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Macroeconomic policy lessons of labor market frictions

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Abstract

The paper explores the consequences of macroeconomic policy for labor market outcomes in the presence of frictions. It shows how policy may be useful in over-riding frictions, as well as how it might generate adverse outcomes. A partial-equilibrium, empirically grounded model is used to simulate policy effects.

The key results are that policy has effects on the stochastic behavior of key variables – measures that reduce unemployment also reduce its persistence and increase the volatility of vacancies. Hiring subsidies and unemployment benefits have substantial effects on labor market outcomes, while employment subsidies or wage tax reductions are not very effective policy instruments.

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1. Introduction

The importance of the role of labor market frictions in aggregate fluctuations is increasingly recognized.¹ Much attention has also been given to movements in the ‘natural rate of unemployment,’ a concept which is closely linked to the existence

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¹ See the discussion in the recent surveys by Hall (1999) and by Mortensen and Pissarides (1999a) and references therein.

of frictions. It has been argued that government policy may have an effect on this equilibrium rate; for example, several authors have claimed that the implementation of certain policies explain, at least partially, high unemployment rates in Europe.² This paper explores the labor market consequences of macroeconomic policy in the presence of frictions. It seeks to address the following questions: Given frictions, how does government policy affect key labor market outcomes in the steady state and what effects does it have on their business cycle properties? More specifically, the paper explores the decline in unemployment following the implementation of different policy measures, the “cost-effectiveness” of each measure, and the changes in the stochastic behavior of unemployment and other key outcomes that follow each policy.

The paper models labor market frictions as costly search and job-worker matching processes. The analysis shows how policy may be useful in over-riding these frictions and how it might generate adverse outcomes. A stochastic, discrete-time version of the search and matching model is used for this purpose. The model is solved for the non-stochastic steady state analytically and for equilibrium dynamics (the dynamic path and business cycle fluctuations) numerically. The idea is to give both qualitative answers – identify the mechanisms that are in operation when a policy measure is introduced – and quantitative answers – by how much does a given policy measure change labor market outcomes. The macroeconomic policy measures examined include hiring subsidies, employment subsidies, wage taxes, and unemployment benefits. These measures are comparable in terms of government expenditures and the results are used to evaluate policy effectiveness. The analysis shows how budget constraints may be used to solve for the value of policy instruments given firms’ optimization and the structure of the market.

Much of the existing analysis in this framework has focused on the steady state.³ In papers that presented numerical estimates, key calibrated values were often assumed or roughly deduced from stylized facts. The innovation of the current analysis is twofold: First, it relates to business-cycle dynamics in addition to the steady state. Thus, the paper shows how policy influences the adjustment of the economy following a shock by deriving the implications with respect to the volatility and cyclicity of all key labor market outcomes. Second, the analysis is empirically grounded, based on Israeli labor market data which have proved to be particularly well suited to study labor market frictions, with time series that match the model’s definitions of the relevant variables. The model is calibrated and simulated with reference to structural econometric estimates. The dynamic analysis is undertaken using a reduced-form VAR of the actual data to specify the stochastic behavior of exogenous variables. This “agnostic” approach precludes the possibility that labor market results will be affected by misspecifications in other parts of a more general macroeconomic model.

Beyond policy implications, an additional interpretation of the analysis is that it provides a tool to assess the effects of varying the amount of frictions. Thus, it shows how frictions of different degree affect the behavior of labor market variables along

² See, for example, Krugman (1994) and the papers collected in Snower and de la Dehesa (1997).

³ See the survey by Mortensen and Pissarides (1999a). Some important contributions are the analyses of Millard and Mortensen (1997), Mortensen and Pissarides (1999b) and Pissarides (1998, 2000, Chapter 9).

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