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Lifting Euro Area Growth: Priorities for Structural Reforms and Governance

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Executive Summary

To live up to its growth potential and secure its inclusive social model, the euro area must make better use of its available labor*. In the aftermath of the crisis, boosting growth is essential to prevent unemployment from becoming a long-term problem and to facilitate the return to fiscal sustainability. Labor utilization in the euro area has been lagging considerably behind its best performing peers. While fewer hours worked may, to some extent, reflect a social choice, higher unemployment rates and lower participation rates, on the other hand, cannot easily be attributed to individual preferences. Here, policies and institutions matter more. And there is little excuse for relatively low labor productivity, a particular bane in southern Europe and an increasing challenge everywhere.*

Kick-starting growth requires a comprehensive approach to labor and service market reforms*. Different circumstances call for different approaches across countries. Countries in southern Europe need to focus on regaining competitiveness, while some in the core should promote higher labor force participation or more open service sector markets. Improving access to the labor market should be high on the priority list everywhere—including through some harmonization of key features of the labor market, which will help deal with intra-euro area imbalances. Differences in labor taxation, unemployment benefit systems, and employment protection will need to be reduced. Improving regulation and reforming taxes and social benefits will be essential to make inroads. For the longer term, focus should be on innovation, education, and on continuing financial sector reforms.*

Strong impetus for reforms will benefit from strengthened coordination*. In the past, reforms have succeeded when the agenda was driven by European institutions and a common sense of destiny, but largely failed when reliant on peer pressure. Recent steps and proposals to strengthen governance over both fiscal and structural policies at the euro area level go in the right direction. More reform authority should be vested at the euro area level and countries should be willing to adjust national policies to secure an effective functioning of the economic and monetary union. In particular, key structural reforms need to be embedded in a stronger surveillance mechanism over fiscal and structural policies; EU transfer rules revised to better reward reformers and punish laggards; and compliance enforced more decisively than in the past. Launching a new common project for labor market reform would be beneficial.*

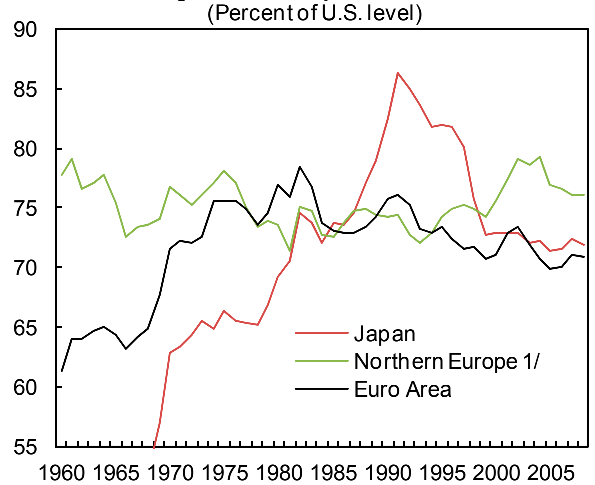
I. DIAGNOSIS[1]

A. Growth Facts

- Euro area per capita GDP stopped converging toward its best performing peers in the early 1980s, leaving a persistent gap.
- Lower labor utilization is a key reason, but productivity matters too, especially in southern Europe.
- While per capita growth kept pace during 2000–08, the recent crisis constitutes a new setback.

Convergence of European GDP per capita toward the level of its best performing peers stopped in the early 1980s (Figure 1). Like Japan, the euro area embarked on a convergence process toward the United States and some other European economies in the first three decades after the Second World War, through technology assimilation, product standardization, trade liberalization, and economies of scale. However, once these easy gains were achieved, the euro area's convergence process stalled, with per capita GDP levels gradually falling behind relative to the United States, northern Europe, and to a lesser extent, Japan (Roxburgh and others, 2010). Over 2000–08, GDP growth in the euro area averaged 2 percent, keeping pace with the United States and Japan in per capita terms, but falling behind some northern European peers.

Figure 1. Per Capita GDP Level
(Percent of U.S. level)

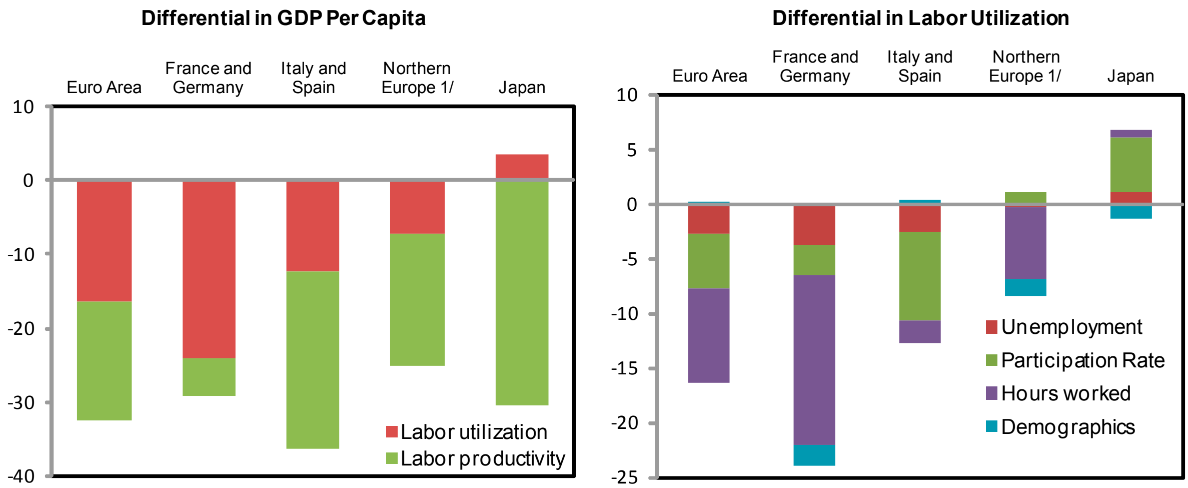


Sources: AMECO database, European Commission; and IMF staff calculations.
1/ GDP-weighted average of Sweden, Denmark and UK.

Lagging GDP per capita levels in the euro area result both from chronic underutilization of labor and lower productivity (Figure 2). The reason for the shortfall in GDP per capita vis-à-vis the United States differs across country groups within the euro area (Mourre, 2009).

