Chapter 15. The political economy of reforms

Many OECD countries undertook important structural reforms in the wake of the global financial and economic crisis. Despite the long-run improvements in well-being that such reforms are likely to bring, they often face strong opposition, particularly in the case of labour market reforms. This chapter describes the factors that make reform happen and the policies that can help support the reform process. Good economic times are the best time for reforms, since then their benefits materialise more quickly. In practice, however, reforms are often undertaken in downturns, when the perceived urgency of reforms, but also their short-term costs are greater. Another political economy consideration is that many reforms create winners and losers in the labour market and affect the distribution of income. Appropriate design and complementary policies can mitigate these potential downsides of reforms to enhance political support.

Introduction

The political economy of reforms is an integral component of the new OECD Jobs Strategy, in recognition of the fact that, without proper design and implementation, policy reforms for stronger and more inclusive labour markets and economies may not achieve their stated goals. Choosing the right opportunity to create support for a reform and to maximise its benefits is important for policy-makers, politicians and, most importantly, for citizens.

Over the past decades, OECD countries have adopted and implemented reforms in a wide range of areas, including labour markets, product markets and financial markets. Most of these reforms have had important consequences for various aspects of labour market performance: employment, job quality, inclusiveness, and resilience and adaptability. Reforms took place in different countries at different times. The period after the outburst of the global financial and economic crisis saw a particularly high number of reforms, especially in the European countries that were hit hardest.

Many reforms involve winners and losers, which can weigh on the political support for reforms. Those who may lose out tend to have strong incentives to lobby against the reform. Sometimes, losses are concentrated within a specific industry, region or group of workers. Countries have therefore frequently combined economy-wide policies with measures dedicated to cushioning the impact on certain industries, regions or workers. Labour market reforms tend to be particularly contentious, as they often affect large parts of the population and so create many potential winners and losers.

Another reason that may make it difficult to get reforms passed is that reforms can give rise to significant short-term costs despite being welfare-enhancing in the longer term. As the chapter shows, for some reforms this is especially likely to be the case when they are undertaken in an economic downturn. The transitional costs of such reforms can be mitigated through appropriate design and complementary policies.

The remainder of this chapter is organised as follows. Section 15.1 briefly describes the context within which governments in OECD countries have been undertaking reforms. Section 15.2 defines ten guiding principles for promoting a pro-active reform agenda and its implementation. Section 15.3 focuses on the short-term challenges of reforms and the policy choices that can help mitigate them. Section 15.4 discusses the issue of winners and losers of reform and how those who may lose out can stand in the way of reform initiatives. The chapter concludes with final remarks highlighting the most important insights.

15.1. A good time for reform?

The global economy, a decade after the onset of the global financial crisis, is enjoying fairly strong and widespread economic growth, even if some large emerging market economies are facing headwinds. The positive economic outlook should be conducive to the successful implementation of required labour market and other structural reforms. In many countries, reforms are needed to confront an array of challenges (see Chapter 2 for a more detailed discussion): productivity growth has been at historically low rates over the past 10-15 years. Real wage growth has been lower still. Inequality is at record-highs, and vulnerable groups face weak prospects in the labour market. Megatrends, such as digitalisation and globalisation, carry opportunities, but also risks for some groups of workers.

During the crisis, deep reforms were undertaken, including in southern euro area countries with a macroeconomic adjustment programme. Recently, reform efforts have diminished, with some notable exceptions (for example France). In part, this is to be expected given that in the countries where reforms were most needed they have been made and some time is needed to assess whether they have the desired impact. The slowdown in reform activity may also be related with reform fatigue or a decline in the perceived urgency of required reforms. Nevertheless, one-third of OECD countries implemented, or were in the process of implementing, an important reform last year in one or more areas of labour market policy (social assistance, minimum wages, collective bargaining systems, gender inclusion, integration of immigrants and minorities, activation policies and labour market regulations) – see OECD (2018[1]).

The counter-cyclicality of reform activity over the past decade – high during the crisis years and low during years of comparatively strong global growth – suggests that policy has been more reactive than pro-active. Such a pattern, which is not unique to the past ten years (Drazen and Easterly, 2001[2]), may not be ideal for several reasons. As will be illustrated below, the short-term challenges of reforms tend to be larger in bad than good economic times. Reforms undertaken in bad economic times may also be driven more by urgent needs rather than long-term well-being considerations. Further, the preparation of reforms takes time which may not be available in the face of a short-term emergency. The next section discusses options for politicians and other policy-makers to support the development of a more pro-active reform agenda.

