Panel Discussion: "Adjusting competitiveness differentials among Eurozone members"

The Future of the Eurozone: Labor Market Reforms, Mobility and Human Capital

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Low labor mobility is one of the core reasons for the competiveness differentials that exist between Eurozone member countries – and their persistence. The lesson from the current crisis is very clear: The Eurozone faces the serious risk of economic and fiscal domino effects. We see that shocks and fiscal imbalances in one country affect other Eurozone countries more quickly and more strongly than initially thought. This had not been expected when the Euro was introduced.

Labor mobility contributes to an optimal allocation of economic resources and it ensures a quick adjustment of labor markets, especially on the regional level. Labor migrants are typically more mobile than the native population. Hence, labor mobility could help to avoid the domino effects we are currently experiencing. Nevertheless, mobility remains low in Europe. This is even more surprising given the huge differences in unemployment rates between Eurozone countries.

However, a number of factors can explain the persistent low mobility in Europe. First, there are underlying demographic trends such as the rising female labor market participation rate, the increase in less mobile double-income households, and an increasing homeownership rate. Second, there are policy-related reasons that prevent many Europeans from fully taking advantage of labor mobility. These reasons include the still existing barriers to the transferability of social security entitlements, the insufficient recognition of formal qualifications across countries, and the insufficient transparency of the European job market and online job search engines. Third, language barriers and cultural barriers are relatively high in Europe, at least compared to other integrated labor markets such as in the United States.

The lack of labor mobility results in European labor markets that mainly function on the national or regional level. If mobility does not substantially increase (which is unlikely to happen in the short run), European labor markets' performance needs to be improved with domestic structural reforms. Such reforms make countries less vulnerable to economic shocks as the example of Germany during the Great Recession demonstrates (Rinne and Zimmermann, 2012). Next to concrete policy responses and the specific nature of the crisis in the German context, the labor market reforms are a key factor in explaining the country's remarkable resilience to the Great recession. They resulted in an improved functioning of the German labor market with an increased effectiveness and efficiency of labor market instruments (Eichhorst and Zimmermann, 2007), improved incentives for unemployed individuals to take up jobs, and increased labor force participation rates. In sum, the reforms contributed to Germany regaining its international competitiveness.

It is, however, important to realize that the underlying factor for the latter development – the decline in unit labor costs – did not stem primarily, as is widely believed, from wage restraint on the part of the trade unions. More important was that the social partners used the collective bargaining process to arrive at more flexible labor arrangements. These allowed the adjustment, restructuring and reorganizing of existing work processes not just at the industry or sector level, but also at the firm level. This newfound localized flexibility is the real source of Germany's new resilience, also during the Great Recession.

Hence, Germany is now widely perceived as a role model for many countries in Europe. But in this context, there is another popular myth that needs to be destroyed. Spending cuts for their own sake were never the "German style," as is now widely, but falsely speculated. During the process of reforming the German labor marking in the early 2000s, fiscal consolidation and growth-oriented labor market reforms were regarded as two integral parts of a successful economic package. It is important to realize the following two key lessons from the German success story. First, the necessary efforts to reduce public budget deficits and to achieve fiscal stability do not rule out growth-oriented public investments. Second, austerity is not a growth strategy *per se*, but fiscal stability is only a necessary condition to achieve future economic growth. Optimizing the use of public resources to foster growth makes sense only if it is combined with structural labor market reforms. Both are vital to the economy, which – like the human body – requires constant exercise and monitoring to get into and stay in shape.

The future of the Eurozone therefore lies in a reform approach that involves optimizing the use of public resources. Fiscal consolidation is necessary for any European growth strategy. The future of the Eurozone lies in continued integration with even more competences for European institutions, especially in the key areas of economic and fiscal policy – which are, of course, subject to democratic control mechanism (e.g., by the European Parliament). These considerations ultimately lead to a "European Ministry of Finance" with competences in the areas of coordinating fiscal policies, establishing and enforcing common rules for the finance and banking sector, and representing the Eurozone at international organizations as a "common voice."

However, fiscal stability needs to be combined with structural reforms in not less than the following four key areas:

1. Structural labor market reforms are needed. It is important in this context to realize the vitality of the Europe-wide learning community on dealing with real-life challenges. It is not a shame to copy and steal what works in other countries: In fact, this is the bottom line of evidence-based policymaking. However, while lessons can be learned, for example, from the German model, we must resist the temptation to believe in any one-size-fits-all solution. Each country can, and each country must, develop its own strategy for labor market reforms. Labor market conditions, requirements, options and challenges differ from one country to the next.
2. Substantial efforts are required to increase labor mobility in the Eurozone. A labor migration regime should be established that ensures the mutual recognition of professional qualifications and a full and transparent portability of social entitlements. Such a regime should be combined with a unified European online job exchange platform. Furthermore, education policies need to be harmonized on the European level and educational exchange programs should be strongly promoted.

3. The key areas of innovations and human capital require well-considered investments as they are central to guarantee long-term economic growth in the Eurozone. These are areas in which it is especially evident that austerity is not a growth strategy *per se*. The comparative advantage of the Eurozone lies in its stock of human capital and innovative potential – and we should not put the substance of our long-term economic growth at risk by any necessary efforts of fiscal consolidation.
4. Alarmingly high youth unemployment rates call for fundamental reforms of the education and vocational education systems (Biavaschi et al., 2012). These reforms should include steps such as a well-resourced and nationwide apprenticeship system to ensure that young people are offered training and career opportunities in non-academic pursuits. As most countries have some forms of vocational training, they are well advised to start with those elements and reform their systems. The main challenge is to make on-the-job learning more systematic and to bring school-based vocational training or general education closer to labor market needs. To achieve this, employer participation and some more systematic vocational training are crucial.

Finally, and next to the necessary efforts to implement these flexible defense mechanisms on the European level, we also need structural reforms on the global level. It is evident that the emergency measures taken in the Eurozone and in the United States will only provide short-term relief. A global debt brake is an important instrument for a long-lasting solution of the debt crisis to push the process of consolidation of public finances and make it binding (Dolls et al., 2012). Such a debt brakes should be fixed in national constitutions and enforced by transnational independent fiscal supervisory councils. The G20 would be a right place for such a global reform measure. We have to realize that if no convincing answers to the debt crisis are found, financial market uncertainty will grow even further.

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