Labour Market Reforms in the Context of Political Power Theory: The Case of Slovenia

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Abstract

The rigidity of labour market has several important negative economic consequences: it stifles job creation, increases discrimination of those it is actually aimed at protecting (young, women and low skilled), hurts the unemployed, slows down economic restructuring and damages its global competitiveness. But reforms are slow and often marked with disputes among partners in the collective bargaining process. Afraid of social security loss, unions usually oppose the reform, while governments usually give in to the union pressures and negative image of reform consequences created by unions and assisted by media. The characteristics of the labour market and labour market reform with respect to bargaining among power groups are examined both theoretically and empirically in the case of Slovenia.

Keywords: labour market flexibility, re-election process, reforms, Slovenia.

JEL: C70, D02, J08

1 INTRODUCTION

Institutional framework has been proven to be an important factor of economic growth and development (Barro, 1991, Berg et al., 1999, Acemoglu, 2005). Labour markets have been widely discussed in the past few years as one of the primary factors of lower competitiveness and sluggish responsiveness to economic changes in many European economies. But European welfare state tradition and worker protection are strong and therefore opposition towards reforms that might endanger the acquired level of rights can be expected to be fierce. The theoretical literature on the labour market relations has shown that the free-labour marker relationship is not efficient. In response to the perceived unfairness and inefficiency of the free market employment relationship, nearly every state intervenes to protect the workers in this relationship (Becker and Casey, 2003; Stigler, 1971). Several negative side effects of labour market regulation have been identified, from less intense job creation to even more obvious discrimination. These negative effects of rigid labour market regulation, which is characterized by difficult process of hiring and firing workers and consequently less intense job creation, working time regulation and high costs associated with these factors, have lead to intense debates over labour market reform in numerous European economies.

Despite the obvious need to introduce reforms to at least some aspects of the labour market, the reforms are being delayed or not implemented. One of the key reasons is the political element. The governments, afraid of losing their positions in the following elections, are reluctant to implement reforms that might be perceived by wider public as harmful to the welfare of the masses. Namely, too often the reforms that could in the middle and longer run be beneficial to the wider public[1], are being interpreted by the unions and the media as negative and only the potential negative side-affects are publicized strongly. Unions often fiercely defend their adopted rights due potential negative short term consequences for some groups in the labour market and the fear of social security loss[2]. The delays and decisions not to implement unpopular reforms will in the longer run stifle economic growth and consequently also job creation, as the competitiveness of an economy declines.

This paper explains labour regulation and propensity to reforms through the context of political power theory and it contributes to the existing literature in several ways. First, it links labour market regulations with political power theory in a systematic, game theory approach. Second, the game theory approach is justified by country case study, Slovenia, a successful transition economy with rigid labour market regulations. The theoretical model, showing how the structure of the elective body affects the reform process, is being examined first by the public opinion polls data to justify the decision for 'not reforming' by the strength of the public opinion. Then the theoretical model is implemented and examined empirically in the general equilibrium

[1] For example, introducing flexicurity elements has been proven to help Danish competitiveness and growth and the model is being mentioned as a solution to enhancing EU growth (see also Madsen (2006) and European Commission (2006)). Also simplified flat tax system has been argued to help the development in the Slovak republic, especially by attracting FDI (Goliaš and Kičina, 2005). But reforms in similar direction have been fought by the unions in Slovenia due to their potential negative impacts, especially in the shorter run.

[2] In Germany changes to unemployment benefits were in debates for 11 years. The Dutch government reached agreement on reforms with labour unions and business organisations in 1982, only after 9 years of failed negotiations (Doing Business, 2004).

framework (Bayar *et al*., 2006; Majcen *et al*., 2009). Our main hypothesis is that in the context of political power theory the reforms' implementation depends on the opinions of low productivity workers about potential benefits of the reform. We investigate, whether the initial desire of the government to reform the labour market towards greater flexibility was actually implemented or whether, as suspected, the actually implemented reform was the 'anti-reform', improving the immediate position of the majority of the elective body.

The article is structured as follows. Section 2 outlines the theories of employment regulation, followed by the development of the theoretical model of the reform process in Section 3. Section 4 portrays the case of Slovene transition and labour market development, where the (un)success of Slovene reforms, its implications and possible development are examined empirically. The final section concludes our work with the main findings.

2 DIMENSIONS OF LABOUR MARKET REGULATION

To correct for the imperfections in the labour market, countries have adopted complex systems of laws and institutions encompassed by employment law, collective relations law, and social security law[3]. According to the literature (Lazear, 1990; Bertola *et al*., 2000; Deakin, 2001), government intervention in the labour markets can take four forms. First, government forbids discrimination in the labour market and endows the workers with some "basic rights" in the on-going employment relationship (such as maternity leaves or the minimum wage). Second, governments regulate employment relationship, for example by restricting the range of feasible contracts and rising costs of both laying off workers and overtime work. Third, in response to the power of employers against workers, governments empower labour unions to represent workers collectively, and protect particular union strategies in negotiations with employers. Finally, governments themselves provide social insurance against unemployment, old age, disability, sickness or death.

In the literature there are three major theories of institutional choice that explain government interventions; the efficiency theory, the political power theory, and the legal theory. The foundation of the first theory was set by Demsetz (1967) and North (1981), emphasizing that the choice of institutions is dictated by efficiency consideration in order to maximize social welfare. According to Glaeser *et al*. (2003), countries choose heavier intervention when market failures are severe (employer abuse of employees is greater in the market), and lighter intervention when distortion associated with government interference become more severe. The efficiency theory is too broad and as such is difficult to reject.