15.2. Guiding principles for the design and implementation of a pro-active reform agenda

Initiatives for reforms to promote well-being often run into opposition, preventing their implementation. This is because many, if not all, reforms involve transitional or distributional costs. Labour market reforms tend to be especially contentious, since, in contrast to regulatory changes in a particular sector for example, they tend to affect all parts of the economy and a larger share of the population. Looking at the history of structural reforms and subsequent performance, ten lessons for the successful design and implementation of reforms can be drawn (Tompson, 2009[3]; Caldera Sánchez, de Serres and Yashiro, 2016[4]):

1. *Electoral mandate for reform*

   An electoral mandate for the government to reform is important. Without approval by the electorate, reforms tend to succeed only when their benefits become very rapidly visible, which is rarely the case for major reforms. The exception may be, as mentioned earlier, times of crises which can create opportunities for "reform surprises", as governments may have no choice other than to reverse course. Another, external force for reform arises for countries that become or are members of an economic union or international organisation. Accession countries in Eastern Europe adopted major reforms before and after joining the European Union (Duval, Furceri and Miethe, 2018[5]). However, without an electoral mandate, there is a risk that such reforms lack sufficient ownership and are (partially) unwound once the immediate need for them has dissipated.

2. *Leadership*

   Strong leadership, by an individual policy-maker or an institution in charge of the reform, is critical. It should, however, not be equated with unilateral action by the government. While unilateral action is sometimes the only way forward, successful leadership usually means winning consent, rather than securing compliance. This is in particular the case for labour market reforms that are facilitated by tripartite discussions between the government and the social partners. Such reforms may be led by a strong government, but are more likely to achieve the desired outcomes when the social partners are closely involved. The "wage moderation" in Germany in the 2000s probably owes much to a common understanding between the government and the social partners that the country's external competitiveness should improve (Bofinger, 2017$_{[6]}$).[1]

3. *Effective communication*

   Effective communication, also through the social media, is essential. Successful reforms are usually accompanied by co-ordinated efforts to persuade voters and stakeholders of the need for reform and, in particular, to communicate the costs of no reform. When, as is often the case, the costs of the status quo are opportunity costs, they tend to be politically "invisible", making the challenge all the greater. It is typically fairly clear who will pay the price for a reform – which firms are likely to come under pressure and which jobs may be at risk – whereas it is not obvious who pays for the status quo: it is difficult to identify firms that have never entered the market or sectors that have not developed or the workers whom they would have employed.

4. *Reform commitment*

   Reform commitment is closely connected with effective communication, but goes beyond it. Announcing a reform early and committing credibly to it can help bring forward the gains from the reform. For example, announcing product market reforms in advance can trigger an immediate response by firms, increasing investment and output even before the reform is actually implemented (Adjemian et al., 2008$_{[7]}$). In the area of labour market reforms, announcing future employment protection legislation reforms early can increase hiring as firms anticipate lower costs of layoff procedures, while avoiding an immediate rise of dismissals as existing rules continue to apply (International Monetary Fund, 2016$_{[8]}$). In downturns, this can be an effective way to limit temporary declines in employment due to such reforms (OECD, 2016$_{[9]}$).

5. *A solid evidence base*

   Policy design must be underpinned by solid research and analysis. An evidence-based and analytically sound case for a reform serves both to improve the quality of policy and to enhance prospects for reform adoption. The impact of economic analysis also depends on the source: research presented by authoritative, non-partisan institutions commanding trust across the political spectrum tends to have a greater effect. The United Kingdom is one among several countries with a history of influential, independent bodies (comprising, for example, the Institute for Fiscal Studies, the National Institute of Economic and Social Research or the Office for Budget Responsibility). Building such institutions can take time, as their effectiveness depends greatly on their reputation. When a reform is passed, it is important to ensure that it is fully implemented, effectively enforced and rigorously evaluated. This requires investing in data collection, if data to monitor compliance and outcomes are not available, and strengthening evaluation mechanisms to assess the effects of reforms. To enable credible impact evaluations, they should be planned at the design stage of the policy reform.

6. *Packaging reforms*

   Policies are often more effective when they are combined in coherent packages to enhance synergies and reduce their transitional or distributional costs (OECD, 2016[9]). For instance, interventions to help workers facing severe barriers to employment may be most effective when they simultaneously involve the design of taxes and benefits (including unemployment and in-work benefits), active labour market policies and minimum wage floors. In a modelling exercise, Cacciatore et al. (2016[10]) find that unemployment benefit, product market and employment protection reforms boost gross domestic product (GDP), employment and wages faster when they are combined than when the reforms are undertaken in isolation.

7. *Sequencing reforms*

   In certain cases, outcomes might be enhanced if reforms are sequenced, for example when product market reforms precede labour market reforms (Blanchard and Giavazzi, 2003[11]). Reforming product markets first can, by lowering rents in product markets, reduce the incentives of workers to fight for a share of these rents and thus resistance to labour market reforms. Another argument for gradualism is that, as governments have a limited amount of political capital, it is best if they allocate it to one reform at a time. However, too long a time lag between reforms may not be desirable either. In the case of New Zealand's reforms during the 1980s and 1990s, a significant time lag (of five years) between the product and labour market reforms reduced the potential overall gains from these reforms (Caldera Sánchez, de Serres and Yashiro, 2016[4]).

