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Who benefits from labor market institutions? Evidence from surveys of life satisfaction

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ABSTRACT

This paper investigates the welfare effects of labor market institutions, placing an emphasis on how the institutions' effects are differentiated by socio-demographic subgroups. We study how life satisfaction is affected by employment protection and the level and duration of unemployment benefit payments. Using data for almost 370,000 individuals in ten European countries, 1975–2002, we find that more employment protection and a higher benefit replacement rate increase the life satisfaction of the average citizen. At the subgroup level, different segments of the population are affected differently by the two categories of labor market institutions. While employment protection is valued especially by employed persons of intermediate age, it is less beneficial for women/housewives and for older persons. More generous unemployment insurance is valued especially by these latter subgroups and by the unemployed.

1. Introduction

Employment protection and unemployment benefit are economic institutions designed to protect people against the adverse effects of macroeconomic uncertainties that arise from recession and unemployment. These labor market institutions have a long tradition in many countries and are widely viewed as essential ingredients of the "welfare state". However, employment protection and unemployment benefit have recently come under attack for being too costly in terms of macroeconomic performance, in particular by reducing economic activity and raising unemployment.[1]

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[1] Results on this proposition tend to be inconclusive. See Layard, Nickell, and Jackman (1991), Blanchard and Wolfers (2000), Bertola, Blau, and Kahn (2002), Fitoussi, Jestaz, Phelps, and Zoega (2000), Belot and van Ours (2001) and Nickell, Nunziata, and Ochel (2005); for an overview and discussion see Nickell (2003).

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In addition to their potential macroeconomic costs, certain types of labor market institutions may be favorable for some segments of the population while being unfavorable for others. Specifically, employment protection is often believed to slow the turnover in the job market, thus excluding certain subgroups of the population from the active population, notably older workers and women. Unemployment benefit, conversely, tends to be favorable for the excluded individuals while the financial burden rests on the employed persons. In line with these considerations, political economy models of the choice of labor market institutions suggest that employment protection is mainly championed by insiders – those who have a job – whereas unemployment benefit mostly favors outsiders.[2]

Against this background, the present paper provides an empirical assessment of labor market institutions and disaggregates this assessment according to a number of socio-economic subgroups. As a measure of the advantages and potential costs of labor market institutions we use an indicator of reported subjective well-being. Specifically, we investigate how the strictness of employment protection and the generosity of unemployment benefits affect the life satisfaction of almost 370,000 individuals in 10 European countries, 1975–2002.

Subjective well-being has previously been found to be considerably affected by macroeconomic conditions (Bjørnskov, 2003; Di Tella, MacCulloch, & Oswald, 2001; Graham & Pettinato, 2001; Welsch, 2011; Wolfers, 2003).[3] This literature suggests that macroeconomic uncertainties have a non-negligible effect on people's welfare, a proposition which had been disputed for more than two decades on the basis of a narrower, strictly pecuniary notion of well-being (Fischer, 1981; Lucas, 1981, 2003).

We follow the subjective well-being approach to applied welfare analysis by running life satisfaction regressions with labor market institutions among the explanatory variables (controlling for individual socio-demographic characteristics, macroeconomic conditions, and country and year fixed effects). We focus on employment protection and the level and duration of unemployment benefits because it is these particular labor institutions that aim at protection against the consequences of macroeconomic fluctuations (in contrast to, e.g., unionization or minimum wages). Due to data limitations, so-called active labor market policies will play only a secondary role in this study, that is, we will include them only as a robustness check. [4]

In addition to confirming the previous findings that poor macroeconomic performance affects life satisfaction in a sizeable and significant way, we find that more employment protection and a higher benefit replacement rate increase the life satisfaction of the "average citizen", whereas a similar effect of longer benefit duration cannot be established. With respect to individual subgroups, we find that stricter employment protection and more generous unemployment benefits both affect retired persons and better educated people less positively than other segments of the population. In addition, employment protection affects the life satisfaction of women and people above the age of 40 less positively than the rest of the population, whereas a higher benefit replacement ratio is particularly favorable for the unemployed and for women, especially housewives. Positive effects of longer benefit duration are only found for older persons, reflecting their risk of long-term unemployment.

Our results are consistent with the idea that employment protection is especially beneficial for the insiders (people who have a job), whereas outsiders (the unemployed, women/housewives, and older persons) favor more generous unemployment benefits. Given the increase of unemployment, especially of older persons, over the period studied, and an increased desire of women to participate in the labor market, these findings may provide a political economy explanation for an observed shift of labor market policy away from employment protection and towards more generous unemployment benefits.

Previous literature has presented evidence of a positive relationship between the level of unemployment benefit and life satisfaction (Di Tella, MacCulloch, & Oswald, 2003; Graham & Pettinato, 2001), focusing predominantly on the 1970s and 1980s. In relation to that literature, the contribution of the present paper is as follows: (1) We consider a more comprehensive set of labor market institutions that comprises not just the unemployment benefit level, but also benefit duration and employment protection. (2) We investigate how labor market institutions affect various socio-demographic subgroups differentiated by sex, age, education level and occupational status. (3) By differentiating between employment protection and unemployment benefit on the one hand and various segments of the population on the other, we shed some light on the political economy of the choice between the two types of labor market institutions.

The paper is organized as follows. Section 2 presents our empirical approach and data. Section 3 presents and discusses the results. Section 4 concludes.

2. Empirical framework

2.1. Method and data

We consider a life satisfaction regression of the following form:

$$LS_{ict} = \alpha_1 EP_{ct} + \alpha_2 BR_{ct} + \alpha_3 BD_{ct} + \alpha_4 U_{ct} + \alpha_5 P_{ct} + \alpha_6 Y_{ct} + \sum_k \beta_k D_{kict} + \gamma_c + \delta_t + \varepsilon_{ict} \tag{1}$$

[2] See Saint-Paul (2000, 2002, 2004) and Boeri, Conde-Ruiz, and Galasso (2004).

[3] In these papers, as in the present study, subjective well-being is used as a proxy for utility. The relationship between subjective well-being (or, synonymously, happiness or life satisfaction) and utility is extensively discussed in, e.g., Frey & Stutzer, 2002, along with methodological issues concerning the utilization of subjective data in economic analysis. Life satisfaction is accepted as a reasonably good approximation of utility in a growing literature in economics (Kahneman & Krueger, 2006).

[4] Data on active labor market policy in Europe are available only from 1985 onwards.