The second theory, by far the leading explanation of labour regulation, is based on political power consideration implying that labour regulations are more protective when leftist

[3] Employment laws govern the individual employment contract (Botero *et al*., 2004). Collective or industrial relations laws regulate the bargaining, adoption and enforcement of collective agreements, the organisation of trade unions, and the industrial action by workers and employers. Social security laws govern the social response to needs and conditions that have a significant impact on the quality of life (old age, disability, death, sickness and unemployment).

governments are in power (Saint-Paul, 2000). Such protection can restore efficiency if in a free market workers are abused, or in lower efficiency if government intervention leads to expropriation of capital by labour. Political power theories can be assessed in two ways. The first holds that the principal mode of political decision making is elections, and that parties that win shape the laws. The second, as described by Becker (1983) and Botero *et al*. (2004), holds that laws are shaped by the influence of interest groups, especially trade unions, and should therefore be more extensive when the unions are more powerful, regardless of which government is in charge.

The third theory is legal theory that has received considerable attention in the discussion of institutional evolution (North, 1981). This theory emphasizes the evolution of the two very distinct legal traditions in Western Europe from 12th century on, namely common law and civil law that was outspread to other regions of the world. Since most of the countries in the world received their basic legal structures in this involuntary way, these structures are exogenous to their economies[4] (Botero *et al*., 2004).

In order to asses the propensity to reform a game theory model in the context of political power theory is presented. Growing literature (*cf*. Persson and Tabellini, 2000; Acemoglu and Robinson, 2005) investigates the importance of political process and vested interests for the propensity to reform. The interaction between interests for re-election, power of unions and role of the media crucially impact the possibility of implementation of reform.

3 REFORM PROCESS IN THE LABOUR MARKET: THE THEORETICAL MODEL

Despite the clear indication by theoretical and practical experiences that rigid regulation aiming at protection is often harmful (*cf*. Botero *et al*., 2004; Bolaky and Freund, 2004; Domadenik, 2007), the reform process towards greater flexibility is very slow. Usually one of the key reasons is the political consequences of an unpopular reform. Despite the clear understanding among economists and even politicians that such a labour market reform can be beneficial to the society as a whole in the long run, the reforms are often not undertaken or at least delayed till the next election, while only necessary patch work takes place[5] (*cf*. Acemoglu, 2003). We develop a theoretical model based on game-theory approach and bargaining among power groups in the labour market in order to explain the propensity to reform and use the model as a theoretical background for the analysis of the reform process in Slovenia.

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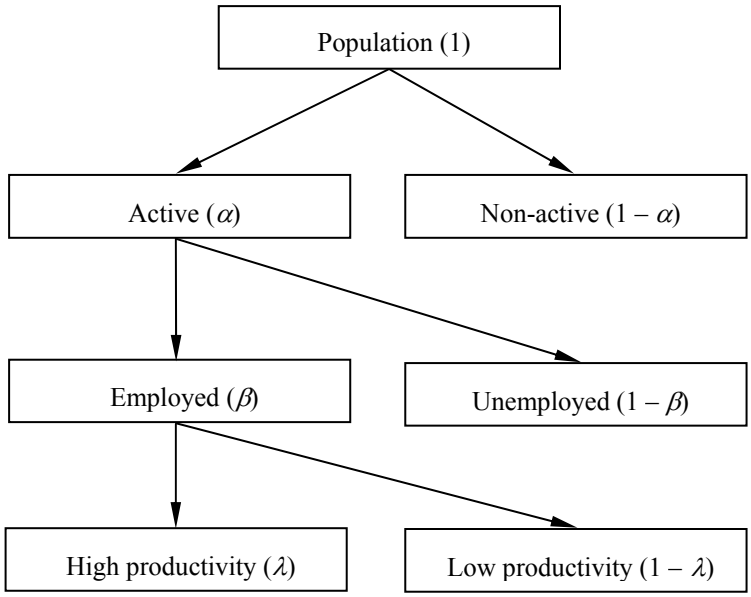
[4] Common law emerged in England and is characterised by the importance of decision making by juries, independent judges and the emphasis on judicial discretion as opposed to codes. From England, common law was transplanted to its colonies, including Ireland, US, Canada, Australia and other countries. Civil law evolved from Roman law in Western Europe though middle ages, and was incorporate into civil codes in France and German in the 19the century. Civil law is characterised by less independent judiciaries, the relative unimportance of juries, and a greater role of both substantive and procedural.

[5] Acemoglu (2003) lists several reasons for such behaviour: (1) voters might be myopic and do not see the potential benefits of the reform; (2) the reform might be socially beneficial to future generations, but because it is not to present generations, there will be a lack of support for it; (3) there can also be several veto players present in forms of lobbies or strong social groups that can block the reform; (4) uncertainty about the cost and benefits to reform might also lead to opposition to reform; and (5) political losers might also oppose reform for all listed reasons and a threat to loss of power.

3.1 Outline of the Model

The model will be based on the intuitive model presented by Fernandez and Rodrik (1991) and Acemoglu (2003). We will extend it into two period model with several interest groups. We start with the simple labour market approach to population groups (Figure 1). The size of the population is normalized to 1. Respective shares of each group within the population are denoted in Figure 1 (in brackets). Total population is divided into active (share α) and non-active (share $1 - \alpha$). The active are further divided into employed (share β in total active population) and unemployed (share $1 - \beta$). The employed are further divided into high productivity workers (share of them in total employed is λ) and low productivity workers (share $1 - \lambda$). We additionally assume that the model is a short term model, therefore there is no need for a balanced public finances budget[6].

Figure 1. Interest groups in the society.



Source: Authors' presentation, 2008.

The political reform must be passed in parliament, therefore it needs political support. But any party, currently in office, will maximize its value function, which directly depends on the possibility of re-election. The reform will go into public debate. Unless it received sufficient public pole support, politicians might feel that passing such an unpopular reform (although necessary in the longer run and also highly beneficial in the longer run) shall endanger their immediate re-election and would not pass the reform[7].

[6] Also, we would like to stress here that the problem is also solved in the empirical model, because it is a computable general equilibrium model (CGE).

[7] For more on related issues see also *cf.* Dur, 1999; Drazen, 2000; Persson and Tabellini, 2000; Castro and Coen-Pirani, 2001; Acemoglu and Robinson, 2005.