8. *Time*

   Successful structural reforms take time. Many successful reforms take two years or more to prepare and adopt. This time for framing a specific reform is often preceded by a multi-year period of "pre-work", in which problems and proposals are debated and studied. By contrast, less successful reforms are sometimes undertaken in response to an immediate pressure. While governments should be ready to use political "windows of opportunity" when they open up, doing so may create problems if it leads to excessive haste. It is also not unusual for reforms to take several attempts, as can, for example, be observed in the legislative process of the United States. Blocked, reversed or limited early reforms need not be seen as failures: they may play a role in undermining the status quo. Successful labour market reforms have often followed earlier setbacks, which helped set the stage for subsequent, sometimes far-reaching reforms.

9. *Overcoming short-term challenges of reforms*

   Structural reforms, especially when undertaken in a downturn, as is often the case, may face short-term challenges, for example by pressuring employment or wages. Such costs can fuel people's resistance to reform and hence make politicians less inclined to undertake the reform in the first place. Complementary macroeconomic and structural policies can help mitigate, or even completely offset, these transitional costs. The issue of short-term reform challenges is important and complex and so the following section is devoted to it.

10. *Winners and losers of reforms*

    Reforms may create winners and losers and also change the distribution of wages and income in the economy. This is likely to be especially the case for labour market reforms, which involve larger parts of the population than more narrow policy initiatives. Those who may lose out, even when in a minority, can have a potent voice and may stifle reform efforts at an early stage. In some cases, but not always, monetary transfers that compensate for such losses in absolute or relative income may be adequate. Another option to reduce reform resistance is to implement a reform gradually through the use of so-called "grandfather clauses". Section 15.4 explores these issues in more detail.

15.3. Short-term challenges of reforms

A large body of research indicates that many reforms of product and labour markets have the potential to improve productivity growth and, possibly, employment over a longer time span. Yet, reforms may face short-term challenges, especially during an economic downturn.

Besides specific factors relevant in the context of each reform, as will be discussed below, other, more general factors can dampen the short-term benefits from structural reforms in a downturn. For example, the number of households and firms with liquidity or credit constraints may be higher, reducing the scope to bring forward reform-driven income gains. For those with no liquidity or credit constraints, the precautionary motive to save in the face of reforms is likely to be stronger in a period of heightened economic uncertainty. Also, in an environment where macroeconomic policy does not, or cannot, respond to lower inflation and external demand is weak, certain reforms, including those that affect wage dynamics, may further depress demand, by increasing real interest rates and dampening consumption and investment.

This section focuses on the short-term challenges of reforms in unemployment benefits, activation spending, product markets and employment protection, the areas where most evidence has been accumulated. These reforms should not, however, be viewed as an exhaustive set of measures for which short-term challenges as regards policy adoption and implementation are relevant. Another caveat is that the focus is on the short-term effects on total employment and output, while the reforms affect many aspects of labour market performance, as the other chapters in this Volume discuss. The section also cites examples of cases in which packages of reforms in different policy areas can alleviate short-term challenges and therefore improve the political feasibility of reforms.

Reforms of unemployment benefits and activation spending

Unemployment benefit reforms may increase or decrease replacement rates, or they may widen or tighten eligibility. Reforms that reduce overly generous income replacement rates appear to increase employment relatively quickly, possibly because they promote job search and hires (Bouis et al., 2012[12]). Such reforms are also found to be associated with stronger investment and output growth. However, the empirical analysis suggests that reducing the generosity of unemployment income support can have negative short-run effects in bad economic times, i.e. when output and employment are substantially below potential (see also the discussion on state-contingent unemployment benefits in Chapter 13). Thus, cutting the level or duration of unemployment benefits in a downturn could run the risk of making the labour market situation temporarily worse, so that these reforms may be met with increased political opposition. A decrease in unemployment benefits could also have the side effect of increasing inflows into social assistance and disability benefit schemes.

Countries with short unemployment benefit entitlements, or tight eligibility rules, and strong fiscal positions could consider temporarily extending the levels or the duration of benefits during a downturn. In the United States, for example, unemployment insurance is automatically extended in bad economic times. The increased generosity makes measures to contain moral hazard through strict enforcement of job-search requirements particularly important. However, these policies are costly and therefore especially hard to implement in countries with large government debt or fiscal imbalances. Insofar as other structural reforms may temporarily increase unemployment, a higher generosity of unemployment benefits can help cushion the rise in unemployment. Italy and Portugal are two countries that reformed dismissal regulations during the euro area crisis. As part of a package of reforms, they also reinforced the unemployment benefit systems, with higher benefits or extended coverage, to better support those potentially affected by job losses.