[1] We thank Adam Bennett, Karl Driessen, Lucca Ricci, Esther Perez-Ruiz, and Claire Waysand for their constructive comments and Edouard Vidon for his contribution on structural reform gap indicators.

Figure 2. Selected Advanced Economies: Differential with the United States, 2006-08
(Percentage points)

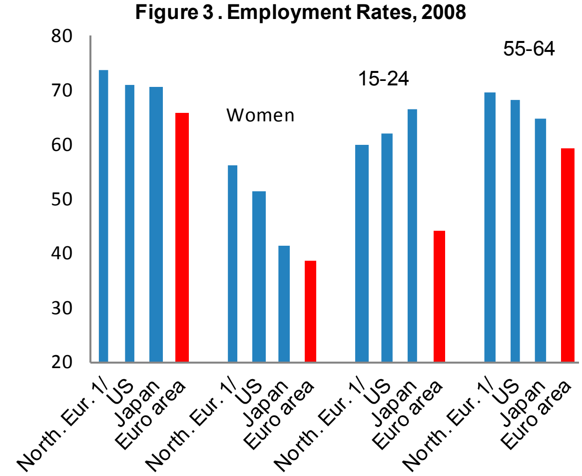


Source: Mourre (2009), European Commission, and IMF staff calculations.
1/ GDP-weighted average of Denmark, Sweden and UK.

- For Germany, France, and some smaller euro area countries, the shortfall is mostly attributable to lower labor utilization while labor productivity levels are close to those in the United States.
- For southern European countries, productivity matters more.
- Productivity will also become increasingly important everywhere as labor utilization rises, because currently unused or underutilized labor is likely to exhibit below average productivity.

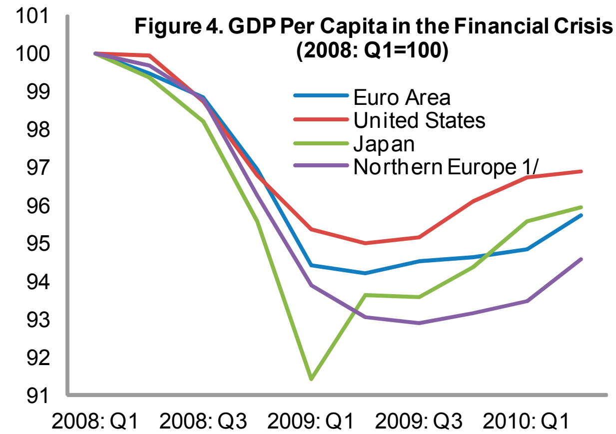
Raising labor force participation in the euro area to the level of the United States would lift GDP substantially. Differences in labor utilization have been attributed to preferences, incentives, institutions, and regulations. Common across the euro area are a higher unemployment rate, a lower participation rate, and fewer hours worked. While the amount of hours worked can arguably reflect preferences, other differences are more likely due to policies and institutions. In many euro area countries, employment participation is particularly low for females, older workers, and the young (Figure 3).

Figure 3 . Employment Rates, 2008



Source: OECD, and IMF staff calculations.
1/ GDP-weighted average of Sweden, Denmark and U.K.

From a cyclical perspective, the euro area's recovery from the global financial turmoil is lagging. In the two years since early 2008, the euro area lost about 2½ percentage points in per capita GDP relative to the United States and barely kept par with Japan, even though Japan's recession was more severe (Figure 4). The euro area is, however, doing a bit better than northern Europe. Typically, recoveries are slower in the euro area, reflecting the larger size of government, longer duration of out-of-work benefits, and other institutional features that limit the speed of economic restructuring. In the current crisis, the extent of economic damage appears to be larger than usual, with the financial sector repair lagging and sovereign risks lingering.



Source: WEO, IMF.
1/ GDP-weighted average of Sweden, Denmark and UK.

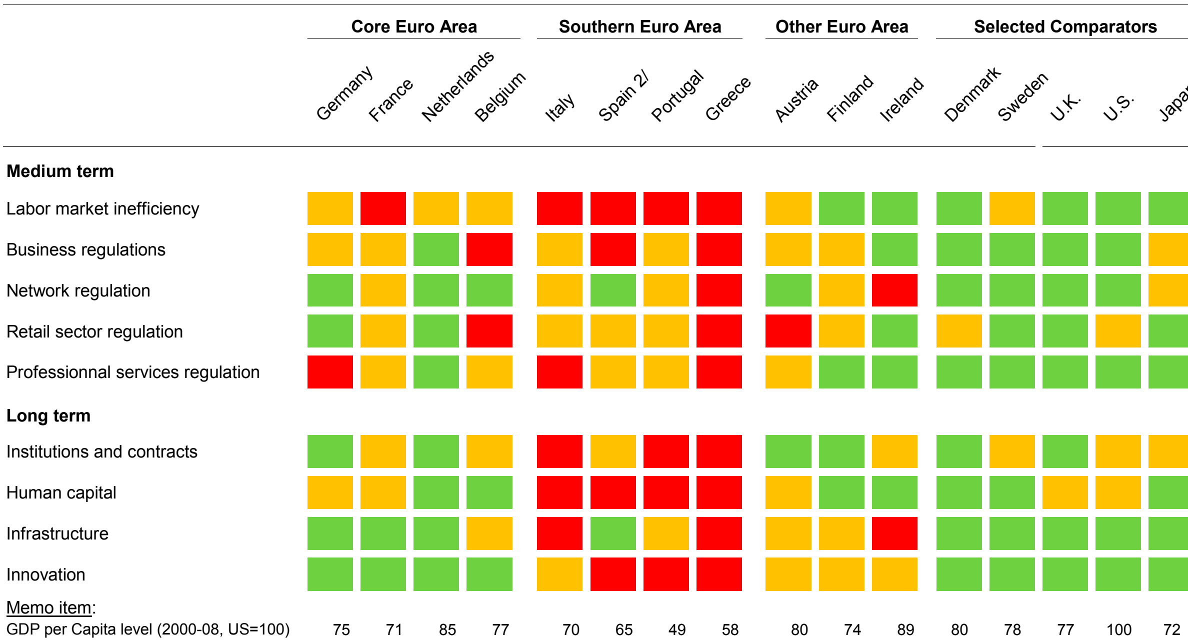
B. Structural Landscape

- Labor markets exhibit reform gaps across the euro area.
- Reforms to lift productivity are equally important in the southern euro area.