At the end of current period election takes place again. Economic consequences of the reform will not be known until the next period, meaning that the politicians will be very reluctant to pass any reform that does not have sufficient public opinion support. The reform will be beneficial to all in the longer run (and thus bring positive consequences to all in the second period), but the positive consequences for some in the longer run will be lower than for the others, i.e. some will benefit more than the others. In the current period some groups will benefit from reform, others will not lose much (i.e. have a slightly lower wage, but keep their jobs), third might lose a lot (i.e. become unemployed).

The main problem in the model is uncertainty. To pass the reform, politicians will want majority public support for the reform. But the outcome for some groups in the current period is uncertain and they will thus be reluctant to support the reform. Therefore, the political outcome will depend mainly on two factors: (1) relative size of groups who win and lose with the reform, and (2) the expected outcome of every particular group of voters.

Table 1. Outline of the model.

Labour market reform proposed	Election ↓ *	Economic consequences of reform take place
Period 1: What the groups already have		**Period 2: What the reform will bring to the groups**
High productivity $w_H\,(1-t)\,(1-T)$ Low productivity $w_L\,(1+s)\,(1-T)$		High productivity $w_H\,(1-T_1)$ Low productivity $w_L\,(1-T_1)$ with probability p or become unemployed with probability $(1-p)$ Unemployment B_1 and higher probability $q_1\,w_{AVG}$ Increased investment, growth and wage impact

Source: Authors' calculations, 2008.

The labour market reform will be directed at increasing the flexibility of the labour market. This implies mainly lower firing costs, potentially lower benefits, or benefits for a shorter period of time. The reform will affect different groups differently (Tables 1 and 2). We assume that the high productivity workers (*H*) are currently receiving a wage that is lower than their productivity, because wage regulation punishes the productive workers at the expense of less productive (e.g. minimum wages) (Lemieux et al, 2009, Lazear, E. P. (2000)[8]. We model this by introducing the

[8] As an indication of the lack of relationship between wages and productivity growth, the growth rates of wages in the private and public sector in Slovenia can be used. IMAD (2007) shows the relationship between productivity and wage growth in the public and private sector. Let's assume that the productivity growth mainly results from the private sector. Despite fluctuations, there is no indication that the relationship between productivity and wages is straightforward, it is subject to policy changes and policy goals.

'rigidity tax' rate (t) into the model. Because firing costs are high[9], firms are reluctant to dismiss some of low productivity workers (L), or at least significantly lower their wages due to union pressures. Consequently firms pay lower wages to higher productivity workers implying that higher productivity workers are being taxed to subsidy lower productivity workers. High productivity workers are receiving a wage $w_H\,(1 - t)$, where w_H is their productivity determined wage, while t is the 'rigidity tax' rate. Low productivity workers are receiving a wage $w_L\,(1 + s)$, where w_L is their productivity wage, while s is the subsidy level existing due to labour market rigidities. The unemployed are currently receiving benefits B, but they also have the chance to get a job with probability q. Both groups are also paying a tax rate T to the government, which is used to finance unemployment benefits B.

The business sector will be the main winner of the reform process. It will be able to adjust their employment levels to economic activity and therefore react quickly to turbulent economic environment. The greater flexibility will also allow employers to focus more on the selection and development of those employees who possess proper skills (Čater and Čater, 2009) instead of losing a lot of time and effort thinking how to get rid of poorly performing employees. Data show that elasticity of demand for labour increases with labour market flexibility (Domadenik *et al*., 2008). Firms hire in good times because they know they can fire in bad. Due to the increased threat of firing, lower productivity workers will be more inclined to accepting a lower wage than they were before. Therefore the subsidy from higher to lower productivity workers will be lower. Each group will be paid according to their own productivity. The reform will also impact the position of unemployed workers and those that might become unemployed after the reform is implemented. Since firms will be able to fire, they will no longer be that reluctant to hire and the probability of getting a job will increase (from q to q_1). The government might also decrease unemployment benefits (B) in order to motivate unemployed to seek for a job.

Table 2. Results of the model*.

Group	Share in society	Gain / loss	Support to reform
Employed			
High productivity			
Current situation		$w_H(1 - T)\,(1 - t)$	
Post reform	$\lambda\,\alpha\,\beta$	$w_H(1 - T)$	Yes
Net gain/loss		$w_H(1 - T)\,t$	
Low productivity			
Current situation		$w_L\,(\,1 + s)\,(1 - T)$	Depends on probabilities, wage change (s) and tax changes.
Post reform	$(1 - \lambda)\,\alpha\,\beta$ (majority)	$(1 - T)\,(1 - p)\,w_L + p\,B$	
Net gain/loss		$p\,B - w_L\,(\,s - s\,T + T\,p)$	
Unemployed			
Current situation		$(1 - q_0)\,B + q_0\,w_{AVG}$	
Post reform	$\alpha\,(1 - \beta)$	$(1 - q_1)\,B + q_1\,w_{AVG}$	Yes
Net gain/loss		$(w_{AVG} - B)\,(q_1 - q_0)$	
Inactive	$(1 - \alpha)$		On average votes cancel out.

*We assume unchanged tax rate T, unchanged B, and discount rate $r = 0$.
Source: Authors' calculations, 2008.

[9] For example Doing business (2009) data shows that the firing costs in Slovenia expressed in terms of weekly salaries are with 37 weekly wages significantly higher than the OECD average (25,8 weekly wages) and the regional average (26,3 weekly wages).

The group hurt most by the reform is the lower productivity workers' group (that might be empirically identified as those with lower level of attained education or could also be understood or modelled as workers in less propulsive sectors). Therefore, this group is most likely to be quite opposing to the reform. They are threatened by unemployment with probability p, potentially lower wages with probability $(1 - p)$ and potentially lower unemployment benefits (had they become unemployed). But on the other hand, there is a chance that they also benefit from reform. If unemployment level lowers, the fund needed for benefits will lower and thus taxing will decline (T), which means higher wages for all employed. Also, if lowering benefits (B) is a composite part of reform, this will additionally reduce fiscal burden and hence taxes.