Increases in public spending on active labour market policies are found to raise output and employment over the medium term (International Monetary Fund, 2016[8]; OECD, 2017[13]). The effects are more pronounced in bad economic times, potentially reflecting larger fiscal multipliers in recessions. They become smaller, but remain when such a spending reform is implemented in a budget-neutral way. The experience from the Great Recession tells a similar story. Countries with a strong activation approach (including Australia, Austria, Norway, Switzerland and the United Kingdom) had a relatively modest or short-lived rise in unemployment (OECD, 2013[14]). Stepping up activation spending can also help cushion negative effects that some other reforms undertaken in parallel may have on employment (Cournède, Denk and Garda, 2016[15]). Systems which receive more funding when the number of jobless rises perform especially well.

Higher activation spending in recessions can be achieved through discretionary measures or, as in Denmark, through automatic adjustments to changes in unemployment. Automatic adjustments tend to work better than discretionary measures, which are often difficult to implement because higher resources on activation compete with other budgetary pressures. Overall, there is a strong case for allocating more resources to active labour market policies in recessionary periods, both on economic and political grounds. The return on spending, in the form of higher income and employment, can be substantial, reducing the economic pain of many workers. In practice, the benefits from higher activation spending tend to be predicated on institutional contexts where an effective activation strategy is already in place. If this is not the case, the scope to rapidly scale up active labour market policies in the face of rising unemployment is limited, as fine-tuning these institutions often takes several years (OECD, 2015[16]). Chapter 9 discusses the conditions for a well-functioning activation system in more depth, including the role that private and not-for-profit agencies can play to enhance effectiveness and alleviate capacity constraints.

Reforms of product markets and employment protection legislation

Recent OECD research has studied the short-term employment effects of two broad reforms: those aimed at fostering competition in product markets (more precisely in the network industries versus the retail sector) and those affecting the rigidity of employment protection legislation. These reforms, if properly designed and implemented, enhance the efficiency in the allocation of labour to the most productive and rewarding uses and contribute to stronger productivity growth. Right after the reform, they nevertheless may face some challenges before their benefits unfold.

Several studies based on micro-data indicate that reforms in the retail sector tend to promote a reallocation of jobs, but entail no job losses, even in the short run (Bertrand and Kramarz, 2002[17]; Skuterud, 2005[18]; Viviano, 2008[19]; Sadun, 2015[20]). This result probably reflects the competitive situation in the retail industry, where deregulation often implies the fast entry of large competitors, while incumbents are too small to strategically anticipate entry by cutting staffing. Owners of small shops and their employees are frequently afraid of the ability of competing enterprises to open a store and quickly win a large share of the local market. They may therefore try to block market entry, as has happened in the United Kingdom, where some local authorities do not permit the opening of "big boxes" at the fringes of urban areas.

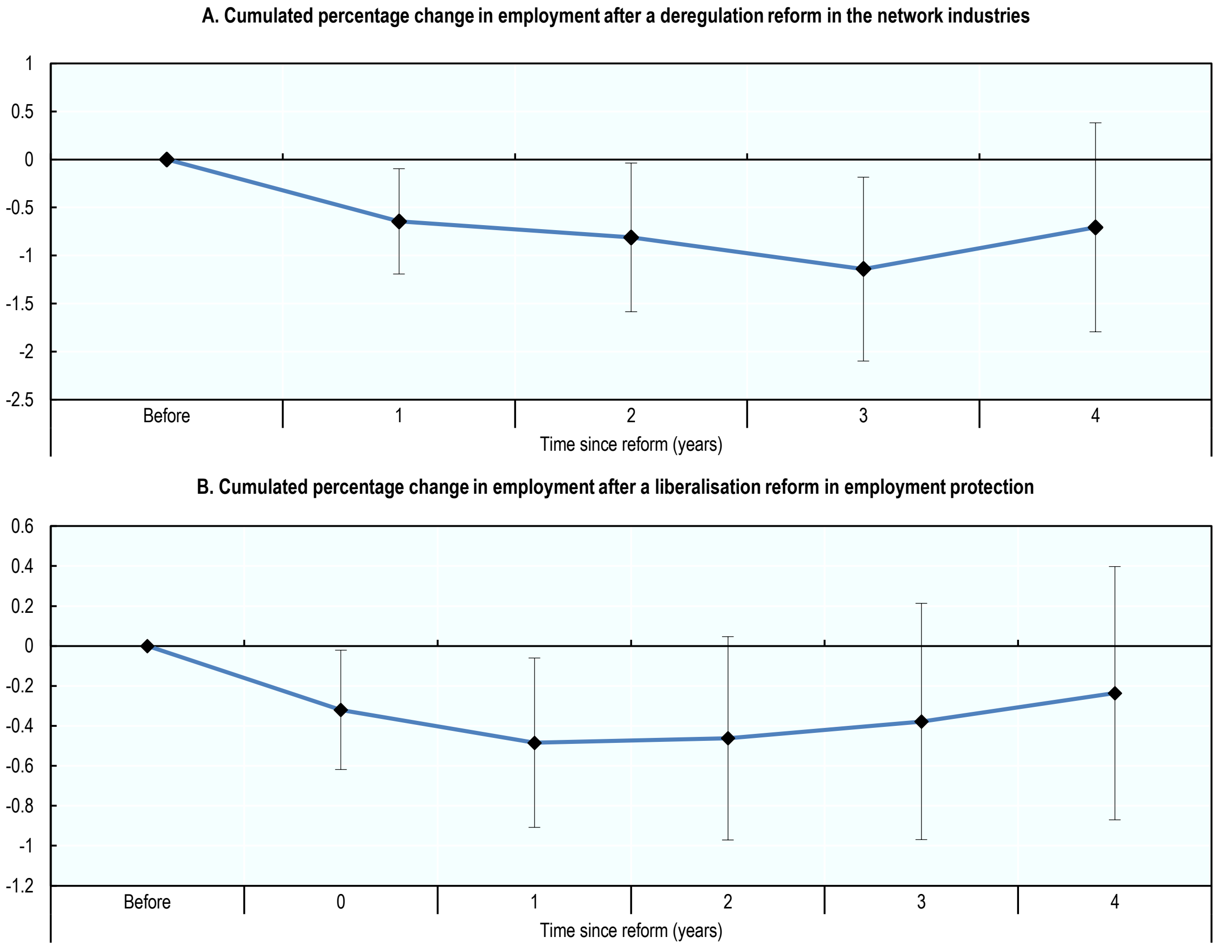
Regulatory reforms in network industries (energy, transport and communication) may have different effects to the ones for the retail sector. In network industries, regulation tends to give rise to more concentrated markets and shelter dominant players. The labour market may thus adjust to liberalisation through the immediate re-organisation of large incumbents and the gradual expansion of successful entrants. This could result in a temporary decline in employment (Bassanini and Cingano, 2018[21]).

