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Economic Modelling

journal homepage: www.journals.elsevier.com/economic-modelling

Active labour-market policies and output growth: Is there a causal relationship? [☆]

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ARTICLE INFO

JEL Classification:

E60
E23
J08
E30

Keywords:

Output growth
Labour-market policy
Cyclical influences

ABSTRACT

While the labour-market impact of ALMP interventions has been extensively studied, an issue that has not been widely addressed in the literature is to what extent active labour-market policies have beneficial effects for the whole economy at the macroeconomic level. This paper addresses this issue by examining how additional resources allocated to active labour-market policies relate to output-growth rates. It also examines the sensitivity of the growth-ALMP relationship to the business cycle. Based on a structural model, we find that whether or not additional resources allocated to ALMPs contribute to raising output growth is a priori unclear. However, using data from OECD countries during 1991–2011 and GMM estimation to account for potential endogeneities, we find evidence suggesting a net positive output-growth differential due to implementing active labour-market policies in normal times of between 0.004 and 0.006 percentage point. This differential becomes larger during economic upturns when market conditions are improving relative to trend.

1. Introduction

Active labour-market policies (ALMPs) are implemented in many countries, either as a primary instrument for increasing labour-market flexibility or as part of an overall strategy for enhancing social cohesion (Casey, 2004; European Commission, 2006; Bonoli, 2010; Duell and Vogler-Ludwig, 2012). ALMPs typically include job-search assistance services, training, subsidized employment aiming to raise labour demand, and measures targeting groups with special labour-market difficulties (e.g. youth, disabled individuals, low-skill employed workers at risk). Between 2000 and 2015, and excluding the crisis period 2008–2010, the amount of public funds allocated to such policies in OECD countries has grown at an average annual rate of 6%, while today ALMP-spending in the OECD area accounts for almost 40% of the overall labour-market-policy budget. Interest in active labour-market policies has also been growing rapidly in developing countries in recent years, as governments in these economies increasingly see ALMPs as a tool capable of both improving labour-market efficiency and reducing poverty (Betcherman et al., 2004; Auer et al., 2008; Kuddo, 2009).

An extensive empirical literature currently exists that evaluates

ALMPs from a microeconomic perspective, estimating, based on individual-level administrative data, how particular programs affect the unemployment-exit and employment-entry probabilities of participants. While the estimated program-outcomes vary between the different studies, there is growing evidence indicating that ALMPs have significant positive effects at the individual level (OECD, 2005, 2015). On the other hand, at the aggregate level, the effects of active labour-market policies remain controversial. Single-country studies using administrative data at national or regional level to take into account indirect consequences of programs for non-participants often find small overall program-impacts, while the findings of the macroeconomic literature, which uses cross-country data to estimate effects of ALMP-spending on aggregate employment or unemployment, are quite mixed (Baker et al., 2005; Bassanini and Duval, 2006; Martin, 2015). At the same time, cross-country analyses of overall ALMP effects at the macroeconomic level, including general-equilibrium consequences of active labour-market policies such as effects on growth, are lacking.

This paper examines whether or not active labour-market policies have beneficial macro-level effects for the whole economy by investigating how ALMP-interventions relate to growth rates. Is there an output-

[☆] We are grateful to two anonymous referees for valuable suggestions and comments on an earlier version of the paper.

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<https://doi.org/10.1016/j.econmod.2017.11.019>

Received 25 July 2017; Received in revised form 24 October 2017; Accepted 19 November 2017

Available online xxxx

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growth gain from allocating additional resources to active labour-market policies? To what extent does the impact of ALMPs on growth depend on the state of the economy? Do active labour-market policies have the same growth consequences in 'good' and 'bad' times? So far these questions have not been explicitly addressed in the literature, despite the fact that the issue of whether or not ALMPs matter for growth has recently become particularly relevant due to sluggish growth worldwide and growing fiscal pressures in many economies which have increased the opportunity cost of financing ALMPs.

While the literature lacks detailed theories of how active labour-market policies relate to output-growth rates, ALMPs can have both positive and negative repercussions on growth. Active labour-market policies can be growth-increasing through higher average productivity in the economy, by helping workers to find jobs that are better suited to their qualifications or experience and by encouraging skill acquisition and human-capital development. Growth-increasing effects may also result from larger labour supply, as ALMPs, by improving participants' employability, provide incentives to the population for labour-force entry. Positive effects on growth may further result from lower equilibrium unemployment to the extent that active labour-market policies, by reducing information asymmetries in the job-search process, can contribute to raising the average job-matching rate. Additional growth-enhancing effects may come from increased overall efficiency in the economy, as the better-quality job-matches and the improvement in the average competencies of the workforce can help speed up the pace of technical change. On the other hand, active labour-market policies require funding, and increasing the scale of ALMP operations in the economy can have adverse repercussions on growth by limiting the resources available for other, more productive, uses or leading to extra taxes. By making unemployment less frightening, ALMPs can also lower growth through higher reservation wages or reduced average job-search effort in the economy. At the same time, the growth effect of active labour-market policies may not be independent of the economy's business-cycle position. For example, the opportunity cost of financing additional programs may well be higher during economic downturns, when the strain on public-sector resources is already sizable. The population's incentive to join the labour force and improve employability by participating in programs may also be weaker the more pessimistic are expectations regarding future earnings and thus the less satisfactory is the current state of the economy. In addition, any net negative effect of ALMPs on average job-search effort in the economy is likely to be more pronounced in times of unfavourable market conditions relative to trend, when job-finding rates are low anyway and the return to search is small, something consistent with the findings of e.g. Bloemen (2005), Krueger and Mueller (2011) and DeLoach and Kurt (2013) which suggest that search effort is in general pro-cyclical.