Labor and service market reforms are the top priority across the euro area (Table 1). Consistent with the widespread labor utilization gap highlighted earlier, all but a few euro area countries exhibit severe weaknesses in their labor markets compared to advanced economy peers. It is particularly acute in southern euro area and in France, but also to a lesser extent in Germany, Belgium, and the Netherlands. Binding business and service sector regulations are also prevalent in the currency union.

Impediments to long-term growth weigh heavily on the southern euro area, but are likely to surface elsewhere as well. Human capital, institutions and contracts, and to a lesser extent, infrastructure and innovation are found to be subpar in the southern euro area compared to other advanced economies, a result consistent with the productivity gap in that sub-region. However, once the core euro area countries achieve higher labor utilization, productivity issues and obstacles to raising long-term growth may well arise there, too.

Table 1. Structural Reforms Gaps in European Economies: A Heatmap 1/



Sources: OECD; World Economic Forum; Fraser Institute; and IMF staff calculations.

1/ See IMF, 2010d for a description of the methodology, and of the detailed components of the labor market heatmap.
2/ The indicators do not incorporate the labor market reform implemented in Spain in 2010.

C. Large Potential Gains

In terms of growth impact, likely gains of comprehensive reforms are substantial. As an illustration, simulations by the IMF for the G20 and by the European Commission suggest that steps to fill half of the gap in the labor market and service sectors with the 3 best EU performers, carried out over 2011–15, could yield as much as ½ percentage point of additional *annual growth* over the next 5 years—although probably less initially as structural reforms do take time to implement (IMF, 2010a; Hobza and Mourre, 2010; OECD, 2008). This reform package would combine (i) a shift from labor to VAT taxes, (ii) a reduction in the level/duration in unemployment benefits and in early and old-age retirement schemes, and (iii) a reduction in entry barriers in network industries (gas, electricity, and telecoms), retail distribution, and professional services.

Moreover, the long-term objective should be more ambitious: closing half of the gap with the United States would seem reasonable. Cross-country comparisons of per capita GDP are subject to caveats (such as adjustments for purchasing power parity). Differences in preferences (for leisure and job security) also matter, and GDP is not synonymous with welfare. Nonetheless, resuming a trend of convergence with leading economies is crucial to improve standards of living, secure the inclusiveness of the euro area social models, and facilitate the return to fiscal sustainability. Growth-enhancing reforms in the euro area would also go a long way toward fulfilling the region’s commitments to global rebalancing, including those made in the context of the G20 Mutual Assessment Process.

II. Required Actions: What Needs to Be Done?

A. Top Priority: More and Better Jobs

- Addressing weaknesses in the financial system is a prerequisite for a strong and sustained recovery.
- Reform sequencing will need to be mindful of its effect on demand in the short run.
- Improving access to the labor market continues to be the main priority everywhere.
- Freeing up retail trade, network industries, and professional services, as well as the incentives to invest, is essential too.

Fixing the financial system is urgent. At the current juncture, excess production capacity is keeping firms' credit demand depressed. However, euro area firms continue to finance themselves primarily through banks; it will therefore be critical that bank capital be increased sufficiently to help support the recovery once private investment opportunities re-emerge. Successful restructuring of weak parts of the banking system and prompt implementation of the new Basel III capital requirements will be essential.

As the post-crisis recovery remains tentative, reform sequencing should be mindful of its effect on demand in the short run. Measures could thus focus on introducing (or better targeting existing) income tax credit schemes, lifting the impediments to service sector growth, and where fiscal room is available, measures to stimulate youth and female employment through tax incentives and better child care provision.[2] Promoting decentralized wage bargaining and removing indexation mechanisms would allow wages to reflect productivity more closely in countries where they have grown most out of line, providing firms with better incentives to invest while not affecting job security. Where fiscal space exists and capacity slack diminishes, supporting private investment, through an investment tax credit for example, would support growth.

However, only a comprehensive approach to reforms will deliver tangible results in terms of generating more and better jobs. Synergies between labor market and service sector reforms should be fully exploited. First, labor market models need to be adjusted to promote inclusiveness, by creating better incentives both for those outside the workforce to re-enter it and for firms to hire. Needed reforms to relax labor market regulation, address labor market dualism, and reduce unemployment benefits duration could be postponed to a second stage, as these measures could initially dampen households' confidence due to temporary higher job insecurity. Nonetheless, they have to be implemented thoroughly. Second, job growth opportunities would need to be generated in parallel, through service sector reforms that decrease insiders' existing rents and foster new entries, particularly in the retail, network industry, and professional service sectors.

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[2] Studies show that women, in particular family second-earners, tend to react more strongly to changes in after-tax wage than other segments of the population (Evers and others, 2008; Blau and Khan, 2007).

Required actions differ across countries, but easing regulation is important everywhere, while tax and social benefit reform could be a common theme. Although the overarching themes run across the entire euro area, current starting points differ, suggesting different priorities for measures that yield the highest growth dividend. Countries in the periphery need to regain competitiveness. Some countries in the core, like France, need to focus on increasing labor participation while others, like Germany, need to tackle obstacles to service sector expansion to support domestic demand. Key reforms and country-specific recommendations for the 16 euro area countries are detailed in Annexes I and II; as an illustration, reform priorities for Germany and Spain are presented in Box 1.

Box 1. Country-Specific Reform Priorities—Germany and Spain

In **Germany**, reforms could strongly boost domestic investment, in particular in the service sectors (IMF, 2010b). The following labor market reforms will be essential:

- softening employment protection, both de jure and de facto, in particular by streamlining labor court proceedings and labor court discretion over severance pay;
- enforcing stronger conditionality of unemployment benefits receipt and improving social transfer recipients' ability to earn additional income, to support growth of the low-wage sector by improving search and work incentives;
- lowering the tax wedge, which remains substantially above the OECD's average; and
- reducing restrictions on rehiring of workers previously employed on temporary contracts.

Supporting growth in the service sectors will require:

- enhancing the powers of the competition authority, with a view in particular to increasing competition in transportation industries;
- lowering formal entry requirements in professional services, including by removing formal requirement of trade association membership and liberalizing degree requirements; and
- facilitating cross-border transfer of degrees and training certificates.