3.2 Theoretical Results

This very simple exercise has significant results for policy markers. First, we would like to stress that the implications of the model are valid for an economy not in distress over a demand or supply shock. In case of crisis and rising unemployment, all workers have problems finding a job.

Now, let's turn to the results of the model. First of all, it is possible to expect a wide support for reform from more productive workers $[w_H (1 - T)\, t]$. This could also be interpreted as workers in more propulsive sectors.

The unemployed $[(w_{AVG} - B)\ (q_1 - q_0)]$ would at first sight also gladly welcome a reform programme. But a more detailed analysis of the above equation might shed some doubt on that. First, if benefits are high (which is the case in many countries), the difference between the expected possible wage and benefits is not high, possibly it is even negative if all other transfers to unemployed are taken into concern (child support, subsidized kindergarten, etc.). Second, the public perception of difference between the possibilities to get a job prior and post reform could be biased. The reform would increase labour market flexibility and thus elasticity of demand for labour would increase. But for unemployed to support the reform, the difference between the two should be more than marginal. They must believe that it would be easier to get a job. Therefore it would be good to promote the reform in the labour market in periods of economic expansion. In such periods expected wages rise but above all the demand for labour would be on the increase. A good economic situation in periods when reform is preparing is highly important, possibly much more than the actual situation just post reform. Of course, the results also depend on the structure of unemployment. The longer term unemployed, the structurally unemployed and the elderly will be more likely to support the reform. As the unemployed are not organised like unions and represent a minority, have low impact on the public opinion.

The most reluctant to accept the reform will naturally be those workers, whose jobs might be threatened; $[p\ B - w_L (s - s\ T + T\ p)]$. They will weigh between potential loss of the job and the expected value of that option, which depends also on the value of potential benefits and the level of subsidization that is taking place. The lower the existing benefits or the benefits proposed by the reform, the lower the likelihood for support. The higher the level of subsidization of lower productivity workers and thus the higher their wages, the higher the opposition to reform will be.

The political support for reform therefore depends mainly on the opinions of those less productive workers in the economy[10]. These also represent the majority of workers in any economy. Therefore their vote is crucial. In reality, the lower productivity workers might not all oppose the reform. Even among the lower productivity workers, the differences are significant. Some of the lower productivity workers are employed in sector whose future is not threatened and their opposition to reform thus depends mainly on the level of subsidization from the higher productivity workers. Those working in less propulsive sectors will be opposing the change much more fiercely. The bigger the threat of low unemployment benefits and higher the chance of becoming unemployed, the higher will be their opposition to the reform. But again, it might be much easier to convince the lower productivity workers that their jobs are not highly threatened and that in case of unemployment it will not be hard to find a new job. Relatively generous benefits would serve as an additional convincing mechanism. Also, the politicians should be aware that the reform will be much easier to pull through in times of economic expansion, although the political motivation to change anything when times are good is low. Expansion means more jobs are being created, wages are growing and the probability to get a job is much higher.

In this context it is important to mention the power of the media, which channel the information to the general public and importantly create the public opinion. The media have a very important impact on politicians and their decisions, because the media make and annihilate political careers (*cf*. Besley and Case, 1995; Besley and Prat, 2006). Therefore good PR and positive public campaign in cases of big reforms by the government is very important. The government should at all times stress the positive aspects of the reform and allow a constructive dialog and admit that there might also be negative consequences for some groups, but that the reform package has taken care of those by certain measures and programmes. Labour market reform should be presented to the public as a well thought through package, which is not aimed solely at making firing easier and lowering benefits but must also take care of alternative measures to increase employment. The more unionized the labour market is, the more important is the cooperation with the unions even in periods when the reform is being prepared. The support of union leaders will in turn also lead to higher support among workers.

The decision for or against the reform is consequently dependant on numerous factors, often not related directly to economic problems in the labour market. Therefore, for successful economic performance it is important to have a government that is aware of the potential traps of policy making and is able to create good and credible programmes, which will obtain wider public support. Only so will reforms actually take place.

[10] An extension of the model could also consider the importance of the expectation formation across various population subgroups for the results of the model. The problem of expectation formation across various population subgroups has been studied by several authors, for example by Malgarini and Malgani (2008) or Wong and Hardy (2009).

4 TRANSITION PROCESS AND LABOUR MARKET DEVELOPMENTS IN SLOVENIA

To illustrate the practical implications of the model, we examine the case of last major proposed reforms in Slovenia and their fate in the light of the theoretical setting of the model. In 2004 the newly elected government proposed a series of ambitious reforms aimed at increasing the competitiveness. One of the more discussed and problematic reforms were the suggested reforms aimed at increasing labour market flexibility and the suggested 'flat tax rate' (Majcen *et al*., 2009). These two were perceived by the general public as reforms that will harm the worker, who will be now easily sacked, and benefit the rich due to the proposed tax change. We examine the basic characteristics of the proposed reform in 2006, the pressure of the public on the government, and the actual outcomes and consequences of the much less significant changes than originally proposed. But in order to understand the characteristics of Slovenian legacy and economic history, which also impact the perception of any reforms, we first provide a brief insight into Slovenian transition and labour market characteristics.

4.1 Transition and labour market characteristics in Slovenia

The results of Slovene transition are at first glance very good. Since 1993 Slovenia has maintained a robust average growth rate of about 4 per cent, and substantially narrowed the income gap with the European Union (in 2007 GDP *per capita* in purchasing power parity amounted to almost 90,6% of EU-27 average). The successful economic performance resulted mainly from higher productivity, especially in the export sector (Damijan and Kostevc, 2006), while employment remained more or less constant. Slovenia has also managed to gradually bring inflation down to 8.6% already by the end of 1995. Inflation continued to decline to the level required to accomplish the Maastricht criteria. In 2006 it was 2.8% and in 2007 3,6% (Statistical Office of the Republic of Slovenia, 2008). In 2007 Slovenia adopted the euro as the first among transition economies. So far, the transition has been quite successful. But lack of political desire and opposing interests of power groups have been delaying several important reforms, including the labour market reform.

