Labour Economics 41 (2016) 32–46

Contents lists available at ScienceDirect

Labour Economics

journal homepage: www.elsevier.com/locate/labeco

Learning from the Great Divergence in unemployment in Europe during the crisis☆

Tito Boeri [a,*,1], Juan F. Jimeno [b,c,d]

[a] Bocconi University, Italy
[b] Banco de España, Spain
[c] CEPR, United Kingdom
[d] IZA, Germany

ARTICLE INFO

Article history:
Received 2 February 2016
Received in revised form 24 May 2016
Accepted 26 May 2016
Available online 28 May 2016

JEL classification:
J64
J66

Keywords:
Unemployment
Labor market institutions
Demand and financial shocks

ABSTRACT

Since the mid-2000s there has been an increasing divergence in unemployment rates across EU countries and age groups. We argue that this divergence has to do with labor market institutions when account is made of their interactions with the magnitude and nature of the shocks from the Great Recession and the Eurozone debt crisis. New macro and micro evidence is provided highlighting the importance of these interactions in explaining cross-country differences in labor market adjustment to shocks. Having identified the labor market institutions responsible for this increasing unemployment divergence, we consider what can be done at the EU level to promote institutional convergence. In particular, we discuss a "positive conditionality" approach that could operate also in good times, and not only under recessions, when conditionality is strong, but some reforms may backfire.

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1. Introduction

The unemployment response to the Great Recession and to the subsequent events associated to the European debt crisis has been extremely heterogeneous across Europe and population groups. The dispersion in EU national unemployment rates reached in 2014 historical peaks. In most countries, notably in Southern Europe, unemployment has also been heavily concentrated among youngsters, with youth unemployment rates well above 40%, and up to four times as large as for the other age groups. Identifying the causes of this heterogeneous response of unemployment is very important for a better understanding of labor market dynamics. The lessons that one can draw from this experience are also important for an evaluation of the EU policy-coordinated approach to macroeconomic stabilization and microeconomic conditionality.

Although the Great Recession and the events associated with the European debt crisis implied demand and financial shocks of different nature, size, and timing across countries, these differences cannot fully account for unemployment divergence in Europe. In this paper we argue that the roots of this increasing heterogeneity in unemployment are in the interactions between the several shocks that hit EU countries since 2007, the nature of these shocks, and the labor market institutions present in these countries at the outset of the Great Recession. The role of institutions in asymmetric labor market response to shocks could have been greater than under previous recessions because the introduction of the euro reduced the scope for macro stabilization policies at the national level. Put it another way, more reforms of labor market institutions would have been needed to reduce the impact of the crisis on unemployment in several countries.

Unfortunately, our analysis suggests that EU policy co-ordination failed to achieve the type of institutional reforms that would have been required to improve the functioning of labor markets, and actually in several cases imposed reforms that backfire during recessions. We therefore develop proposals to improve the role of supranational authorities in reforming sub-optimal institutions, by exerting conditionality not only during downturns, but also at normal times. In particular, we propose to increase the coordination of the main guidelines of employment policies in European institutions, and to implement some programs at the European level. In this regard, we call for European employment policies to complement national policies in the areas of employment protection legislation, and unemployment insurance. Allowing countries to benefit from these complementary institutions,

☆ This paper draws from presentations at the ECB Forum on Central Banking, Sintra 2015, and at the Festival of Economics in Trento. We are grateful to the editor and a referee for helpful comments.

* Corresponding author at: Bocconi University, Economics, via Roentgen 1, Milano, Italy.
E-mail address: tito.boeri@unibocconi.it (T. Boeri).

[1] Currently President of the Italian Social Security administration (INPS), is Professor of Economics at Bocconi University.

http://dx.doi.org/10.1016/j.labeco.2016.05.022
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conditional on carrying out structural reforms, would establish the type of positive conditionality that is needed. In addition to exerting positive conditionality, such supranational labor institutions would obviate to the limitations of national stabilization policies imposed under a monetary union. The fact that these complementary institutions target EU citizens rather than governments or local administrations or intermediaries, make them more transparent and socially acceptable. We also consider a policy enforcement mechanism for these European institutions, which is based on a stronger cross-country co-ordination of social security administrations in monitoring entitlements of those moving across jurisdictions. In particular, we propose to introduce a European social security number or identifier, which would allow for a stricter control at the EU level over the implementation of these pan-European programs. It would also contribute to encourage more mobility of workers in Europe, making social security entitlements fully portable across jurisdictions.

Our approach is eclectic and tries to draw evidence from different sources. By using macro data and digging into Okun's type relationships we show that the relative impact of shocks on GDP and unemployment was dissimilar across countries. We also highlight that the rise of unemployment and the increasing differences of unemployment across countries and socio-demographic groups are not unrelated phenomena: there is a positive correlation across countries, and across time between the average unemployment rate, and the dispersion of unemployment across population groups. We complement this macro evidence with new data coming from a survey on firms carried out by the *ESCB Wage Dynamics Network* (WDN) that provides information on their responses to different shocks (demand, finance, costs-push) along several dimensions (employment, wages, working hours). The country differences in this regard provide further insights as to the interactions between labor market institutions and shocks that are at the roots of the EU unemployment divergence. We conclude that the Great Divergence arises from a triple interaction: between magnitude of the macroeconomic shocks, nature (financial vs. real) of these shocks, and labor market institutions conditioning firms' adjustment to those shocks. This implies that coping with it is not simply a matter of macroeconomic stabilization at the EU level, but also of institutional reform.