Econometric estimations, based on sector-level data, confirm this line of reasoning. Lower entry barriers to network industries are found to lead to a temporary job loss which is at its maximum three years post-reform, but disappears afterwards (Panel A of Figure 15.1). Comparing results in business-cycle downturns with those in upturns shows that the initial negative employment effects only arise in bad times. In a related study that uses firm-level data, Gal and Hijzen (2016[22]) find that, in the first two years after a sector-specific deregulation reform, employment in large network industry firms declines or remains the same, whereas employment in large retail firms increases.

Employment protection legislation (EPL) governs the rules on the hiring and, especially, firing of workers. Flexibility-enhancing EPL reforms thus have the potential to improve job allocation, reduce labour market dualism and promote productivity (see Chapter 7). With respect to long-term employment, empirical studies suggest that reforms have no or a small positive effect. Immediately after the reform, however, employment may decline as firms wanting to dismiss workers can now do so at a lower cost, while other firms may take time to hire new workers. These issues were studied in the same sector-level empirical framework that was used above for reforms of network industries (OECD, 2016[9]).

The study finds that reforms of employment protection legislation that reduce dismissal costs are associated with short-term employment losses, but these are reversed within a few years on average (Panel B of Figure 15.1). These transitional losses are not sizeable when the reform is implemented in an economic upswing. Moreover, they are less acute in countries with significant labour market dualism, which are also the countries that experience the greatest benefits from reforms that lower the use of fixed-term contracts. A similar conclusion was reached by International Monetary Fund (2016[8]) and related micro-econometric studies (OECD, 2016[9]).

Figure 15.1. The temporary employment costs of regulatory reforms



Note: The figures report point estimates and 90%-confidence intervals of the cumulated percentage change in employment due to reforms in network industry regulation (Panel A) and job dismissal regulation for regular contracts (Panel B). The estimates refer to a reform lowering the OECD indicator of entry barriers by one point (Panel A) and a reform lowering the OECD indicator of employment protection legislation by 0.2 points (Panel B).

Source: OECD (2016[9]), *OECD Employment Outlook 2016*, http://dx.doi.org/10.1787/empl_outlook-2016-en, using *EU-KLEMS Database*, *OECD Product Market Regulation Database* and *OECD Employment Protection Legislation Database*.

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One way to avoid a spike in dismissals after a job dismissal reform is the introduction of "grandfather clauses". These clauses preserve entitlements of existing workers, for example by applying the new rules only to new hires. The limited available evidence, including from Portugal (OECD, 2017[23]), suggests that grandfather clauses help avoid the short-term negative effects of EPL reforms and can even have a small positive effect on employment in the short run. Grandfather clauses have, however, the downside of delaying the desired reform effects on allocative efficiency. Another way to cushion the impact of a flexibility-enhancing EPL reform is to accompany it with a simultaneous expansion of active labour market programmes, as discussed above.