The rate of unemployment has remained relatively low and was declining during transition mainly due to privatization model, which maintained status quo and avoided large layoffs at the beginning of the transition. Policymakers avoided social tensions with high state subsidies to loss making firms in apparel, leather and many other industries. From 1993 to 2002 the ILO unemployment rate fell by about one-third, to 6.3%, which is a low unemployment rate compared with other transition economies and lower than those of many EU members (Riboud *et al*., 2002). The unemployment rate varied around 6% till 2007, when it even fell to 4,9%, well below the EU-27 average of 7,1% (Eurostat, 2008). But the low overall unemployment rate does not reveal large regional disparities, and unemployment remains highly concentrated among unskilled and older workers. Moreover, the average duration of unemployment has been increasing, suggesting that the bulk of unemployment is structural.

Despite successful growth, the growth of employment lagged. The labour force declined by 2 per cent during the first 6 years of transition (1992-1997), while employment declined by 5 per cent although real output increased by 21 per cent. Also labour force participation rate declined, reflecting strong flows of the working-age population into nonparticipation. The structure of

employment changed significantly, reflecting the rigidities in the labour market legislation. Many older workers retired in the early 1990s, some under company pressure and with the encouragement of government-sponsored early retirement programs. The trend toward a falling share of older workers was reversed by the pension reform, passed in 1999 and implemented in 2000, which introduced (among other policy measures) a gradual increase of the retirement age. Young workers faced more difficult access to jobs because of the tight labour market; while on the other hand, the returns of education increased dramatically, making university education more attractive. Major part of the inactive young cohort is in the education process. The number of college students nearly tripled by the year 2002, which can be contributed to significant increase of returns of education for all groups of educational attainment. Table 4 reveals the distribution of after-tax income using the aggregation of taxpayers into five categories regarding their education. The results clearly imply correlation between the level of education and the level of income. More educated taxpayers report substantially higher income; as the data show, the average annual income of taxpayer with at least university education is 2.5 times higher compared with the income of taxpayers with completed primary school or lower education (16,792 EUR versus 6,476 EUR) (Table 3).

Also minimum wage legislation, where minimum wages were set at 48 per cent of average wage in 2005 (very high by international standards), employment protection legislation that imposes strict regulation on working time schedules and layoff practices, high tax wedge and other structural reasons are further issues that cause additional distortions. These problems resulted in low international competitiveness of Slovenian labour market and significantly contributed to the low international competitiveness of the whole economy.

The labour market is consequently one of the most problematic aspects of Slovene competitiveness, besides the pension system, bureaucracy and governance quality, which is confirmed also by the IMD (World Competitiveness Yearbook, 2006), WEF (Global Competitiveness Report, 2005) and the World Bank's Doing Business study (2009). The reports stress especially the tax legislation (including high personal taxes and social security payments) and labour market characteristics, primarily restrictive labour market regulations, firing legislation, wage rigidities, high tax rates and social security costs, problems with employing immigration workers, employment of women in the private sector and inadequate education are being mentioned as problematic.

4.2 The Proposed Labour Market Reform

Reform in the labour market has been a hot topic on the agenda of several governments, but so far it has remained at the stage of proposals, because all negotiations with the unions failed. Such a reform would be harmful mainly to those less skilled, whose jobs would be more threatened due to economic restructuring. The pressure from unions has been thus constantly strong and also successful, because so far, except for some minor adjustments, no reform that would significantly help reduce distortions in the labour market was passed. The reforms mainly promote employment programmes, but do not tackle the main problem – rigidity.

The newly elected right oriented government, which came to power in 2004, had a very ambitious general economic reform plan that was aimed at increasing competitiveness of the economy (Government Office for Growth of the Republic of Slovenia, 2005). One of the important aspects of the reform programme was also labour market reform.

The labour market reform proposal consisted of six major measure packages all aimed at increasing the efficiency of the labour market. Increasing the flexibility of the labour market was one of the primary concerns of the reform suggestion. High firing costs are the primary reason for the reluctance of employers to give workers permanent contracts. Instead the firms protect themselves against high firing costs with contracts for a specified period of time. To do that lowering firing costs were suggested, shorter firing notice, maximum severance costs, for both workers and managers. The reform also suggested introducing flexi-time work options, job sharing, work from home, which would all also help at least partially to solve the problem of population ageing and increase the employment options of women and also reduce their discrimination in the labour market.

The proposed change in the salary system in the private and public sector was aimed at increasing the flexibility of the wage system, determined by collective bargaining, to allow for a more stimulating wage system, especially for those with higher education and hence higher productivity. The proposal also suggested that workers would be able to participate on profit sharing, if so was decided in firms. To achieve that, several measures were proposed. First, the industry collective bargaining would have a less important role; it would only determine minimum wages, while actual wages would be determined directly in bargaining on firm level. A wage reform in the public sector was suggested, aimed at decreasing fiscal pressures and realigning some anomalies in the wages in public sector. The reform also proposed that wage growth should be related to productivity growth not to threaten long term performance of firms and at the same time to ensure that workers also capture the benefits of increasing wealth.