After having laid out the facts, we evaluate the institutional reforms sponsored by EU supranational authorities during the crisis. We begin by surveying the recent relevant literature on the impact of labor market institutions during financial recessions, and at different phases of the business cycle. Then we compare these results with the actual recommendations developed by EU supranational authorities during the crisis, and argue that EU conditionality to a large extent failed to take into account the main conclusions from this literature. Since we are aware of the political resistance to comprehensive labor market reforms, and of the fact that EU-conditionality is stronger under bad times, we advocate a "positive" conditionality that could also operate under normal business conditions to induce institutional reforms.

We structure the paper as follows. We first document, in Section 2, the main facts about country-specific unemployment trajectories, and the differences across socio-demographic groups within each country, paying particular attention to youth unemployment. To gauge the relative role of shocks and institutions, we first focus on outliers in Okun's equations, and, secondly, present some new microeconomic evidence on how firms adjusted wages, hours and employment in response to demand and financial shocks, and how those responses are related to cross-country changes in unemployment. Based on this analysis of the interactions between shocks and institutions, we look, in Section 3, for theoretical mechanisms that could possibly explain our findings, drawing on the still rather limited literature on finance-labor interactions, and on the optimal timing of labor market reforms over the business cycle. Finally, in Section 4 we conclude with an assessment of the EU-wide policy response to unemployment, and provide some examples of how positive conditionality could operate to promote institutional reforms in the EU.[2]

2. Characterizing the heterogeneity in unemployment

2.1. Some key facts on the Great Divergence in unemployment in Europe

Figs. 1 and 2 illustrate the main unemployment facts that motivate our analysis. Fig. 1 plots the three country groupings resulting by disentangling different unemployment trends throughout the crisis: i) countries whose unemployment rate was barely affected by the crisis (Belgium, Czech Republic, Germany, Hungary, Malta, Austria, Poland, Romania and the UK)[3]; ii) countries that experienced a rise of unemployment below the EU average, mostly followed by a fall in 2013–2014 (Denmark, Estonia, France, Luxembourg, Netherlands, Slovakia, Finland, and Sweden); and iii) countries that experienced an increase of unemployment larger than the EU-28 average (Bulgaria, Latvia, Lithuania, Slovenia, Ireland, Greece, Croatia, Italy, Cyprus, Portugal, and Spain).[4] Fig. 2a displays a range of unemployment rates within the Euro area. The difference in the average unemployment rate between the top and the bottom quintile is 15 percentage points (in relative terms they differ by a factor of four). A similar comparison in the United States, between the averages of the ten states with the highest and ten states with the lowest unemployment rates, yields a gap of less than 5 percentage points.[5]

Admittedly, unemployment dispersion, both across countries and across regions, rises during recessions. However, its recent increase across countries in Europe is not merely a cyclical phenomenon: the observations for the 2012–14 period lie well above the 95% confidence interval of the linear regression of the standard deviation of unemployment rates on GDP growth during the period 1984–2014 (Fig. 2).[6]

A main driver of European cross-country unemployment divergence is youth unemployment. On average, youth unemployment was in 2014 about 25% both in the EU and in the Euro-zone and stands above (often well above) 40% in Southern Europe while remaining at single-digit levels in Austria and Germany. The standard deviation of youth unemployment across European countries is at its highest level since the mid-nineties Table 1a).[7] The increase in dispersion is also noticeable when we consider overall unemployment. Both the youth and the overall unemployment rates have a marked national dimension. As shown in Table 1b, when decomposing cross-country and within country dispersion in unemployment, the fraction explained by differences in NUTS-2 EU regions within each country declined substantially in recent years.

The rise of unemployment and its increasing dispersion across socio-demographic groups are two interrelated phenomena. Fig. 3 documents the positive correlation, across countries and over time, of the standard deviation of the unemployment rate (defined over gender and 5-years

[2] To "develop concrete mechanisms for stronger economic policy coordination, convergence and solidarity" and "to prepare next steps on better economic governance in the euro area" are nowadays issues at the top of the economic policy agenda. See Juncker et al. (2015).

[3] In these countries the increase of the unemployment rate was at most 1 pp.

[4] Casado et al. (2015) looking at worker flows in a smaller sample of European countries, also find similar groupings.

[5] However, unlike the United States, Europe has not experienced a decline in participation rates. Also, in stark contrast with previous recessions, where soft-landing schemes to retirement were widely used by firms attempting to downsize, employment rates among older workers actually increased in most European countries throughout the Great Recession and the euro area debt crisis. For more details, see Boeri and Jimeno (2015).

[6] The sample is composed of EU countries for which harmonized measures of annual unemployment rates exist since 1984.

[7] Another illustration of the degree of cross-country heterogeneity regarding the incidence of unemployment across socio-demographic groups is provided by Casado et al. (2015), who show that in those countries where unemployment rose, job losses were highly concentrated among younger workers. Thus, the explosion of youth unemployment was, unlike in previous recessions, not only related to a hiring freeze, but also to the heavy destruction of jobs held by young people, with the dissolution of temporary contracts, while, at the same time, employment rates among older workers were increasing.

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