Deregulating job protection: Surprising IMF/OECD messages

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IMF rediscovers "Political Economy"

This summer, the IMF challenged yet another pillar of neoliberal thinking when it published its Working Paper on the negative impact of deregulating job protection on the labour income share. Whereas the economic mainstream has systematically argued that technological progress is the main reason for the global trend of falling labour share (see OECD chapter 2 and IMF), this new paper finds a strong link with the policies of weakening job protection that have been pursued over previous decades.

By introducing the element of bargaining power between labour and capital into this discussion, the IMF thus provides for an important broadening of the policy discussion going beyond the standard recommendations to invest more in education and training: "This paper contends that, alongside these (non-mutually exclusive) drivers, changes in institutions that weakened worker bargaining power have also played a role". It seems that the IMF, which usually adheres to the neoclassical economic argument that wages in the absence of rigidities are completely driven by marginal productivity and technological developments, has rediscovered the *political economy* thinking of classical economists such as Karl Marx and Adam Smith.

Using a newly constructed database of the major reforms in employment protection legislation (EPL) undertaken by 26 advanced economies over the period 1970-2015, the IMF finds that introducing a major reform to reduce job protection pushes the aggregate labour income share in GDP down by 0.8 percentage points after two years. The effect then levels off to 0.6 after five years. These results from the pure country-level analysis also correlate with the results of the slightly more elaborate country/industry-level analysis. This uses US worker displacement data as the basis for determining those industries where EPL would 'bite' more, as they would have higher 'natural' lay-off rates. Nor do the coefficients really change when factors such as technological progress and global trade are included in the regression.

The IMF research also finds evidence that declining labour shares are associated with falling real wages. Those industries where worker displacement in the absence of job protection would be high see real wages falling by 1.5 percent after four years compared to industries that have lower 'natural' lay-off rates. To put it more simply: reducing job protection weakens labour's bargaining position thus resulting in lower wages that drive down the labour income share.

In a next step, the IMF uses the estimates from these regressions to do a 'back-of-the-envelope' calculation and see how much the weakening of job protection contributed to the overall decline in labour share. It finds that "deregulation may have accounted for about 14 percentage points of the overall labour share decline in advanced economies over 1970-2015". Once again, this number appears to be robust as it barely changes when the same calculation is done for different time periods: 1970-2007 (to exclude the Great Recession) or 1990-2010 (to focus on the period that experienced the steepest decline in the labour share).

In a nutshell: the IMF, aka 'I aM Fired' in the immediate aftermath of the Asian financial crisis, now finds that job protection is by no means neutral as a determinant of income distribution. What is at stake when weakening job protection is that Labour loses out, while Capital wins.

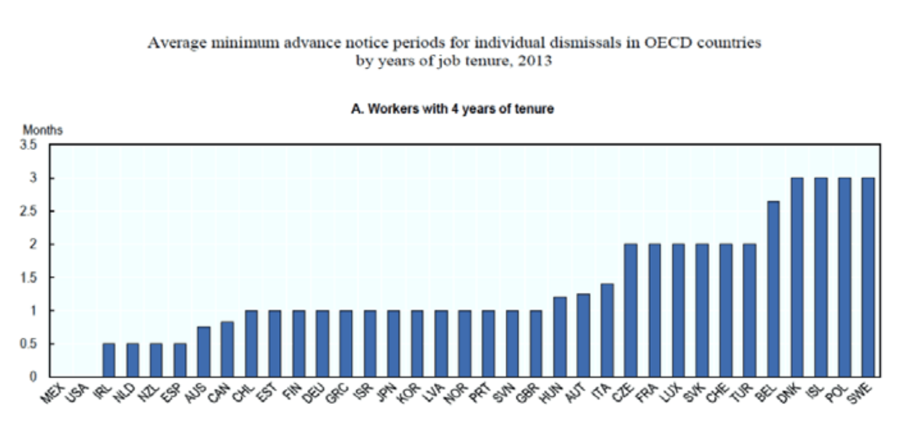
Displaced workers: a more balanced OECD view on advance notification

Another interesting piece of research is the OECD's work on nine country cases that examine how to get displaced workers back to work (job displacement is defined as permanent economic dismissal affecting workers with at least one year of tenure). Here, one remarkable policy message running throughout the OECD research (chapter 4) is the importance of adequate job protection in the form of advance notification.

Here, its starting point is that early intervention and starting the process of adjustment *before* workers become unemployed has many advantages. One is that the 'hysteresis' effect under which labour market prospects decline the longer a worker is unemployed can be averted. This is because, on the employers' side, prospective employers tend to view job applicants who are still at work more favourably than those who are already unemployed. And, on the side of the workers, intervening early when workers are still in a job serves to limit long unemployment spells during which skills and work-related attitudes could deteriorate.

Additional benefits of reaching out to dismissed workers when still on the job arise in the case of mass lay-offs. Group counselling and job-search activities can be more easily organised during the period of notification at the workplace, a benefit that is of particular value when Public Employment Services risk being overwhelmed by the sheer number of lay-offs. Moreover, group activities can be psychologically useful in helping to overcome the reluctance of experienced workers to consider career shifts away from a sector or occupation in decline. There is also the possibility of organising 'job fairs', which bring together about-to-be displaced workers with potential employers.

Of course, one indispensable condition for reaching workers before they fall into the "black hole of unemployment" is that workers are given a decent t period of advance notification. Without such notification, there is no vehicle to organise this early intervention while notified workers are still on the job. Hence, according to the OECD "there appears to be a clear case to require at least a minimum level of advance notification to workers, unions and public labour market authorities, since it is a *sine qua none* for early intervention" (page 147). This is then followed by a graph (see below), pointing out that advance notification requirements differ significantly between countries and that "countries with relatively low notice requirements should consider raising them (…)" (page 149).



Things get even more interesting with the next step in the OECD's analysis as a link is made with social partners' initiatives providing about-to-be-displaced workers with early support. Here, the OECD refers in particular to the example of Swedish Job Security Councils. These labour market institutions are jointly managed by trade unions and employer organisations and financed by sectoral collective bargaining agreements. Basically, they offer services (personal advisor, help in finding a new job, training, and help in starting a business of their own) to workers from the moment they have been notified of their dismissal. Robust advance notification periods, as Sweden has (see graph above), are again indispensable as these allow the full deployment of the services of these Job Security Councils while workers are still in full touch with the labour market.

A striking outcome of combining 'advance notification' with social partner-organised labour market support is that 90 percent of displaced workers in Sweden are re-employed within a period of a year, a percentage that is much higher than in other economies. At the same time, losses in future earnings in the new jobs are much less pronounced. (For more information on these Job Security Councils, including the importance of other structural labour market characteristics in Sweden such as the well-established tradition of sector level bargaining, strong trade unions and rather strict labour law also in the form of the famous 'First In, First Out principle, see here).

In conclusion

These IMF/OECD findings are refreshing as they draw attention to the benefits of labour market institutions. Job protection prevents inequalities from rising by stabilising the labour income share. Advance notification allows early intervention measures before displaced workers lose contact with the labour market. And sector-level collective bargaining can be used to pool resources so as to effectively finance this policy of early intervention. Trade unions and progressive politicians should take note and put this research to good use as an alternative to the usual policy agenda of labour market deregulation.