Collective bargaining institutions also influence the short-term costs of EPL or other reforms. Co-ordination in wage bargaining helps negotiators take into account the macroeconomic effects of reforms (OECD, 2018[24]). In situations where some firms in a sector are hit more than others, collective bargaining systems that, within a sectoral framework, give individual firms scope to adapt wages and working conditions to their individual situation – often referred to as "organised decentralisation" (see Chapter 8) – can limit short-term job losses. The higher flexibility to set wages and working conditions allows firms to adjust wages or hours instead of employment. Spain's 2012 labour market reform, which coupled a relaxation of EPL with more flexibility in collective bargaining, markedly reduced job separations, especially for temporary workers (OECD, 2014[25]).

Macroeconomic policy support

The evidence summarised in this section suggests that structural reforms can have short-term costs, especially when they are introduced at an unfavourable stage in the business cycle. These short-term costs can undermine political support.

Demand-side (i.e. monetary and fiscal) policies are suited to mitigate a negative impact from reforms in the short run when demand is weak and hence to support public backing for reforms. The effectiveness of monetary policy in stimulating demand depends on the functioning of the financial system and the importance of liquidity- or credit-constrained households and firms. The effectiveness of fiscal policy may be enhanced in recessions due to a higher multiplier effect (Auerbach and Gorodnichenko, 2012[26]; Blanchard and Leigh, 2013[27]).[2]

Monetary policy is an important tool for ensuring that structural reforms do not have disinflationary consequences. However, it has its limits. For example, following the global financial and economic crisis monetary policy contributed a lot to sustain activity and promote the recovery. But in many advanced economies it also hit the zero lower bound, with short-term nominal rates set near zero. To a certain extent, this has been overcome through unconventional monetary policy, in particular central banks providing forward guidance on long-term nominal rates and buying up bonds of longer maturities.

It is in cases such as these, when monetary policy is at its limits, that fiscal policy can be especially powerful to mitigate the costs of structural reforms and garner political support. Fiscal policy also has the advantage of being able to target particular segments of workers affected by a reform, for example through active labour market policies. Generally, the effect on aggregate demand is likely to be stronger for government spending measures than tax cuts. Spending measures have a direct impact on aggregate demand, while tax reductions have a more muted effect since they may be saved because of, for instance, high uncertainty. In practice, fiscal stimulus measures can be designed on both the spending side and the tax side to have a rapid and substantial effect.

Among public spending measures, investment tends to be the most powerful instrument (Fournier and Johansson, 2016[28]; Hijzen et al., 2017[29]). In contrast to boosting current public expenditure, higher investment adds to the capital stock and so has not only a short-term demand effect but also a longer-term supply effect. In situations with little scope for additional monetary stimulus, an expansion in well-designed public investment projects can even pay for itself, i.e. raise output more than increase debt, thus reducing the public debt-to-GDP ratio (OECD, 2016[30]).

Some tax reductions can also be put in place to increase household disposable income and boost household spending in the short term. While in theory consumption should not respond much to temporary changes in taxes, as households are likely to smooth their consumption over their lifetime, the evidence suggests that temporary tax reductions can boost consumption in the short term. This is particularly the case for cuts in labour taxes or social security contributions targeted at lower-income workers, as spending by this group is closely tied to its disposable income due to liquidity constraints (de Mooij and Keen, 2012[31]).

The scope for expansionary fiscal policy may, however, be limited when long-run fiscal constraints are significant. During the early 2010s, several southern euro area countries faced difficulties to mitigate the short-term impacts of labour market and other reforms, due to lack of fiscal space. In such environments, the positive effect from a fiscal expansion could even be offset by the contractionary effect through adverse reactions in financial markets. These considerations underline the need to create fiscal space in good times to be able to use the fiscal lever for promoting demand when needed, not only to counteract a negative demand shock, but also to support the implementation of structural reforms.