In **Spain**, regaining competitiveness and boosting production in the tradable sector is the priority (IMF, 2010c). Consistent with the measures taken by the government in June 2010, labor market reforms need to focus on reducing dualism and encouraging permanent hires. To that effect, the following measures will be crucial:

- lowering severance pay on permanent contracts to at least EU average levels and making the increase of such severance payments more gradual in the early years of tenure;
- preventing excessive use of unfair dismissals; and
- decentralizing wage setting, for example by moving to an "opt-in" rather than "opt-out" system for collective bargaining, and eliminating automatic indexation.

Reforms in the service sectors should:

- ensure an ambitious implementation of the EU Services Directive, especially to lower entry barriers in the area of retail trade imposed at the local and regional levels;
- eliminate restrictions on professional services, in particular by narrowing qualification requirements and reducing existing regulatory differences across regions; and
- relax restrictions in the rental market, such as landlords' obligation to automatically renew leases for the first five years and the cap on rent increases to CPI inflation.

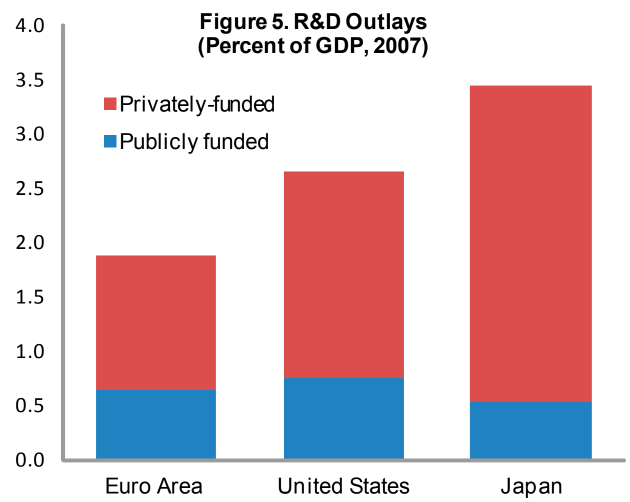
B. Complementary Priorities: Robust Finance, Innovation, and Education

- Revitalizing securitization, developing capital markets, and generating attractive conditions for venture capital will put the financial sector back at the service of the economy.

- Innovation and education are essential to sustain growth over the long term.

Financial sectors will need to be oriented to support growth. Developing capital markets further will help firms diversify their sources of financing, as will the revitalization of well-regulated securitization markets, and the establishment of more attractive conditions for venture capital (Christiansen, Schindler, and Tressel, 2009). Such measures will create room for banks to focus more on supporting smaller firms—in relatively large number in the euro area—which are at a higher risk of being constrained on financing, but at the same time are key for innovation. Some countries, most notably in southern euro area, will need to take measures to encourage savings, for example through private pension schemes, so as to relieve constraints on growth from external imbalances and provide a stable source of funding for productive investment.

Better innovation and education can fill a substantial part of the productivity gap. On both counts, the euro area lags, with spending on private R&D and the share of graduates completing tertiary education substantially below United States and Japanese levels (Figure 5). While private involvement usually delivers innovation more efficiently, public investment might still be needed where distortions persist, contingent on existing fiscal space.



Sources: European Commission; IMF staff calculations.

Specific measures to foster innovation and education could include the following:

- **Extending the use of R&D tax credits across the euro area**, to replace existing direct grant schemes—tax credits require less administration and only reward successful projects—and more generally making tax systems more conducive to private R&D.

- **Promoting the links between universities and business-related research**, in particular by allowing universities to patent output even when research has been financed through public programs (as permitted by the Bayh-Dole act in the United States).

- **Increasing the share of adults reaching tertiary education**, including by encouraging return to studies throughout the professional career.
- **Offering more and better vocational education and retraining**, especially as working life lengthens.

III. Delivering Coordinated, Comprehensive Reforms

A. Political Economy of Structural Reforms

- Large-scale growth-enhancing national reforms seldom happen without the specter of a crisis, involve compromises, and take time.
- EU-driven reforms have been more successful where national authority was delegated but failed when relying on peer pressure.

Market pressure may succeed where other approaches have failed. When faced with unsustainable conditions, national authorities often manage to push through otherwise difficult reforms, as evidenced recently in Greece and Spain. But even under pressure, past labor market reforms generally did not consist of comprehensive packages unambiguously beneficial to employment. They involved complex trade-offs between institutions to overcome resistance in particular areas. In most cases, reforms were designed to (re-)establish competiveness, thus initially leading to export-led growth. The reluctance to reform appears to be based at least in part on the perception that voters punish reformist governments. However, the evidence suggests that reformist governments have the same likelihood of being re-elected as those that favor the status quo and that governments receiving a clear mandate to reform go on to be re-elected (Buti and others, 2010; Tompson, 2009).

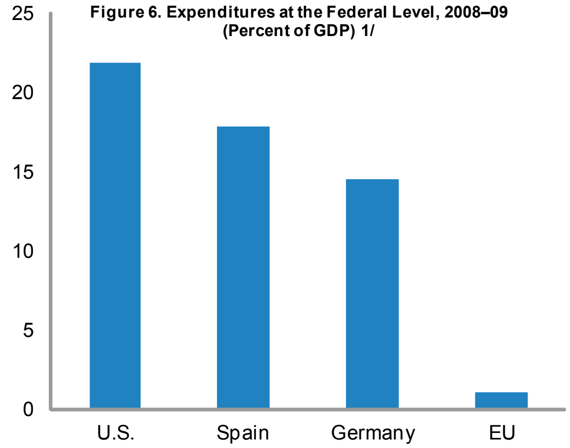
EU driven reforms have succeeded when accompanied with clear powers, but failed when reliant on peer pressure. The Single Market Program, coordinated by the European Commission, has been successful in opening product market access and leveling the playing field. By contrast, labor market and social policy reforms, left to national authorities, and subject only to peer pressure, have proceeded gingerly. One reason may be technical, as harmonization in most product market areas was relatively straightforward to achieve in a top-down approach, whereas labor market institutions are country-specific, more complex to reform, and changes also need to reflect (country-specific) preferences. Still, soft coordination methods—such as the Lisbon Strategy process—failed to deliver the appropriate incentives to reform: the creation of the euro area did not generate an impetus to reform labor markets, and paradoxically, the absence of immediate pressure on exchange rates in the currency union made reforms to sustain competitiveness less compelling.

B. Principles for the Design of Euro Area Incentives to Reform

- Building in central incentives is necessary.
- Larger EU transfers conditioned on reform implementation could help.
- These transfers should be accompanied by a transfer of fiscal competence to the euro area level but without raising overall public debt.

