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The joint impact of labour policies and the "Great Recession" on unemployment in Europe

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ABSTRACT

The paper consists of an empirical analysis of the separate as well as joint impacts on total and youth unemployment of indicators of labour market policies on the one hand, and the financial crisis associated with the "Great Recession" on the other. In particular, we investigate labour market data in the past two decades for the Enlarged Europe and adopt a variable accounting for the idiosyncratic severity shock of the crisis. This time-varying and country-specific crisis variable enables us to test empirically and in a novel way the joint impact of labour market policies and the economic crisis on labour market dynamics even when accounting for common macro shocks.

1. Introduction and motivation

A large body of literature investigates the impact of labour market institutions and policies, such as active and passive labour market policies, on unemployment. Moreover, a growing number of scholars have more recently focused on the impact of economic and financial crises on labour market dynamics

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in general. However, there are still few studies that address the question of the complex joint impact on unemployment of both labour market policies and the financial and economic crisis occurring during the “Great Recession”.

Our empirical analysis and econometrics exercise seek to determine the role of labour market policies in shaping the relationship between the financial and economic crisis and (total and youth) unemployment. To this end, we calculate the effect of the last crisis on unemployment for different types and levels of labour market policies and also consider the interaction among proxies for the crisis and labour market policies.

The paper is organised as follows. Section two provides an extensive literature review on the determinants of unemployment as well as on the relationship between (youth) unemployment on the one hand and labour market policies and financial crises on the other. Section three presents our testable hypotheses and empirical strategy. Section four describes the data and provides details of the calculations of labour market policy indicators, as well as of the severity of the last economic and financial crisis. Section five develops the empirical analysis and sets out the empirical model’s results by looking at a longitudinal panel of 30 European countries in the past two decades. Finally, section six concludes with some policy implications.

2. Literature review

There is a huge body of theoretical and empirical literature on the determinants of total and youth unemployment differences across countries and regions and their dynamics. The best-known unemployment determinants are related to general macroeconomic conditions, such as GDP growth and productivity dynamics, according to Okun’s law (see Lee, 2000; Solow, 2000; IMF, 2010, for empirical applications). In this section, we concentrate on more specific unemployment determinants that are of crucial interest for this paper, namely: (i) institutions and policies, (ii) institutions and shocks, (iii) the impact of the past and the most recent economic and financial crisis.

2.1. Labour institutions and policies

Since the seminal OECD (1994), the so-called “Eurosclerosis” phenomenon – defined as the weak employment performance of Europe – has been related to institutional variables. According to the institutional economics tradition, the labour market (and market only) institutions comprise: labour taxes, unemployment benefits (amount, duration and replacement ratio) as key indicators of so-called passive labour market policies, the degree of unionisation (union density and union coverage), the structure of collective bargaining (degree of coordination and/or centralisation), Employment Protection Legislation (EPL), the incidence of temporary and part-time contracts, active labour market policies (ALMP), the liberalisation of product markets, housing policies, and many other factors besides.[1]

Among the empirical work in this field, the OECD report (2006) highlights the statistical significance of tax wedges in explaining high unemployment rates together with generous (unemployment) benefit systems and stringent (anti-competitive) product market regulations,[2] while the degree of coordination in collective bargaining appears to improve labour market performance. As far as the EPL is concerned (e.g. tight firing regulations in Southern European countries), the available evidence is mixed, although the majority of studies find a positive relation between EPL and the unemployment rate (e.g. Heckman and Pagés, 2003). Turning to product market

[1] Nickell (1997) proposes measures for eight “labour market institutions” and finds that in general high unemployment is associated with welfare systems that do not put pressure on the unemployed to search for and accept work offers, with high taxes on labour and also with no co-ordination in wage bargaining. The key role of ALMP, together with unemployment benefits, in explaining the changes in employment and unemployment rates is confirmed by the estimations of Destefanis and Mastromatteo (2010), while Betcherman et al. (2004) observe that only some active labour market policies have a positive impact on labour market performance. For investigations at both national and regional levels in the European context, see Perugini and Signorelli (2004, 2007).

[2] Hence, product market reforms can reduce unemployment rates (Fiori et al., 2008).