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Political instability and labour market institutions

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ABSTRACT

This paper investigates the relationship between political instability and labour market institutions. We develop a theoretical model in which political instability creates incentives for a government to introduce labour market regulation in the economy. The distortionary effect of regulation on unemployment effectively puts a constraint on the design of fiscal and public policies. We empirically investigate these predictions using panel data for 21 OECD countries for the period 1985–2006. Our results are consistent with the view that political instability is associated with more regulated labour markets, lower labour taxation, and lower unemployment benefit replacement rates.

1. Introduction

The recent financial crisis has brought employment and growth back to the top of the policy agenda of most industrialised countries. In the public debate, slower growth and poor employment performance have often been associated with lack of governments' commitment to reform extensive labour market regulation. Moreover, policy makers often report a growing concern that frictions in the political process may hinder policies that are oriented to the long term (OECD, 2012; EC, 2013).[1] In this context, it is worth asking why labour market regulation is so pervasive in developed countries, and why governments find it so difficult to reform the labour market.

This paper explains how labour market regulation may arise as a result of political instability. We show that labour market regulation may be the optimal choice of a government that maximises the welfare of its constituency rather than social welfare. Since workers constitute the majority of voters, the government cares about workers regardless of the political preferences of its constituency. This creates incentives to introduce regulation that creates wage rents, which in turn increases unemployment in the economy. Moreover, the distortionary effect of labour market regulation induces the government to moderate labour taxation to alleviate unemployment and increase social expenditure on unemployment benefits. In this way, the government effectively discourages any fiscal and public policy that is not valued by its constituency. We also show that, when individuals differ in their

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[1] Recognition of the role of political instability in determining market regulation and institutions lies behind many attempts on the part of international organisations, such as the *OECD Job Strategy*, the EU *Lisbon agenda*, the World Bank's report *Understanding Regulation*, and the more recent *EU2020 Strategy*, urging governments to reform labour markets.

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unemployment probability (i.e. there are insiders *à la* Blanchard and Summers (1986)), the government reduces the unemployment benefit replacement rate when the political power of insiders increases.

These results hinge on the existence of an asymmetry between labour market regulation on the one hand, and fiscal and public policy, on the other. We argue that the regulation of labour markets, being embedded in the institutional setting, is hard and costly to change. In contrast, fiscal and public policies are easier to change within the government budget. In this context, with political instability, labour market regulation becomes the state variable that gives the incumbent government an instrument to control future fiscal and public policy.

We empirically investigate the main predictions of our theoretical framework using panel data for 21 OECD countries over the period 1985–2006. We specify and estimate an empirical model to explain how political instability is related to labour market regulation, labour taxation, and the unemployment benefit replacement rate. Our results are consistent with the view that political instability induces government to regulate the labour market, to reduce labour taxation, and to lower the unemployment benefit replacement rate. The above results are shown to be robust to a number of extensions, such as the inclusion of alternative political variables, systems with different legal origins, and predetermined indicators of political instability.

This paper contributes to the debate on the political determinants of labour market institutions. First, it sheds light on the effects of political instability on the choice of labour market institutions taking as given the political process. Existing papers (see e.g. Wright (1986); Saint-Paul (1996); Pagano and Volpin (2006); Boeri et al. (2012)) have mainly focussed on political economy issues, showing that the level and mix of institutions depend on the characteristics of the median voter. Second, it contributes to the large literature that looks at the economic effects of political instability. In our framework, labour market regulation plays a similar role as public debt in Alesina and Tabellini (1990) and Persson and Svensson (1989): it is a strategic variable that affects the action of future policy makers. In existing studies, a similar role is played by property rights protection (Svensson, 1998) and long-run capital taxation (Devereux and Wen, 1998; Azzimonti, 2011). Other contributions have focussed instead on how political instability, risk, and short-term policy making may negatively affect the design of institutions that foster economic growth (e.g. private and public investments; see Alesina and Perotti (1996); Aidt and Dutta (2007); Busse and Hefeker (2007)). Third, this paper is also related to the literature on labour market institutions and unemployment. Traditionally, studies that analyse the impact of labour market institutions on equilibrium unemployment consider them as exogenous (see Bassanini and Duval (2009); Arpaia and Mourre (2010) for reviews). More recent contributions also investigate how institutions may arise endogenously e.g. due to demand for protection during economic crises (Galasso, 2014), international trade (Raess, 2014), and globalisation (Hessami and Baskaran, 2014).

This paper is organised as follows. Section 2 presents the theoretical model. Section 3 describes the data and the empirical strategy. Section 4 presents and discusses the main results, alternative specifications, and a set of robustness checks. Section 5 provides some concluding remarks.

2. A model of political instability and labour market regulation

We introduce a static partial equilibrium model to describe a small open economy composed of a private and a public sector. In the private sector there is an imperfectly competitive labour market, where a mass of homogeneous workers inelastically supplies one unit of labour to satisfy aggregate labour demand. In the public sector there is a government, whose policy action occurs in one period (say a legislature). The government has three policy instruments: labour market regulation, fiscal policy, and public policy. Labour market regulation affects the ability of workers to extract wage rents, and creates unemployment in the economy. Fiscal policy consists of the choice of labour taxes to finance public expenditure, while public policy allocates expenditure between alternative public goods.

The central assumption of the model is the existence of a natural asymmetry between labour market regulation on the one side, and fiscal and public policy on the other. Labour market regulation is by its own nature broad, pervasive, and is embodied in institutions. These features make it hard and costly to undo regulation set in the past. In contrast, fiscal and public policies are determined within yearly budgets, and any new government sets its own budget.[2] To model this asymmetry, we assume the following timing: at stage 0, the government sets labour market regulation; at stage 1, the government sets and implements fiscal and public policy, and implements the labour market regulation previously set at stage 0; at stage 2, after all policies are implemented, wage and employment equilibrium levels are realised.

We assume that there are two parties in the political arena, denoted by a and b, which get political support from their respective constituencies A and B. Constituencies A and B are composed of individuals who derive utility from labour income, and have different preferences for public good provision.[3] Without loss of generality, we posit that party a is the incumbent government at stage 0. However, between stage 0 and stage 1, a political shock may occur, which replaces the incumbent with its competitor, party b.

In this context, we have political instability *à la* Alesina and Tabellini (1990) and Persson and Svensson (1989): labour market regulation becomes the state variable that gives the incumbent government an instrument to control the fiscal and public policy of its

[2] The existence of this asymmetry is also supported by empirical evidence. In countries characterized by pervasive labour market regulation, e.g. Germany, France and Italy, reforms introducing more flexibility in employment contracts have often been delayed by strong opposition and lengthy consultation with the social partners (Deroose et al., 2006).

[3] This assumption can be interpreted in terms of an electoral competition model, where all voters derive utility from labour income, regardless of their preferences for public good provision. This view recalls political power theories of labour market regulation, which argue that workers represent the majority of voters such that any party in the political arena aligns its policy platform to their preferences (see Botero et al. (2004); Saint-Paul (1996)). In this section we consider workers that face the same unemployment probability. Later on, we consider an alternative setting where individuals differ in their probabilities of becoming unemployed. This extension finds its micro foundations in a voting model where the median voter can be unemployed, and chooses the level of the unemployment benefit replacement rate.