Better incentive mechanisms for reforms will be essential in areas where decision making remains national. Incentives to foster reform efforts and comply with recommendations could be channeled through a reformed EU budget where disbursements would be closely linked to reform implementation, in line with the Commission's proposals to retool financial sanctions and use the EU budget as an incentive scheme. Currently, the EU budget represents only 1 percent of EU GDP, far below the typical size of a central government in federal systems (Figure 6). In addition, the common agricultural policy and structural funds, whose disbursement is not contingent on policy reforms, absorb more than 70 percent of the budget. In a revised framework, EU transfers could be larger. To foster structural reform, they should be conditional on a set of ex ante agreed measures—reflected in National Reform Agendas—and assessed by an independent expert group, as a way to reward good behavior and punish adverse policies.

Figure 6. Expenditures at the Federal Level, 2008–09
(Percent of GDP) 1/



Sources: Eurostat; German Federal Statistical Office; U.S. Office of Management and Budget; and IMF staff calculations.

1/ Total payment appropriations for the EU.

Larger EU transfers may well be necessary to induce reforms. This means going beyond the current EU budget, which is strictly limited by the Treaty, to a system that uses more transparent EU-wide instruments—such as green levies. This approach would allow a euro area approach to shaping initiatives that boost growth, employment, and cohesion—especially in areas where intra-area spillovers are large. Increased revenues accruing to the center would go hand in hand with a transfer of spending competency—for example R&D or infrastructure—where spillovers can be large. EU transfers could be withheld if countries do not comply with the reform agenda. Such an assessment should be done by an independent expert group. Peer review should be avoided, as pressures to weaken discipline would arise, as experienced in the past with the Stability and Growth Pact (SGP). The design of the incentive scheme would thus need to include strong conditionality to avoid moral hazard. At the minimum, recipient countries would have to be deemed to be pursuing prudent policies and to abide by EU deficit limits to obtain funds.

C. New Governance

- In a monetary union, the case for coordinating reforms is strong.
- A simultaneous comprehensive approach will create much needed cohesion.
- Making labor market reform a euro area project is essential.
- Networking national productivity commissions would revitalize product market reform.

Differences in economic structure and structural reforms create spillovers, especially in monetary union. The premise so far was that product market reforms were natural candidates for harmonization, whereas social and labor market models could remain differentiated, reflecting country-specific preferences. However, the question arises as to whether the euro area can be an effective economic and monetary union with very different national labor market models: first, asymmetries in labor markets can exacerbate asymmetries in reaction to technological shocks, globalization, or sustainability concerns. Second, uncoordinated structural reforms act as asymmetric shocks in monetary union, leading to divergences in economic performance across member states. Third, with the unfolding crisis, it has become even more apparent that compartmentalized national markets, including through the non portability of social systems across borders, hinder labor mobility within the euro area.

There are benefits from embarking on a simultaneous, comprehensive approach. Such an approach would reap synergies across reform areas, thus minimizing adverse spillovers and enhancing benefits (Everaert and Schule, 2006). With vested interests opposing reforms at the national level, implementing reforms together could generate more buy-in as every country would be perceived as doing its share to improve the overall functioning of EMU. The cost of inaction could become more apparent when neighboring economies embark on reforms that boost their competitiveness. Finally, simultaneously enacting structural reforms is more efficient at fostering growth, as it activates cross-border synergies.

Stronger coordination through an increased euro area-wide approach is desirable. The need to build better incentives to reform into the European governance framework is hardly new (Sapir and others, 2003). But the crisis has made changes more pressing. Reforms under way following the October 2010 Council decisions will strengthen governance over fiscal and structural policy (Box 2). Yet some features that led to weak enforcement in the past remain, and the structural reform strategy continues to rely on peer pressure. In this area, more is needed at the national level to increase reform ownership and commitment. For example, reform commitments to the EU enshrined in the governments' "National Reform Agendas" should be better scrutinized by national Parliaments. Moreover, the Commission, perhaps backed by a "European Growth Expert Group" of wise persons, should have more power to issue warnings in case of noncompliance.

Box 2. October 2010 Decisions of the European Council on Economic Governance

On October 28–29, 2010, the European Council endorsed the report of the Van Rompuy Task Force on economic governance in the EU. It called for a "fast track" approach, with the objective of reaching agreement with the European Parliament by summer 2011 on the legislative proposals.

The Van Rompuy Task Force report endorsed by the Council recommends:

- Creating a mechanism for macro-economic surveillance to complement the budget-focused SGP. This mechanism should include an early warning system to detect risks of real estate bubbles, unsustainable external imbalances, and divergences in competitiveness. It might result in sanctions for euro area countries;
- Strengthening the SGP. More focus would be put on the debt criterion and sanctions would be more automatic, implemented at an earlier stage, and decided through reversed majority—a Commission recommendation on sanctions would be adopted unless a qualified majority of Council Member States votes against it;
- Deepening and broadening coordination, notably through the "European Semester" through which national budgets are assessed by the European Commission at the draft level. The "European Semester" will be implemented as of January 2011;
- Establishing a more robust framework for crisis management in the medium term, to address financial distress and prevent contagion from one country to another; and
- Fostering stronger institutions, notably at the national level, where it advocates the use or setting up of public institutions to provide independent analysis and forecasts on domestic fiscal policy matters.

A project focused on labor market reform would reinvigorate and better balance the euro area economy. Few people doubt that within national borders, labor market features should be harmonized to create a level playing field for all workers. Given the importance of spillovers within EMU and the desirability of a more mobile labor force, this goal should be pursued at the level of the monetary union. In a sequel to the "Single Market" initiative, which harmonized goods markets, a "Single Labor Market" initiative could be adopted. This does not require labor market features to be entirely identical (just as VAT rates need not be the same everywhere), but a degree of harmonization would certainly improve the functioning of the monetary union. As a first best, harmonization should cover areas identified above as critical priorities to spur growth, such as labor taxation, unemployment benefit systems, and employment protection legislation. At a minimum, striving for "best practices" should drive structural reforms momentum across the euro area.

A network of productivity commissions should be established to renew momentum in product market reform. To facilitate the implementation of the services directive and to expand it to the sectors not yet covered, especially professional services, independent national productivity commissions (modeled after the example of Australia) could be established and a

hub created at the level of the EU. These commissions would have the legal mandate to assess the economic costs and benefits of remaining regulations and their compliance with EU directives. Governments would be required to respond to their recommendation in national as well as European parliaments.

