Labour Market Deregulation and Productivity: IMF Finds No Link

Ronald Janssen, *Social Europe Journal*, 15 April 2015

New research by IMF staff has found there is no evidence that reforms that deregulate labour markets have any positive impact on increasing the economy's growth potential. As labour market deregulation has been a key ingredient in the IMF and troika's financial bail-out programmes in several European member states, this raises serious questions about the way the IMF itself has managed the financial crisis – particularly in Europe.

This finding appears in a text box within a chapter of the IMF's World Economic Outlook (published in full on April 14) on the perspective of a long lasting slowdown in economic growth. On the basis of the usual econometric work, the IMF claims that total factor productivity can be increased by using more highly skilled labour and ICT, by investing more in research and development and by lowering the level of regulation in product markets. In contrast, the IMF does not find any statistically significant effects on total factor productivity that result from labour market regulation.

This is important, and not just for the bail-out countries. Indeed, ever since 2000, when European policy makers drew up the famous Lisbon Strategy of making the EU the most competitive economy in the world by pursuing a strategy of innovation, some have promoted the claim that very flexible labour markets are essential in boosting innovation. If business could fire workers easily, then new and innovative firms would be able to attract the new workers they need to expand their business. Likewise, the greater wage differentials that would emerge when Europe got rid of its multi-employer collective bargaining system would propel the work force out from companies in decline and cutting wages into the firms of the future. It is the story of 'creative destruction' told by Schumpeter after WWII. This story may well be old but it has been extremely well 'marketed' by the European Commission and related institutions and interest groups over the past decade. It is to the credit of the IMF researchers that this myth is now being exposed – in a flagship publication of the financial elite itself.

Labour market deregulation and jobs: Flawed research

This, however, is not the end of the story. Indeed, growth performance depends on productivity but also on the level of input of production factors such as labour. In other words, the IMF and related institutions could still argue that labour market deregulation, even if it does not influence total factor productivity, could still contribute to enhanced growth performance by boosting labour supply. This line of thinking pops up when the IMF, in the same publication, writes that:

Severe financial crises, which tend to be followed by long and deep recession, may lead to a permanent decline in the level of potential output by increasing structural unemployment (…). This is particularly the case for economies with rigid labour market institutions.

To back up this latter assertion, the IMF refers to papers that say[1] that labour market reforms can lower unemployment as much as a typical banking crisis would increase unemployment.

The ILO, however, already showed in 2014 that this research does not stand up to much scrutiny[2]. In particular, the database used in the research quoted by the IMF is seriously flawed. There are, for example, methodological breaks in several of the time series that are being used, breaks of which the authors themselves admit they were not aware (see footnote 1 of the ILO paper).

[1] Bernal-Verdugo L., Furceri D., Guillaume D., *Crises, Labour Market Policy, and Unemployment*, IMF Working Paper 12/65, 2012, published as: Banking Crises, Labour Reforms, and Unemployment. *Journal of Comparative Economics*, Vol.41, 2013; *Labour Market Flexibility and Unemployment: New Empirical Evidence of Static and Dynamic Effects*. IMF Working Paper 12/64. Also published in: Comparative Economic Studies, 2012, Vol. 54 (2).

[2] Mariya Aleksynska, Deregulating labour markets: How robust is the analysis of recent IMF working papers?, ILO, 2014.

Labour markets and jobs: The more serious work

It is not just mind boggling to see that the IMF is still referring to research that has been profoundly debunked but also strange that it does not seem to be aware of other research reaching opposite conclusions. One such example here is a 2013 paper on the 'tenuous link between labour market institutions and unemployment'[3].

The novelty of the latter work is that it covers ten economies from Central and Eastern Europe (CEE) besides the traditional OECD countries. In doing so, it brings in new evidence from a larger group of economies on the actual effects of labour market (de)regulation. This, together with the fact that most of the CEE countries have come under a strong policy influence of international organisations promoting deregulation, implies that the conventional view of labour market rigidities being responsible for high unemployment can be tested more adequately than was the case before.

The findings of the above paper are quite remarkable but at the same time also in line with previous critical research[4].

First, regulations that protect existing jobs show no statistically significant link with unemployment whatsoever.

Secondly, their finding that unemployment benefit replacement rates show some correlation with unemployment is not very stable. The authors also signal that the causality may run in the reverse direction. In other words, if the empirical finding is that high(er) benefits and high(er) unemployment move somewhat in line with each other, this is because high unemployment forces governments to increase benefit levels and not because of presumed negative incentive effects of benefits on the unemployed.

Finally, when omitting six observations that are outliers from the entire dataset, there is not a single labour market institution that is still showing a statistically significant link with unemployment. There is, however, one exception: coordination of wage bargaining lowers unemployment and does so in a robust way. In other words, the more trade unions and employer organisations are able to coordinate the process of wage bargaining over different sectors and companies, the lower unemployment tends to be.

The latter finding is ironic. By systematically pushing for single employer/company-based negotiations, thereby undermining multi-employer wage bargaining systems that are capable of organising such a coordination process, the IMF and the European institutions have been attacking the single labour market institution that, according to this and similar research, is able to reduce unemployment.

Conclusion

To conclude: the IMF's finding that labour market deregulation does not improve productivity is certainly striking and trade unions should certainly use it to tell the Commission and the ECB that their model of such deregulation is wrong. At the same time, however, one should also keep in mind that there continues to exist a deep bias inside the IMF against labour market regulations and related workers' rights, a bias that is more ideological than anything else since it is not based on any serious evidence.

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[3] Sabina Avdagic and Paola Salardi, Tenuous link: labour market institutions and unemployment, *Socio-Economic Review*, 2013, 11.

[4] Dean Baker, Andrew Glyn, David Howell, and John Schmitt, Unemployment and Labor Market Institutions: The Failure of the Empirical Case for Deregulation, September 2004 ; Servaas Storm and C. W. M. Naastepad, *Macroeconomics Beyond the NAIRU*, Harvard University Press, 2012