The reform proposal also focused on the reform of the tax system by decreasing the tax burden and simplifying the administrative procedures. Among the different proposals, a flat-tax system (similar to the Slovak one with a single (and same) tax rate for personal income tax (PIT), capital income tax (CIT) and value added tax (VAT)) divided the public opinion and was later rejected in particular by labour union. The finally adopted tax reform, effective from January 2007, includes new PIT and CIT codes, new tax procedure rules, the gradual abolition of payroll tax and several changes to less important taxes, e.g. the inheritance tax. Among the major changes of the PIT and CIT codes one should emphasize the reduction of the highest marginal PIT rate from 50% to 41%, schedular 20% taxation of interest, dividends and capital gains, and the reduction of statutory CIT rate from 25% to 20%. In comparison with several CEE countries that decided in favour of more radical approaches, Slovenia once again decided on a more gradual approach. But, as Majcen *et al*. (2009) show, the consequences of the reform are relatively modest and give benefits to practically all taxpayers, while they harm the government budget in the short run. The outcome of the initially very ambitious reform package was thus finally quite modest, because the government gave in to the pressures of the unions and the negative campaign in the media.

Despite the ambitious plans in the field of labour market changes and tax system changes, only minor changes were implemented, primarily in the tax system. We show that even these

implemented reforms in general were not damaging to the welfare of the 'popular vote', indicating the power of the negative public image of the reform.

4.3 Why is the Reform Being Delayed?

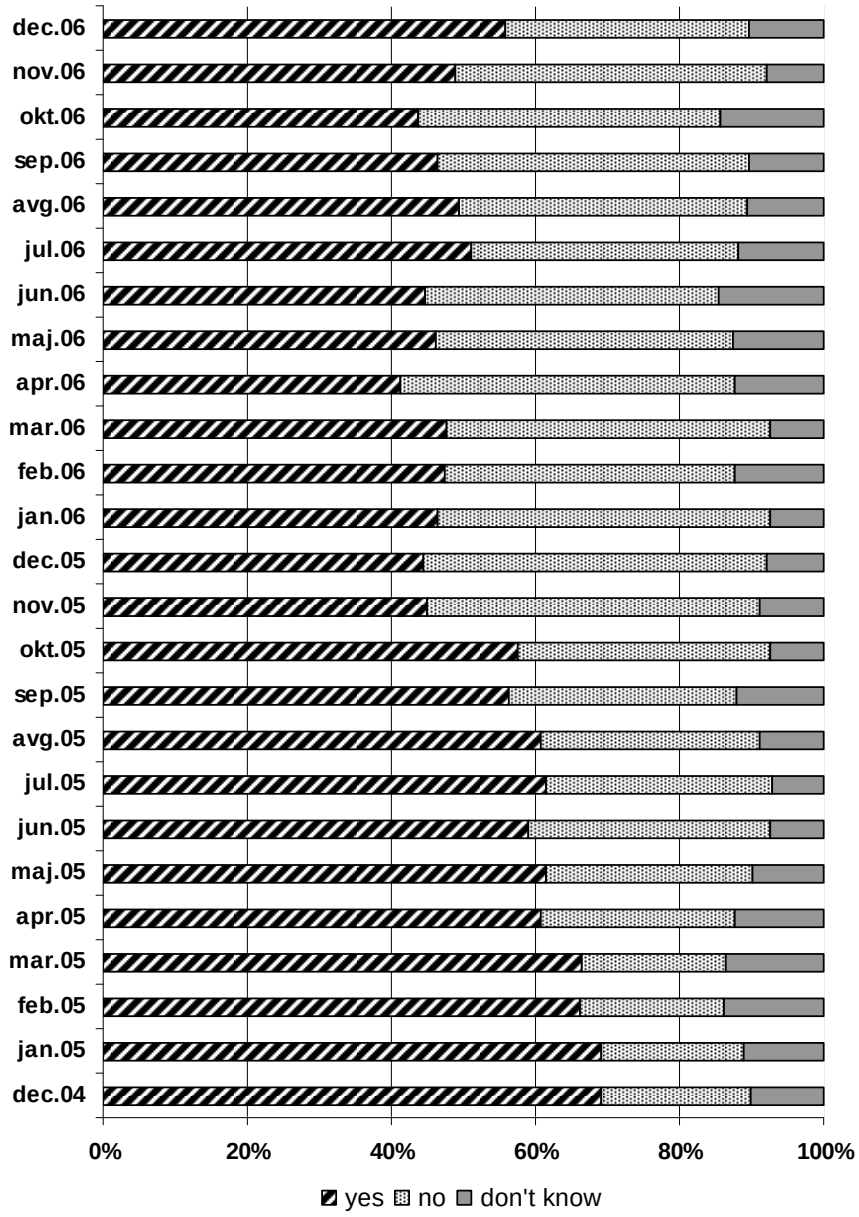
Since the beginning of transition the changes in labour regulations and wage system were subject to collective bargaining. In August 1990, a general collective agreement between the Chamber of Commerce and the Trade Union Organization was signed. In this agreement, the initial wages for each category of workers were set, supplemented by industry-specific agreements that effectively converted initial wages into minimum wages at the level of industries. At the level of each firm, the union and management bargained in the context of the firm's annual plan to further adjust industry level wages. The multi-layer bargaining structure resulted in both wage dispersion and rapid wage growth.

As tripartite negotiations between unions, government and employer associations might be justified with social consensus and were used to implement basic reforms at the beginning of transition, national wage bargaining in the later stages of transition were questionable and led to pervasive effects. Several studies on wage systems in firms reveal that almost all firms kept the traditional, fixed pay system with a very low variable part (Prašnikar *et al*., 2000; Domadenik *et al*., 2008) Moreover, a fixed part of wage in the total wage bill increased during transition.

After almost 20 years of transition it became evident that a deep microeconomic reform of the labour market is needed. Government, Chambers of Commerce and Union representatives sat down and tried to agree on new Labour Code that was in power since 1993 and has many elements not familiar to a market economy. After tough discussion they agreed to a few minor changes mostly being associated with layoff conditions. Although employers warned the government and employees that the changes are not too profound, the union leaders were too strong. A new Labour Code became effective in January 1, 2003. It seemed that the majority of people, the voters, were disappointed by the negotiations and voted for the new government that offered deeper solutions in its election campaign.

