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Structural labour market reforms in the EU-15: Single-country vs. coordinated counterfactuals☆

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ABSTRACT

Recent turbulent times have spurred a response by policy-makers to engage in a number of labour market reforms to enhance economic resilience and flexibility. Amid discussions about the most efficient ways to conduct such reforms, whether individually or simultaneously, we still lack evidence on the cross-country interactions and international interdependencies that may strengthen or weaken economic responses within an economic union. This paper deals with three policy tools – unemployment benefits, activation policies and the tax wedge, and demonstrates that they dissipate across open economies. We document evidence of both positive and negative policy spillovers among European economies and carry out a counterfactual of coordinated policies which prove to be needed for some but not other policy variables. We find that coordination strengthens macroeconomic responses to labour market policies.

'Within a single market and major trading bloc like the EU, it makes good sense to co-ordinate national economic policies. This enables the EU to act rapidly when faced with challenges such as the current economic and financial crisis' (European Commission, 2012)

1. Introduction

Recent financial and European sovereign debt crises have intensified discussions on the need to complement the European monetary union with fiscal coordination. Though this paper analyzes only one particular aspect of a real economy, namely responses to changes in structural labour market reforms, a number of important results that may inform current policy debate emerge. We examine how structural labour market policies – unemployment benefits, activation policies and the tax wedge – by individual members of the EU-15[2] affect not only the domestic economy in question, but also other countries in the union. We focus on the 'old' 15 European Union members for which quarterly data over a long period is available and thus heterogeneous responses can be reliably uncovered. More specifically, we show, based on a compact model of the global economy, how labour reforms work themselves out in a data-driven framework that admits a rich structure of interdependencies within the economic union.

Clearly, varying levels of openness, fiscal policies, labour market institutions and economic structure all have an impact on the ways foreign economies react to changes in home labour market policies. The old issue of high unemployment in Europe has spurred research on institutional conditions, dubbed *Eurosclerosis* and understood as a combination of high unemployment, low mobility and rigid labour markets. However, Europe remains

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2 EU-15 consist of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom. All but Denmark, Sweden and the United Kingdom are members of the euro area too.

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far from homogeneous, despite common market and free labour mobility (in fact, the latter constitutes one of the major pillars that underlie the European Union, henceforth EU).[3] Indeed, as evidenced by Bentolila (2010), the unemployment situation during the recent recession has differed significantly across countries. For example, French unemployment has hardly increased, while unemployment in neighbouring and institutionally similar Spain has skyrocketed (Spanish experience has also been documented by Dolado and Stucchi, 2008) A model case is Germany, the success of which is usually ascribed to the so-called *Kurzarbeit* reduced working hours programme and Hartz reforms.[4] Yet a simple argument of more flexible labour markets conceals much of the institutional contents of flexibility, especially in an ever-more interdependent world. Thus, country-level analysis, where international dimension is held fixed, risks omitting channels through which domestic economy adjusts after reforming its labour market. What is more, acting within a monetary union necessitates an evaluation of the effects from changing labour market institutions at home on all other member states.

Empirical results are far from being clear-cut: though high replacement rates (unemployment benefits) and high tax wedges may decrease employment, active labour market policies (ALMP) seem to have no significant implications for unemployment, except for some categories (such as training) (see Bassanini and Duval, 2006; Bouis et al., 2012; Nickell et al., 2005; Orlandi, 2012). Microeconometric studies have yielded mixed results on the effect of active labour market policies on employment too, see Card et al. (2015) for an extensive meta-analysis. In line with Blanchard and Wolfers (2000), Bassanini and Duval (2006) find evidence that high unemployment benefits amplify the adverse unemployment effect of shocks, thus emphasizing a need to consider macroeconomy and labour market policies within one framework.

Interactions between labour and goods markets, particularly for open economies, are hard to disentangle from economic theory perspective too. It is ambiguous what response should be expected from higher openness on domestic labour markets: though higher openness helps to reduce unemployment, labour markets exert no effect on openness as depicted in the theoretical model due to Felbermayr et al. (2011), a positive correlation between bad labour market institutions at home and abroad is predicted by Felbermayr et al. (2013), which combines a heterogeneous firms trade model of Melitz (2003) with the search and matching approach of Mortensen and Pissarides (1994); to the contrary, a country harms its trading partner by reducing its labour market frictions in Helpman and Itskhoki (2010); Alessandria and Delacroix (2008), in turn, obtain that a rigid economy (in terms of the labour market) increases its welfare, whereas a flexible one suffers due to the terms of trade effects.

