

Growth issues have evolved into a tool of *structural surveillance*, complementing primarily the OECD's country surveys. In line with previous issues, *GfG 2015* once more tries to promote structural reform policies as a magic bullet against current economic and social ills - unemployment, low growth, poor productivity, fiscal deficits and current account imbalances. However, there are a number of problems with the underlying approach of *GfG*. A particular problem is being caused by the claimed universality of its analytical concept and the derived recommendations.

GfG stands for the superiority of the liberal market economy model, comprising fairly deregulated and thus competitive product and labour markets. Moreover, it implies that such a regime triumphs over all others, in particular over coordinated market economies characterized not only by a diversity of institutions and forms of organisations and perceived as stemming from delayed adjustment, social or political inertia, or dependency on a country's legacy. Thus, *GfG* appears not only to be blind towards the existing diversity of cultures and institutions across economies which are most often the outcome of social and political developments, conflicts, compromises and decisions that are embedded in a specific society during a given historical period. It also disregards complementarities and interaction between institutions.

The latter has serious implications for the prediction of effects caused by the implementation of reforms as recommended by *GfG*. Particularly worrisome in this regard is the fact that recommendations to reform product and labour markets are often based on estimates that consider only the institution to be reformed. As neither the analysis, nor the estimates sufficiently take into account the interaction between institutions, reforms recommended risk to fail or might even generate adverse effects as they impair interactions among different and interlinked institutions. Hence, in order to understand the effects of institutional change, it is of utmost importance to pay careful attention to the potential for institutional complementarities across the whole sphere of the political economy.

It is fair to say that *GfG* does not deny that differences in economic, social and political institutions exist across the OECD. On the contrary, while acknowledging institutional differences, it blames poor or substandard performance regarding growth, productivity and employment on allegedly inappropriate institutions, in particular labour market institutions. In doing so, it implicitly calls for a departure from institutional diversity and a shift towards a new model of an ideal economy. A key issue in this context is the fact that its recommendations for structural policy reforms are informed by a „*one model fits all economic environments*"view of institutions in capitalist market economies. Regrettably, the one-model-fits-all-approach fails to pay sufficient attention to existing institutional complementarities across the spheres of the political economy and to acknowledge that there is more than one road to Rome – that is to say that more than one economic model can deliver economic success.

There is no evidence suggesting that institutional differences cannot persist in a global economy and that competitiveness does require that labour institutions converge to a single dominant form. For instance, comparative advantages only develop with diversity between economies. It is a story about gains that come from differing from one's neighbour, not from emulating him.

There are more compelling arguments for maintaining institutional differences across economies and thus a variety of capitalism as well. Research and on-hand experiences show that there is a historical pattern in which capitalist countries temporarily tend to do better than others in some periods (i.e Japan in the 1970s-1980s, the US in terms of employment during the 1990s, Germany subsequent to the 'Great Recession' after 2007/2008) but then often run into problems. This pattern is more consonant with the view that capitalism permits national differences in institutions to persist than with the view that all economies must converge to a single institutional structure. Capitalist countries have historically had quite different labour market institutions and social policies. High mobility and numerical flexibility are key features of the US labour market, corporatism and coordinated collective bargaining are prevailing in the Nordic countries and Austria, while the dual apprenticeship system and employment protection interact in Germany. And, throughout the EU "social partners" negotiate agreements, whereas in North America the term has no meaning. That has caused a well-known labour economist to emphasize that labour markets are potentially the most idiosyncratic markets in advanced capitalist economies[9].

Conclusion

In line with previous issues of *Going for Growth* the new one claims to identify policy priorities necessary to boost growth, productivity and employment. It derives the requests for reform by applying once more the *one model fits all economic environments* approach. In doing so, it disregards both the lessons to be drawn from the responses of different labour market to the crisis as well as the findings of recent OECD analysis carried out outside the Economics Department of the organisation. Disregarding new evidence cannot sufficiently be described as presenting 'old wine in new bottles.' Instead, it may be closer to a 'not invented here' approach, not unknown in research and development process of large organisations. However, more important is the observation that *Going for Growth 2015* is not going to strengthen the credibility of the OECD and its reputation as a 'learning organisation'. In order to strengthen its credibility and its reputation, the next issue of *Going for Growth* needs to provide robust evidence of systematic positive effects of reforms, in particular of labour market reforms such as an improved employment performance, based on the creation of more decent jobs and reduced inequality through complementarities and the interaction of strong labour market institutions. Such an exercise, bringing new evidence to the fore, would at the same time boost the confidence with which such reforms could be promoted.

[9] Freeman,R., SINGLE PEAKED VS. DIVERSIFIED CAPITALISM: THE RELATION BETWEEN ECONOMIC INSTITUTIONS AND OUTCOMES. NBER Working Paper 7556; Cambridge, Mass. 2000, p 1.