After 2004 the new government started with a more liberal approach to institutional organization, proposing a program of deep reforms, whose final goal was to increase international competitiveness of the economy. Initially, flashy promises gained the government wide public support, close to 70% (see Figure 2). In December 2004 the government established the strategic council for development. As intensive public debate over reform characteristics started, the reform package started taking shape and its liberal character was becoming more and more apparent. Public support to government dropped to around 60%. The core of the reform proposal was a flat tax rate and a labour market reform. The proposal led to a big campaign against reforms, publishing TV and newspaper ads, organizing several events and eventually in November 2004 unions gathered more than 20.000 people to protest against the reforms due to the fear of loss of social security and the desire to retain the workers' rights at the existing level. Unions demonstrate their negotiating power against government and employers' organizations in this manner. It was successful. Public support to the government plummeted to only 45% in November 2005 (see Figure 2). The union pressure and negative public image of the reform process continued. Quite successfully, if the unions were asked.

Figure 2. Public opinion poll: Do you support the policy choices of the government?



Source: Ninamedia (2007).

The labour market reform has (so far, by the end of 2008 and the end of office for the government elected in 2004) not been implemented. This does not mean that no results were achieved. The Minister of Labour resigned and new came to power. She is praised by the unions for her understanding approach.

Out of the ambitious reform plan, the only more significant change was the income tax reform, implemented in 2007. This reform will also have some, though partial and limited effects on the labour market categories, such as the labour supply, real wages and unemployment rates. But, the reform package was far from the initially planned drastic reform. The data, based on the simulation results of Bayar *et al*. (2006), reveals that the government gave in to the pressures of

unions and that the actually implemented reform. Despite obvious positive effects of the reform in terms of employment growth, the obvious result is also that the income position of the major voting groups improves.

4.4 Simulation of the Tax Reform and Its Impact on Wages and Employment

The theoretical model argued that the (un)popularity of a reform package might be the main obstacle to its implementation, given that any government strives to remain in position after the oncoming election. Public poles data revealed that the popularity of the government fell dramatically when the ambitious reform plan was presented. After long and scrutinizing public debate, the biggest reform was the tax system reform, which also had some labour market implications. However, as revealed shortly, the results of the simulations show that one of the key results will also be the improvement of the income position for the majority of people. The political acceptability of the reform was the priority over its economic dimensions.

In order to demonstrate this issue, the elements of our theoretical model, presented in Section 3, were then implemented in a dynamic general equilibrium model of the Slovenian economy (Bayar *et al*., 2006), linked to a microsimulation model (Majcen *et al*., 2007). The resulting modelling framework, entitled SloMod, takes into account the structure and all the fundamental mechanisms of the Slovenian economy, as well as all the important elements of the structural and tax reforms, including the reform of social transfers, changes of the government expenditures, and the volume and structure of financial flows between the Slovenian and EU budgets. All economic agents, i.e. households, firms, government and the foreign sector, are assumed to adopt an optimizing behaviour under relevant budget constraints. The difference between the theoretical and the empirical model is in the level of detail, where the latter, built within the general algebraic modelling system (GAMS) and solved numerically with the PATH algorithm, enables the implementation of much richer economic structure.

Namely, in SloMod labour is differentiated according to the level of education in three skill groups; unskilled labour, skilled labour and highly skilled labour. Substitution possibilities between labour by skill type are reflected by a CES function. Labour market by skill type is closed by changes in unemployment, thus introducing rigidities. The responsiveness of real wage rates to the labour market conditions is modelled by a wage curve, while the behaviour of labour supply is determined through a labour supply curve. Wage differentials of the wage curve are derived as the ratio between the wage rate by sector and skill and the average wage rate by skill level, while the labour supply curve assumes a positive correlation between the domestic labour supply and the real average net wage rate. Taxes are also modelled in much detail, where we take into account the existing and proposed PIT, CIT, VAT and social security codes, with associated allowances, standardized costs and exceptions. Modelling of the government is in accordance with the existing and projected budget data.

Having this in mind, the data in Table 3 reveals that the government actually gave in to the pressures of the public opinion and passed a very populistic reform. Namely, the 2007 PIT reform obviously improved the income position of the majority of taxpayers. Although the changes in absolute values were higher in higher income brackets, the income did increase, which was a favourable result. Also, the feared increase of labour market flexibility proved to be

exaggerated, as changes to the legislation were only marginal. Therefore, the main result of the reform was an increase in income with little other change. A very populistic result.

Table 3. Distribution of average after-tax income, by education (in EUR in 2004 prices).

Education	Share of taxpayers	After-tax income (2006 PIT Code)	After-tax income (2007 PIT Code)	$I_{2007/2006}$
Primary school or less	15.6%	6,410	6,476	101.0
Lover cycle secondary school	23.0%	7,247	7,348	101.4
Upper cycle secondary school	33.2%	9,105	9,311	102.3
Non-university higher education	8.8%	12,653	13,001	102.8
University education or more	12.4%	16,375	16,792	102.5

Source: Authors' simulations with the microsimulation model.

As a results, the inequality increased, but the differences caused were not publicized enough to be widely perceived by the public as negative. From the social point of view, the adopted PIT and CIT codes seemed to be the most acceptable, with the present value of welfare changes for individual scenarios of 72.6 million EUR (see Table 5). On the other hand, all of the proposed scenarios would increase income inequality in Slovenian society to a greater or lesser degree, including the finally adopted PIT and CIT codes. However, according to the Gini coefficient, the Atkinson index, and the squared coefficient of variation, this increase is the smallest in case of the 2007 PIT and CIT codes. The values of the income inequality measures and their respective changes can be observed in Table 4.

Table 4. Projected welfare variation measure and income inequality measures, based on household equivalent disposable income (household level).

Measure	2006 PIT Code	2007 PIT Code
Present value of welfare changes	68,887	72,571
Index (REF = 100)		105.3
Gini coefficient	0.2730	0.2785
Index (REF = 100)		102.0
Atkinson index	0.2523	0.2594
Index (REF = 100)		102.8
Squared coefficient of variation	0.3024	0.3210
Index (REF = 100)		106.2

Source: Authors' simulations with SloMod and the microsimulation model.