IV. Conclusion

Making better use of available labor would allow the euro area to live up to its growth potential and secure its inclusive social model. Providing more jobs with higher productivity will improve the sustainability of the euro area along several dimensions, not in the least in the fiscal arena. It will also allow for a more inclusive economy, with viable social safety nets.

Only a comprehensive approach will rekindle strong growth over the medium term. Strengthening the financial system is a prerequisite for the recovery and sustained financing of much needed investment. But equally or even more important, complementary labor and service sector reforms are essential to boost investment and growth. Reforms will need to be mindful of their effect on demand as long as the recovery remains fragile, but improving regulation and reforming tax and social benefits will be key to provide incentives for job creation and investment, and foster innovation.

Strengthened policy coordination at the euro area/EU level could give a strong impetus to reforms. Key structural reforms should be embedded in a stronger Stability and Growth Pact, with surveillance focused on the joint accomplishment of fiscal sustainability and structural reforms for growth. EU transfer rules should be revised to reward reformers and induce laggards to make greater efforts. Overall, more reform authority should be vested at the euro area level, and compliance enforced more decisively than in the past. New governance projects, such as the drive for a more harmonized labor market, would revitalize the euro area.

ANNEX I. KEY REFORMS IN THE LABOR MARKET AND SERVICE SECTORS

Labor market models need to be adjusted to promote inclusivity. Although the detailed measures vary on a country-by-country basis, reforms are needed across the euro area (Annex Figure 1). Key reforms should include:

- **Rewarding the return to work for the unemployed through initially generous but limited-in-time support**. While income support allows financial security during recessions, the set-up in many euro area countries has generated inactivity traps, especially for low-wage earners. Unemployment benefits duration should be shortened—for example, net replacement rates still top 75 percent of previous earning after one year of unemployment in Luxembourg, the Netherlands, and Portugal. In addition, training requirements and job search activation should be tied to benefits more closely and enforced more rigorously, to stimulate employability and employment re-entry.
- **Attracting second-earners to join the labor force**. The implicit tax on the gross income of a second earner tops 70 percent when including social security contribution, benefits loss, and the cost of child care in Austria, France, Ireland, and the Slovak Republic. Measures especially geared toward second earners, combining tax incentives—including allowing women to file their labor income separately from their husband in countries with joint family taxation—and better child-care support, could be specifically targeted at raising female participation. IMF staff estimates show that cutting labor income taxes paid by women by 5 percentage points would increase the GDP level by 1¾ percentage points, for a fiscal cost of ½ percentage point of GDP.
- **Fostering longer lifetime contribution to the labor market**. Early retirement schemes and too low retirement ages—out of line with rising life expectancy—are wasteful as they prevent society from benefiting from older workers' acquired experience. Measures to improve long-term fiscal sustainability should therefore focus on raising the pensionable age—more than on reducing pension benefits, which would also be potentially detrimental to demand.
- **Lowering labor costs to boost hiring**. The large tax burden has made production in Europe more capital-intensive than elsewhere, with detrimental effects on employment, social cohesion, and ultimately growth. Shifting taxes away from the labor factor and toward consumption therefore presents strong potential for growth.
- **Easing regulations to offer better job opportunities to all**. Boosting labor flows would require a relaxation in regulations on labor contracts, particularly in Spain, France, Luxembourg, and Portugal. If labor flows are less constrained, finding a job becomes easier, and the apprehension associated with losing one's job diminishes. A more dynamic labor market equips society better to reallocate resources toward vibrant sectors, and to integrate growth-inducing innovation.

- **Removing labor market dualism**. "Insiders" have enjoyed better job security than in other social models elsewhere in the world, but at the expense of a large share of the population, the "outsiders" who cannot find a job. Creating a more level playing-field for all workers would imply harmonizing labor contracts and employment legislation between permanent and short-term employment in countries where recourse to temporary work has been especially prevalent, as in Spain and France.

Service sector reform should aim at decreasing insiders' existing rents. Stronger competition would allow new entries in the various sectors, fostering both more robust innovation and efficiency, hence stimulating private investment and employment. Special emphasis would need to be put on:

- Fostering competition in the retail industry, through a further relaxation in opening hours and zoning restrictions. Regulatory conditions in the retail sector are particularly strict in Austria, Belgium, Finland, France, Greece, and Luxembourg.