15.4. Winners and losers of reforms

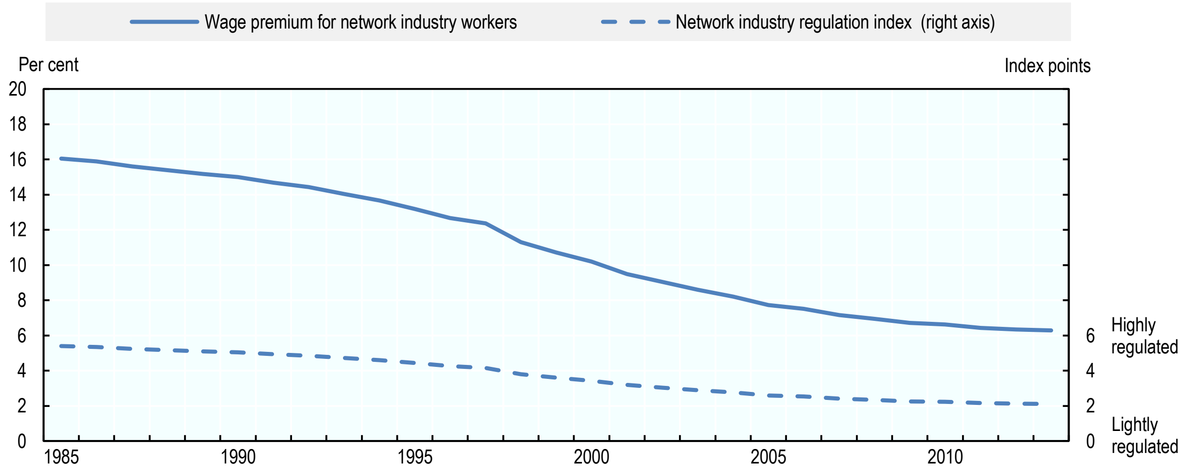
Structural reforms can make some people worse off, temporarily or permanently. A reform that removes licensing requirements for taxis in urban centres is likely to durably reduce incomes of incumbent taxi drivers. Increases in the retirement age reduce the time available for leisure of people who will need to work longer. Reforms that increase the flexibility of open-ended contracts reduce the job security of workers on these contracts (unless these workers continue to be entitled to their old protection rules through the grandfathering of the reform). Changes to the systems of unemployment insurance and social assistance alter the amount of benefits that persons receive or can expect to receive. Initiatives to modify a country's collective bargaining system can be politically particularly sensitive, as they often influence the pay of a large number of workers in the economy.

Most structural reforms create winners and losers. Losing out usually is associated with a move down in the wage distribution. A downward move in the wage distribution is likely to be especially painful when it comes with a decline in wages or wage growth. Reforms can also influence other aspects of job quality, such as job security and satisfaction. As insights from behavioural economics suggest, declines in job quality can be particularly salient to the people involved. The resistance to the reform by the individuals who are negatively affected by the reform can therefore be strong. In some cases, as in the taxi example, the weight of affected incumbent workers for political decision-making may be disproportionately high, given their ability to organise themselves better than the beneficiaries, who are more numerous, but individually gain less than those who lose out (Olson, 1971[32]; Boeri et al., 2006[33]).

Another example for reforms where losses are narrowly concentrated are sector-specific deregulations. For instance, in the past extensive regulation in network industries ensured that workers in these industries benefited from higher wages and stronger job security. The large liberalisation of network industries in nearly all OECD countries over the last 30 years has changed this situation dramatically, with workers in network industries losing out compared with other workers. Such considerations are not unique to network industries, but similarly arise in other regulated sectors (Jean and Nicoletti, 2015[34]).

To give an idea of the magnitudes involved, in the late 1980s, the average wage premium for network industry workers is estimated to have been 16% (Denk, 2016[35]), compared with workers who had similar characteristics but were employed in other sectors. Based on the data in the OECD Product Market Regulation Database, regulation in network industries declined strongly and in 2013 was 60% lighter than 30 years before. This liberalisation of network industries has reduced the average wage premium for network industry workers to an estimated 6% (Figure 15.2). Without deregulation, every year the incomes of network industry workers, relative to other workers, would have been up to about 10% higher.

Figure 15.2. Network industry regulation and wage premium for network industry workers



Note: The figure shows the average regulation of network industries in 21 OECD countries and the associated estimated wage premium for workers in this industry. The wage premium measures how much more workers in network industries earn compared with workers in other industries who have the same observable characteristics (such as age, gender and education). The simulations use the average estimate according to which one unit of the regulation index increases the labour earnings of network industry workers by 3.0%.

Source: Estimations based on Denk (2016[35]), "How Do Product Market Regulations Affect Workers? Evidence from the Network Industries", *OECD Economics Department Working Papers*, No. 1349, http://dx.doi.org/10.1787/5167d865-en, using Eurostat Structure of Earnings Survey, *OECD Product Market Regulation Database* and specific micro-data sources for Australia, Germany, Korea, Switzerland, the United Kingdom and the United States.

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Compensation to people who are adversely affected by a reform has sometimes helped make structural reform happen (OECD, 2010[36]; Trebilcock, 2014[37]). It may be implicit, for example in the form of "flanking programmes" (such as re-employment services), as mentioned in the previous section, but can also involve monetary payments (Høj et al., 2007[38]).

From an economic point of view, compensation tends to be more justified when the reform creates a disadvantage that workers, or capital owners, could not anticipate at the time of their career, or investment, choice. An example are people who have recently acquired a firm or paid for a licence (for example for a taxi), not expecting a reform at the time of the purchase. Higher competition would reduce the value of the firm or licence, as previously expected rents were capitalised in their value. A similar case can arise for laid-off people who committed all their life to working for a protected utility giant in an industry that is being opened up to competition by other firms.