It is, therefore, of interest to quantify major labour market institutions in the monetary union empirically and their effects on macroeconomic performance while allowing for the effects to act not only domestically, but also EU-wide. In particular, changes in the labour market are embedded in competitiveness and international prices, and they can create or divert trade and even result in an undesirable result for the union as a whole. As is duly summarized by Blanchard (2006), 'it is one thing to say that labour market institutions matter, and another to know exactly which ones and how.' To answer this question, international dimension turns out to be crucial as labour market policies tend to dissipate within the economic union. The statistical framework should be sufficiently flexible to admit diverse results, both in terms of cross-country dependencies, and also in terms of the way policy affects openness and the macroeconomy, more generally. Unlike traditional panel analysis, which assumes homogeneity in responses of shocks across economies, we will allow for spatial heterogeneity. Moreover, we will analyze dynamic responses, adding a possibility for co-integration within and across economies. We thus draw from the literature on global macroeconomic modelling (see Pesaran et al., 2004 for pioneering work in the area, Garratt et al., 2006 for the textbook treatment, and Chudik and Pesaran, 2016 for the recent overview of the methodology and its vast applications) with explicitly modelled cross-sectional dependence.

Our approach differs from a number of current (mainly theoretical) contributions in that we want to evaluate how policy reforms in labour markets affect competitiveness and openness, along with other macroeconomic variables, and not the effect of trade liberalization reforms, which are less standard policy tools for advanced and highly integrated European economies.[5] Our contribution mainly consists of demonstrating the use of the GVAR model to uncover discretionary policy shocks using traditional trade and price competitiveness weights, documenting the spillovers of labour market policies among EU-15 countries, and tracking macroeconomic responses for country-specific and coordinated reforms. More precisely, we find, first, that labour market policies which are coordinated achieve the desired results more effectively (i.e. the effects are larger as compared to when the policy was enacted by a single economy), thereby we emphasize the importance of coordinated policies within the economic union. Second, some reforms may benefit the reformer but worsen economic outcomes in other members of the economic union (as, for instance, happens to be the case with active labour market policies in Germany which increase German employment and GDP, but adversely affect the Greek economy). Third, we emphasize heterogeneous responses on other countries and on the domestic economy, depending on the reformer that transmits its policy shocks. Although the focus here is on the responses to changes in structural labour market reforms, the paper has wider policy implications, in particular when it comes to aggregate welfare.

Our plan of the paper is as follows. In Section 2, we define policy variables and provide some context from the latest reforms, motivate the use of trade linkages and spatial effects of reforms, as well as describe a baseline panel data model and discuss an alternative estimating system of equations that is robust to country-specific heterogeneity in parameters and cross-sectional dependence, and admits counterfactuals of single-country and coordinated reforms. Discussion of empirical results is covered in Section 3 Finally, Section 4 concludes, and specifies both policy implications and directions for further research. There is an extensive Online Appendix that collects all supporting material and reports a rich set of country-specific results and extensions.

[3] Relatedly, the European Pillar of Social Rights should complement the EU social 'acquis' in order to guide policies to ensure well-functioning and fair labour markets. See ec.europa.eu/social/pillar.

[4] See OECD (2010) for more details. Moeller (2010) argues that the specific type of German flexibility does not stem from high labour turnover rates (hiring and firing), but through an unprecedented level of buffer capacity within firms. Faia et al. (2012) confirm that unlike the standard demand stimuli, 'Kurzarbeit' policies yield large fiscal multipliers, as they stimulate job creation and employment. Another relevant account can be found in Burda and Hunt (2011).

[5] Theoretical papers include Dutt et al. (2009), Helpman and Itskhoki (2010), Felbermayr et al. (2011), Felbermayr et al. (2013), Cacciatore (2014), Helpman and Itskhoki (2015), among many others. A few contributions along the lines of ours, where labour market reforms in open economies are put at the forefront of research, include Dao (2008) and Felbermayr et al. (2015), which deal with labour markets effects on trade markets. There is also a literature on labour market reforms and their effects on, for instance, debt consolidation (Papageorgiou and Vourvachaki, 2015) or within-country (regional) convergence (Spilimbergo and Che, 2012).

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