To what extent, then, do the favourable effects of ALMP-spending on output growth outweigh the adverse side-effects? What are the mechanisms at work and interactions involved? Is the growth-ALMP relationship positive or negative on average at the aggregate level? This paper seeks to add to the current literature by explicitly examining the underlying mechanisms that are likely to lead to a causal growth-ALMP relationship and by providing broad cross-country evidence on whether, and under what circumstances, public spending on active labour-market policies contributes to raising output growth. To this end, we first use a structural model to identify the key channels at work and investigate potential business-cycle asymmetries. Then, using data from OECD countries¹ during 1991–2011, we test for a relationship between output growth and ALMP-spending and examine its sensitivity to

business-cycle conditions.

The rest of paper is structured as follows. Section 2 briefly discusses the existing empirical literature, focusing on macro-level studies of ALMPs. In Section 3 we use a structural framework to identify the key mechanisms leading to a causal growth-ALMP relationship. Section 4 discusses the empirical methodology and the data and presents the estimation results. Section 5 contains concluding comments.

Based on the structural framework, we find that whether or not more expansive ALMPs contribute to raising output growth depends on a set of complex interactions which may not be independent of the economy's business-cycle position. Based on data for OECD countries, we find evidence suggesting that active labour-market policies have on balance net growth-enhancing effects during normal times. The output-growth differential due to implementing ALMPs during normal times is found to be between 0.004 and 0.006 percentage points. This positive differential becomes larger and is more robust during economic upturns.

Our findings have important policy implications in suggesting that implementing active labour-market policies is on average worthwhile from the perspective of the whole economy, even when the corresponding programs do not contribute much to raising the total number of jobs in the short run. At the same time, our results have implications with respect to the optimal timing of expanding ALMPs. From a microeconomic perspective, increasing the scale of ALMP-operations in the economy appears rational during downturns when unemployment is rising. But more ALMP-spending during periods of unfavourable economic conditions relative to trend may not lead to the maximum return from active labour-market policies in terms of per-capita output growth. Indeed, while it may seem appealing for governments to expand ALMPs in 'bad' times, both our structural model and our empirical results suggest that the output-growth gain from more ALMP-spending is larger in 'good' times. There appears therefore to be an issue as to when additional active labour-market policies should be implemented. If policymakers' ultimate objective is higher per-capita output-growth, our results suggest that active labour-market policies might need to be overall more expansive when economic conditions are improving. This is in line with the findings of several recent studies of the labour market, including Crepón et al. (2013), Cacciatore et al. (2016) and Gehrke and Weber (2017), which suggest that structural reforms and other policy changes are likely to have weaker effects in recessions than in expansions.

2. Active labour-market policies

Over the last decade, a great deal of research effort has been devoted to providing estimates of the effects of ALMP-interventions on labour-market outcomes. A large part of this literature uses country-based micro-level data and focuses on how the employment situation of individual workers is affected by their participation in programs. While the estimated program-outcomes vary, depending on the country considered, type of program and length of observation period, most papers report evidence indicating that, at the individual level, active labour-market policies yield significant benefits. This is confirmed by several evaluation surveys and meta-analyses of the findings of conventional microeconomic approaches, which suggest that programs providing job-search assistance, training and private-sector employment incentives pay off at the individual level as workers who have participated in such programs are more likely to find or maintain a job over the medium or long term than workers who have never participated (Card et al., 2010, 2015; Kluve, 2010; OECD, 2015). But while the standard microeconomic approach to evaluating ALMPs is of great importance in establishing whether the existing programs have achieved their intended effect at the individual level, it cannot determine the overall outcome in the labour market as potential indirect consequences of programs for non-participants are not taken into account. Accounting for such consequences, a number of recent micro-based studies find evidence of a smaller average impact of programs compared to what standard microeconomic analyses would suggest (Lise et al., 2004; Crepón et al.,

¹ Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Israel, Italy, Japan, Korea, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Spain, Sweden, Switzerland, United Kingdom, United States. The country sample follows from data availability for all the variables.

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