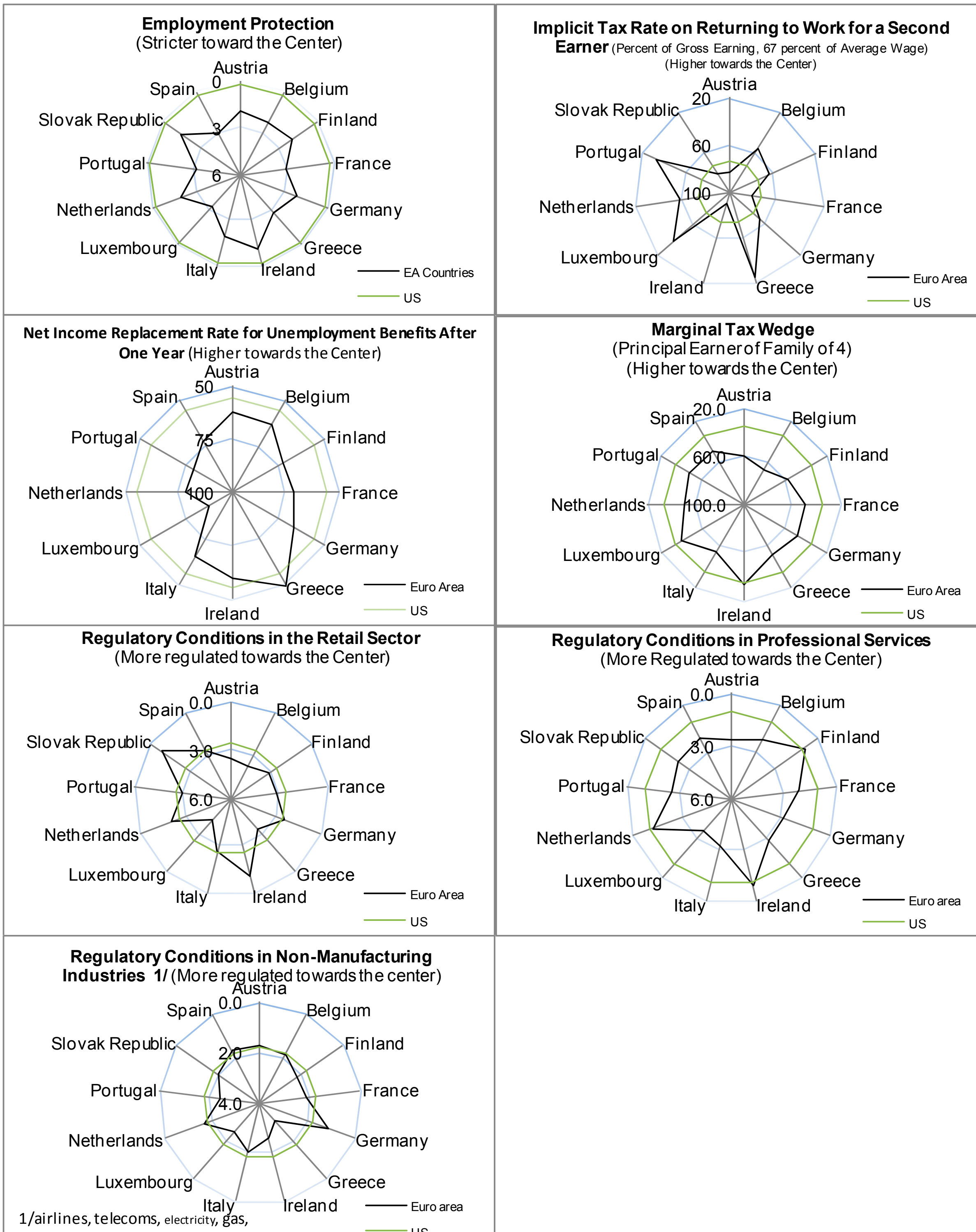
- Easing formal restrictions on the size of some professional services sectors such as *numerus clausus* and compulsory membership in professional associations, as is the case of Luxembourg, Italy, Germany, and Greece.

- Lifting entry barriers in network industries (for example transportation and energy), through changes in regulation and an end of the de facto monopoly of the state-owned company.

- Improving the business environment more generally, through a reduction in red tape and in restrictions to operate, as well as a reform of overly onerous personal bankruptcy rules.

Detailed reform agendas will need to be tailored to country-specific situations. Annex II lists high priority measures identified by IMF country teams.

Annex Figure 1. Euro Area: Structural Indicators for Labor and Services Markets 1/



Source: OECD.

1/ Each country is compared to its euro area peers (blackline) and to the U.S. (green line). Best policies are situated at the

Annex II. Euro Area: Country Specific Recommendations

Country	Area of Reform Priority	Specific Measures
Germany	Make labor market work better	Soften employment protection, both de jure and de facto, in particular by streamlining labor court proceedings and labor court discretion over severance pay Support growth of low-wage sector by improving search and work incentives, in particular by: • enforcing stronger conditionality of unemployment benefit receipts • improving social transfer recipients' ability to earn additional income Lower the tax wedge, which remains substantially above OECD's average Reduce restrictions on rehiring of workers previously employed on temporary contracts
	Support the growth of the services sector	Enhance the powers of the competition authority, with a view in particular to increasing competition in network and transportation industries Liberalize price setting in professional services Lower formal entry requirements in professional services, including by removing formal requirement of trade association membership and liberalizing degree requirements Facilitate cross-border transfer of degrees and training certificates
France	Improve the functioning of labor markets with a view to lifting the employment rate	Achieve minimum wage moderation and better training, to reduce inactivity traps for young and low-skilled workers by: • eliminating the *coup de pouce* (minimum wage increases beyond those linked to inflation) • further developing apprenticeship programs and sector-specific training and re-training opportunities Increase senior employment by: • raising the minimum age for pension eligibility • enforcing job-search requirements and applying penalties for refusals of reasonable job offers more consistently
	Increase competition in retail and service sectors	Reduce regulatory barriers in the retail sector by: • abolishing administrative entry limitations for discounters • eliminating restrictions on opening hours and sales periods • combining market liberalization with the end of price regulations on key products, for example in the pharmacy sector Liberalize services sectors by: • introducing greater competition in health-related services and professional services (notaries, accountants) • implementing the EU Services Directive
Italy	Decentralize wage bargaining to take into account regional differences in productivity and the cost of living	Activate a mandatory level of bargaining at regional level to supplement the national collective agreement for employees not covered by firm-level bargaining. The reform should start with the public sector. Revisit the system of performance-related incentives, including tax breaks, that have been poorly implemented Combine labor tax reductions with unions' commitment to wage moderation at national level
	Boost product market competition	Reduce mandatory information requirement for setting up business, in particular by making "one-stop shop" single electronic contact points (*Sportello Unico per le Attività Produttive*) operational and developing use of IT at the local level (as identified in Law Decree 112/2008) Enhance the role of competition bodies in formulating policy by: • raising the statutory cap on authorized personnel level of the Antitrust Authority (low compared to peer countries) • developing a check list of pro-competition practices with the contribution of the Antitrust Authority, and establishing "watchdogs" at regional level to enforce this check list • introducing an annual law covering competition and market issues

Annex II. Euro Area: Country Specific Recommendations (Continued)

