Reforming the *Liberal* Welfare State International Shocks, Unemployment and Income Shares

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Main Motivations of the paper

- Rising concerns about unemployment and job creation with divergence in income shares that accrued to labour (OECD, 2015)
- *International Competitiveness*

  Labour market deregulation and Welfare State retrenchment in industrial economies

- Two conflicting concerns
  - 'Rigid' labour markets held responsible for Europe's relatively high unemployment rates
  - Labour market deregulation (particularly in *liberal* WS) compounds insecurity generated by globalisation.
- Fears of a backlash against international openness.

- *Flexicurity:* combination of labour market flexibility with *employment* (rather than *job)* security,

- Consensus around a 'recalibration' agenda of WS towards a *'flexicurity model',*

This Paper focusses on

- the effects of labour market reforms in the direction of flexicurity (which is defined as a strategy that aims to strengthen both the security and the flexibility of labour markets by influencing both sides of the market) on labour market outcomes, and
- tries to find answer to the question: Can reforms of the *liberal* WS regime (e.g. UK) "in the direction" of *flexicurity* improve labour market outcomes and the economy's response to shocks?

- the **effects** of reforms on ***dynamic*** behaviour of the economy in response to international openness ***shocks***

- ***The distributional impact of reforms:*** shares of different income sources-shares of income from labour and non-labour sources, on ***household gross and net disposable income***

The Literature

The literature provided by the paper is very rich and is divided into different parts corresponding to the objectives .

- Effects of labour market reforms on labour market outcomes
- Business cycle and openness
- Redistributive effects of trade shocks
- Effects of WS policies on income distribution
- 'Secular' increases in 'functional inequality

> Why a focus on Household income shares?

- ... Even with CRS technology, household income shares fluctuate even when shares of GDP are constant

  HGI = GDP - (Public Expenditure + Next Exports)

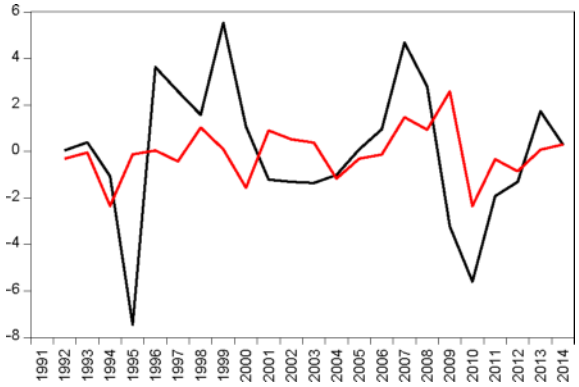
- Shares of components of household income are a better reflection of the 'welfare implications' of policies across 'income groups'

- Variability over time of the wage income as share of household income is much higher than that of GDP shares

  Transfers which affect household income tend to be volatile as they are likely to respond to cyclical fluctuations

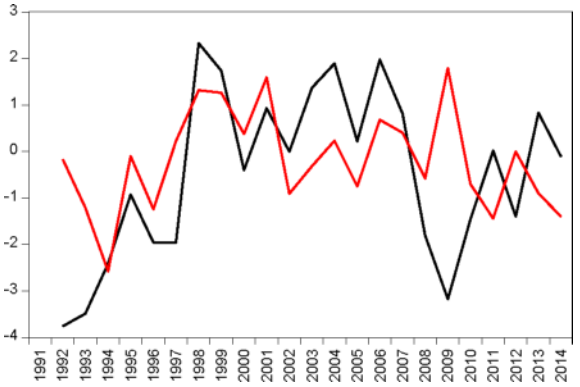
Volatility of wage income shares in HI and in GDP

Denmark's share of wage income



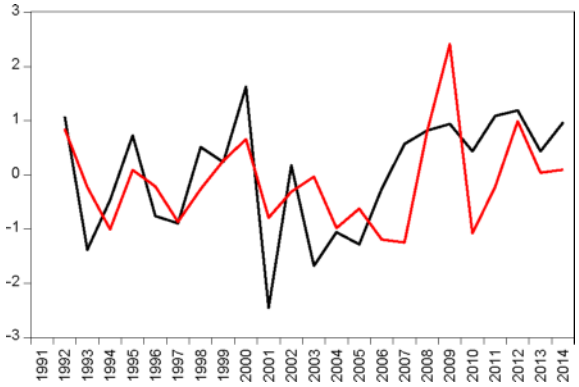
SD = [3.00 1.13]

UK's share of wage income



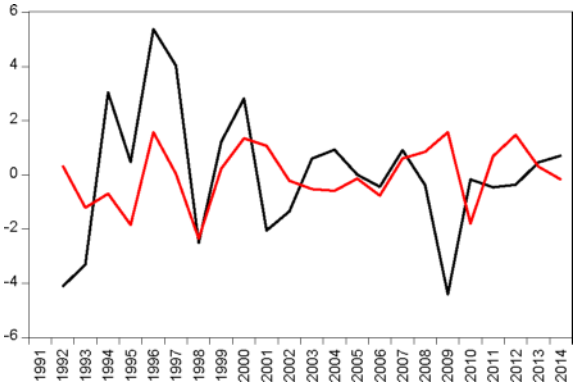
SD = [1.83 1.09]