An important judgement in the context of compensation is whether the reform puts people at an unfair disadvantage relative to other workers. Workers adversely affected by higher import competition often fall in this category, which motivates programmes such as the Trade Adjustment Assistance in the United States. In other instances, however, reforms can reduce wages or job quality, but not in an unfair way, even if the reform was not expected. This is the case when regulatory reforms reduce large economic rents, while nevertheless leaving some rents. Compensations to people who lose out but continue to be advantaged, although to a lesser extent than before, can be unfair towards others funding the compensation to these workers or capital owners (Cournède et al., 2016[39]).

A further consideration is that reforms that lower the wage premium in regulated sectors do not necessarily decrease the wage growth of workers in the deregulated sectors, if the overall wage increase generated through higher economy-wide productivity offsets the fall in their relative wages. For the case of network industries, simulations suggest that the income-enhancing effects of past reforms in these industries have almost exactly offset the fall in the wage premium, so that network industry workers have experienced a relative, but no absolute decline in wage growth following the reform. It is not clear that workers should be compensated for the loss of their relative income status, which was due to regulation, even when they keep the same wage level.

Compensation can have the additional downside of encouraging behaviour that reduces efficiency. The anticipation of compensation may induce ex-ante rent-seeking and lower incentives to promote productivity (Kaplow, 2003[40]). Paying compensation could hence even harden resistance to reform, since incumbents may seek to maximise pay-outs. At least in principle, an arguably fairer and more efficient "compensation strategy" would be to reform product and labour markets very broadly rather than narrowly in certain sectors or segments. As illustrated above, this strategy can offset the relative losses in wage growth that workers may experience from greater competition in their sector with purchasing power gains from parallel reforms in other sectors (Blanchard and Giavazzi, 2003[11]; Gersbach, 2004[41]).

Conclusion

Labour market and other policy reforms have the potential to promote stronger and more inclusive labour markets and economies. Nevertheless, this has not made them universally popular or easy to enact. This chapter has shed new light on how a better preparation, design and timing of reforms can enhance their political feasibility and attractiveness. The most important lessons from the analysis can be summarised as follows.

Structural reforms are best undertaken during good economic times

Structural reforms are often undertaken when the status quo is no longer sustainable and thus in many cases during an economic downturn. However, the evidence clearly suggests that structural reforms tend to have the smallest – if any – side effect on employment when implemented in good times. For example, when demand for their products is high, relaxing job protection regulations will not entice firms to shed much of their workforce. Even when reforms temporarily depress domestic demand, a favourable climate in trading partners' economies can make the benefits from reform become visible more rapidly. The general message is that, when the economy does well, there is no time for complacency.

To ensure success, reforms require political leadership and broad support

Most structural reforms involve trade-offs and thus are not supported by everyone in society. At the same time, however, successful reforms require a critical mass of electoral and political support. Broad acceptance of the need to reform is often easier built in crisis situations. Generally, a strong leadership and evidence base, rigorous evaluation after the reform and effective communication (including by using new technologies) can help ensure success of a reform and continued support. Solid evidence and evaluation require investing in data collection, where the necessary data for monitoring compliance and outcomes are not available. Another element that facilitates the adoption and implementation of good reforms is high levels of co-operation and trust between the government, employers and workers.

Addressing their short-term challenges can help build support for reforms

Some structural reforms may entail labour market costs during the transition. Monetary and especially fiscal policies can help cushion potential short-term contractionary effects. In terms of fiscal policy, stepping up active labour market policies and temporarily increasing unemployment benefit levels or durations are likely to be most suited to both boost aggregate demand and support people who are most affected. Clever design can also help contain short-term costs. For example, in the context of job dismissal reforms, “grandfather clauses” that preserve old entitlements protect current jobs and avoid a spike in layoffs, but may delay the benefits of reform.

Policies that support those who may lose out can help make reform happen

To ensure political support and broad increases in well-being, governments may design reforms in a way that they embed compensatory elements for those who are most likely to be negatively affected. Compensation is often implicit, for example when it comes in the form of activation programmes, but sometimes it can also involve money transfers. As a general rule, compensation strategies are more likely to be warranted for reforms creating a disadvantage that workers did not foresee at the time they made their career choice. By contrast, reforms that remove privileges to certain firms or workers lead to incumbents losing out, but only insofar as they no longer benefit from unfair advantages. Compensatory payments are in these cases harder to justify, although they may still help make structural reform happen.

Notes

[1] Following the general election in 1998, the new government established the *Pact for Work, Education and Competitiveness*. Trade unions hoped that weaker wage growth would create jobs; employer associations saw the benefits of lower relative labour costs; and the government supported take-home pay and external competitiveness by reducing social security contributions financed with higher indirect taxes.

[2] Chapter 13 in this Volume discusses the roles of monetary and different fiscal policies for labour market resilience.

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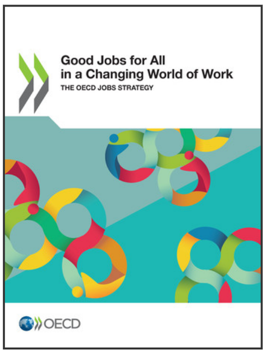

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