Country	Area of Reform Priority	Specific Measures
Spain	Overhaul the labor market with a view to reducing dualism and encourage permanent hires	Lower severance pay on permanent contracts to at least EU average levels, and make the increase of such severance payments more gradual in the early years of tenure
		Prevent excessive use of unfair dismissals
		Decentralize wage setting (for example by moving to an “opt-in” rather than “opt-out” system for collective bargaining) and eliminate automatic indexation
	Further reform service markets	Ensure an ambitious implementation of the EU Services Directives, especially to lower entry barriers in the area of retail trade imposed at the local and regional levels
		Eliminate restrictions on professional services, in particular by narrowing qualification requirements and reducing existing regulatory differences across regions
		Relax restrictions in the rental market, such as landlords' obligation to automatically renew lease for the first five years and the cap on rent increases to CPI inflation
Netherlands	Make labor market work better with a view to lifting the employment rate, especially for women, older workers and low-skilled young workers	Selectively reduce labor taxes for hiring unemployed workers over 50, phase in the income-based tax credit to make it attractive for low-earning partners with children, and increase statutory retirement age from 65 to 67 while providing financial incentives for workers to continue working after minimum retirement age (62)
		Relax the strict employment protection legislation for regular contracts by: • simplifying the dismissal system--including appeal procedures-- and making it more predictable • clarifying the rules governing layoffs • reducing severance payments to older workers to the level of those for other workers • expanding the range of "appropriate work" that must be accepted by unemployed in the Unemployment Insurance Act and reducing the duration of unemployment benefits
	Promote competition in retail distribution sector	Ease restrictions on shop opening hours, large scale outlets and zoning regulations
Belgium	Raise the employment rate	Step up active labor market policies and limit the level/duration of unemployment benefits
		Raise the effective retirement age by further limiting pathways into early retirement and extending activation programs to older workers
		Relax employment protection legislation, including for workers on temporary contracts
	Increase competition in product and services sectors	Strengthen the independence of the competition authority. So that it is able to conduct independent sectoral analyses and issue specific policy recommendations
		Implement the EU Services Directive to further services sector liberalization
Austria	Increase labor market participation of older and low-skilled/foreign-origin workers	Enact legislative changes at Länder level to increase children participation in full-day pre-school facilities, with free provision on a means-tested basis

Annex II. Euro Area: Country Specific Recommendations (Continued)

Country	Area of Reform Priority	Specific Measures
Greece	Forster competition in the product and service markets	Reduce entry barriers to professional services Improve transportation services by: fees • establishing an independent regulatory and supervisory body for the railway sector • restructuring the state-owned railway company with a final objective of privatization • privatizing transportation infrastructures, including ports and airports
Finland	Increase labor participation of older workers	Eliminate the early retirement schemes ("unemployment pipelines") while enhancing retraining for older long-term unemployed Strengthen activation requirements for sickness and disability benefits Improve opportunities for part-time work, including for retired persons
	Make the education system more efficient	Speed the transition from secondary to tertiary education, in particular by introducing tuition fees with an means-tested loan system, to better direct students to areas of labor market demand. Raise incentives for timely tertiary education graduation, in particular by tightening annual minimum requirement for progress in study to qualify for study financial support, and revising university funding rules
Portugal	Make labor market work better	Promote firm level wage bargaining to allow companies to opt-out from industry-wide arrangements Reduce severance payments (which area above EU average level) both for fair and unfair dismissals Relax employment protection for regular workers with a view to reducing protection gap with temporary workers Relax working time regulations to help reduce cyclical employment losses Promote vocational training to raise labor quality
	Further improve the business environment	Streamline licensing processes for businesses and more generally accelerate the implementation of the authorities' SIMPLEX program Expedite the revision of existing legislation to make it compatible with the EU Service Directive Resume the privatization process and expand performance monitoring of state-owned enterprises
Ireland	Raise employment to avoid persistence of current high unemployment rate	Introduce gradual decrease of benefits over time of unemployment spell and stricter job search requirements Provide more resources to the unemployment agencies (FÁS) to provide efficient job search assistance to the growing number of unemployed Review the level of minimum wage to make it consistent with the general fall in wages
	Improve competitiveness to promote exports as a sustainable source of growth	Reform planning and licensing systems in net work industries, so as to increase competition in sheltered services sectors Focus public resources on high-priority projects in the knowledge-based economy
Slovak Republic	Make labor market work better with a view to reducing the high level of structural unemployment among young and low-skilled workers	Allow regional differentiation of the minimum wage to reflect differences in structural unemployment, by capping the minimum wage to 40 percent of regional median wage and abolishing any formal link between the minimum wage and the contractual wage. The reduced minimum wage (at 75 percent) should also be extended to the 18-21 age group. Better target and monitor active labor market policies, by improving their regional targeting, expanding training measures for young unemployed, and narrowing job creation subsidies to long-term unemployed.
	Improve effectiveness of the education system	Enhance the funding and quality of tertiary education, by introducing tuition fees for full-time tertiary students along with means-tested grants and loans, and by giving greater autonomy to tertiary education institutions along with stronger performance-based management Promote better vocational and professional training to align skills with labor market needs, by developing more occupationally-oriented curricula at the tertiary level, with a stronger involvement of employers

Annex II. Euro Area: Country Specific Recommendations (Conculded)

Country	Area of Reform Priority	Specific Measures
Slovenia	Reform the pension system to encourage labor market participation	Increasing the retirement age Link pension to CPI inflation instead of to wage developments
	Improve service markets functioning	Promptly implement the EU Services Directive
Luxembourg	Improve the functioning of labor market, with a view to providing incentives to work	Eliminate the automatic wage indexation to inflation, starting with volatile price elements Introduce stricter criteria for access to unemployment benefits and revise down the eligibility period for older workers Review income support system to address inactivity traps, in particular by targeting minimum guaranteed income schemes to individuals truly in need and scaling down generous child allowances and parental leave
	Reform the pension system	Make pension benefits actuarially neutral for early retirement Better align pensions to lifetime contributions by reducing current generous replacement rates and gradually increasing statutory retirement age and eligibility criteria
Cyprus	Improve the functioning of labor market	Introduce legislation to address the high gender pay gap Introduce training programs for low skilled and immigrant workers--most hit by the crisis--to enhance their employability Reduce the size of the public sector, as it draws resources away from the private sector of the economy Remove incentives to early retirement
	Ensure wage moderation to regain competitiveness	Eliminate the wage indexation mechanism and link wage increases to productivity developments at the firm level Reduce wage increases in the public sector until the existing large pay gap with the private sector is closed and more generally abolish automatic increases in public sector wages Support labor supply through immigration flows and higher female participation
Malta	Make labor market work better	Eliminate the wage indexation mechanism and link wage increases to productivity developments at the firm level, possibly through a social pact to forge consensus on a new productivity-linked indexation mechanism Encourage female labor market participation, through fiscal incentives for part-time and flexible work arrangements, training programs and affordable childcare services Reduce the state involvement in the economy, by continuing the privatization process (including through the search for strategic investors for Bank of Valletta) and implementing Enemalta's debt restructuring plans
	Strengthen competition in the product and service markets	Provide the competition authority with adequate capacities and institutional independence to investigate monopolistic behavior in the retail and wholesale markets

Source: IMF desks.

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