By implementing the 2007 PIT and CIT codes, total employment is projected to increase due to the strong expansion of the private sector and increasing labour supply. The total labour supply is expected to increase by 1.4% in 2013 and by 2.5% in 2025 as a consequence of real wages' growth (see Table 6). The increase in the labour supply of highly skilled people would be particularly strong (2.2% in 2013 and 3.8% in 2025). Employment increase is significant in manufacturing (more than 10% in 2013 and almost 20% in 2025 in some sectors) and services (*cf*. Majcen *et al*., 2009). The expansion in the high technology sectors is especially vigorous (13% in 2013 and 16.1% in 2025). Employment increase compared to the baseline case is evident even in agriculture (2.9% in 2013 and 5.6% in 2025).

As a consequence of significant job creation, unemployment would decline (see Table 5). The overall unemployment rate would decline from 10.7% in 2004 to 5.4% in 2013, and to only 3.2%

in 2025. The unemployment rate among unskilled workers (i.e. with completed elementary school) would more than halve, declining from 19.8% in 2004 to 8.4% in 2025. Among skilled and highly skilled workers, the decline in the unemployment rate would be even more impressive; among skilled workers the unemployment rate would fall from almost 10% in 2004 to 4.6% in 2013 and to 2.3% in 2025, and among highly skilled workers it would be almost completely eliminated (decrease from 3% in 2004 to only 0.3% in 2025).

Table 5. Projected labour market effects of the 2007 tax reform.

Labour market category	Year	2006 PIT Code	2007 PIT Code	$I_{2007/2006}$
Unemployment rate, all skills (in per cent)	2013	5.41	5.55	102.6
	2020	3.86	3.97	102.8
	2025	3.23	3.33	103.1
Unemployment rate, unskilled (in per cent)	2013	12.00	12.24	102.0
	2020	9.53	9.76	102.4
	2025	8.40	8.62	102.6
Unemployment rate, skilled (in per cent)	2013	4.56	4.69	102.9
	2020	2.96	3.06	103.4
	2025	2.34	2.42	103.4
Unemployment rate, highly skilled (in per cent)	2013	0.79	0.84	106.3
	2020	0.40	0.43	107.5
	2025	0.28	0.30	107.1
Number of unemployed, total	2013	66,177	67,947	102.7
	2020	62,522	64,410	103.0
	2025	63,900	65,883	103.1
Labour supply, total (% change in comparison to baseline scenario)	2013	1.42	1.63	114.8
	2020	2.09	2.29	109.6
	2025	2.45	2.64	107.8
Labour supply, unskilled (% change in comparison to baseline scenario)	2013	0.80	0.88	110.0
	2020	1.15	1.22	106.1
	2025	1.34	1.41	105.2
Labour supply, skilled (% change in comparison to baseline scenario)	2013	1.37	1.58	115.3
	2020	2.03	2.23	109.9
	2025	2.39	2.59	108.4
Labour supply, highly skilled (% change in comparison to baseline scenario)	2013	2.24	2.59	115.6
	2020	3.29	3.62	110.0
	2025	3.83	4.16	108.6
Real wage growth rate, unskilled (in per cent)	2007–2013	0.62	0.61	98.4
Real wage growth rate, skilled (in per cent)	2007–2013	0.97	0.95	97.9
Real wage growth rate, highly skilled (in per cent)	2007–2013	1.58	1.53	96.8

Source: Authors' simulations with SloMod.

Productivity growth, increased labour demand, and a significant decline in the unemployment rate should result in higher real wages and higher real income. The increase is particularly strong for highly skilled workers and amounts to 1.6% per year on average by 2013 (see Table 5). It is also strong for skilled workers (1.0% per year on average). The increase in real household income with respect to the baseline case (between 9.6% for the first quintile and 15% for the fifth quintile in 2013, and respectively 19.8% and 27.4% in 2025) should produce a significant boost in private consumption (around 20% for all the categories in 2025) and savings. Savings would increase given higher real return on capital.

5 CONCLUSION

Theoretical and empirical research confirms that a more flexible labour market is not a threat to employment and social security but actually in the longer run increases the dynamics of job creation. After all, employment is the best system of social security. The actual victims of rigid labour market institutions are unemployed workers and more productive employees while the so-called "lost generation" (the less productive workers) who are supposed to be laid off, support stringent regulation and are the main receivers of monopolistic rents. Therefore, despite being aimed at protecting the labour force, rigid labour legislation has many negative macroeconomic and microeconomic consequences.

Despite the obvious need for changes towards increasing the flexibility of the labour market, the changes are often slow and delayed for as long as possible. Due to pressure from both the unions, supporting usually the "lost generation", and the media, emphasizing mainly the potential negative impacts of the reform, especially the loss of social security, the politicians usually give in to the pressures due to the fear of losing office in the next election. Thus often the actual reform is being discussed for a decade before a more significant step is made. And often it is ultimately the high unemployment and other economic problems that force the government into the decision to reform, not the actual desire and understanding of all involved parties that reform has been necessary for quite some time.

In the paper we test the hypothesis that in the context of political power theory the reforms' implementation depends on the opinions of low productivity workers about potential benefits of the reform. The majority of proposed labour market reforms were not implemented due to huge resistance of mostly low income citizens. Tax reform introducing new PIT and CIT codes was implemented mostly due to its clear positive effect on increasing net income of all taxpayers. Therefore we found theoretical and empirical support for our hypothesis.

Our research gives a new theoretical and empirical evidence of political power implications when implementing labour market reforms. However, the model is for now quite simple and apart from media doesn't include labour unions as important factor that affect general opinions of especially less educated people. Political power theory will in the next stages of research have to be augmented by bargaining models between different parties. Empirical evidence shows that those models are very appropriate especially when speaking about former socialist economies like Slovenia.

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