Germany's share of wage income



SD = [1.08 0.866]

Sweden's share of wage income



SD = [2.40 1.11]

The Model

Broad features of the model are that it is a :

> Dynamic Stochastic General Equilibrium (DSGE) model,

> Small Open Economy (SOE): easy characterisation of exogenous international shocks

> Accumulated factor (K) & non accumulated factor (L) with endogenous labour supply

- Final good: perfectly competitive

The model includes the following sectors:

- The household sector
- **The final good producing sector**
- **The differentiated good producing sector**
- **The labour market**
- **The government**
- **General equilibrium**

Labour Market Reforms

> Starting from flexible WS system as benchmark

- High flexibility
- Low unemployment insurance

> 'Reform packages' consist of different combinations of **four** policy ingredients:

(a) An increase in the unemployment replacement rate (b/wh), which increases security via the implementation of a PLMP;

(b) An increase in per-capita training expenditure (x^T) which can be thought of as an ALMP aimed at increasing workers' employability;

c) An increase in the firing cost (f) , which reduces labour market flexibility; and

(d) A reduction in the vacancy creation cost share in GDP, via a reduction of the unit cost (x^V), which increases labour market flexibility.

It is argued that:

- Policies ‘a’ and ‘c’ increases unemployment and reduce GDP. However, they increase labour income and reduce capital income.
- Policies ‘b’ and ‘d’ reduces unemployment and increase GDP. As a result, an increase in x^T – policy ‘b’ redistributes income towards wage earners, whilst a reduction in x^V - policy ‘d’ does the opposite.

RP1: Reform Package 1, consisting of (a) & (b)
RP2: Reform Package 2, consisting of (a) & (c)
RP3: Reform Package 3, consisting of (a), (c) & (d)
RP4: Reform Package 4, consisting of (a), (b), (c) & (d)

- **RP1** combines an increase in unemployment benefit 'b' (a PLMP) with an increase in the training expenditure per worker x^T (an ALMP) and can be thought of as putting the emphasis on providing security to the unemployed while increasing employability.

- Combining increases in unemployment benefits ‘b’ **in RP2** with increases in firing costs ‘f’ that would be required to take the system in the ‘direction’ of the Danish model results in a redistribution of income towards wages.
- By augmenting RP2 with a reduction in the vacancy creation costs (x^v), RP3 reverses the contractionary outcome of implementing the former reform package: vacancies rise, unemployment reduces and GDP recovers while income share changes in favour of wage earners.
- Finally, RP4 which combines all the policies is the most successful in terms of unemployment reduction and economy wide expansion, but it reduces the share of wages income.

“Reform Packages”

	Higher	Higher	Higher	Higher
	Security	Training Expenditure	Firing cost	Flexibility
RP1	√	√		
RP2	√		√	
RP3	√		√	√
RP4	√	√	√	√

- ✓ The **above results** suggest that there exist reform packages which consist of specific combination of PLMPs and ALMPs that can improve upon the labour market outcomes of a liberal welfare state system.
- ✓ In addition, such reform packages will, inevitably, have redistributive effects that alter the share of income sources in total household income.

- ✓ In particular, the authors find that when accompanied by specific ALMPs that foster employability and job creation, more generous PLMPs that offer protection to the unemployed can in fact reduce unemployment and increase the level of economic activity.
- ✓ The results also show, that these reforms also tend to reduce the share of labour income and raise that of capital and profit income, as a result of higher productivity and lower outsourcing.

- Analyse impact of international shocks before/ after reform implementation

The impact is studied through the:

- Foreign demand *contraction- F^*, and*
- Trade cost *increase- ϕ*

These shocks can affect the terms of trade(affecting commodity flows) and interest rate differentials (affecting capital flows).

The authors show that

Country's terms of trade fall in both cases, but more so after a trade shock $\rightarrow$ larger **negative effect** on productivity, aggregate output, vacancy creation and unemployment . Thus

- ***b*oth shocks have the same qualitative effects on labour market outcomes: unemployment increases while the number of vacancies, labour market tightness and the probability of finding a job fall.**
- **Also in both cases, firm profits and labor income fall$\rightarrow$ household consumption and investment, the final good output and GDP all fall.**
- **However, quantitatively, the impact of the shock to ϕ is much more enhanced than that of the shock to F*.**

Through the use of the model and different figures, the authors have also shown that :

Shocks have 'redistributive' effects:

- *The two shocks* have opposite impacts on the relative shares of different income types:
- The negative trade shock redistributes income towards wages and capital (i.e. towards the primary factors of production) and away from profits,
- whereas the negative foreign demand shock does the opposite.
- As with the labour market implications of the shocks, the redistributive effects of a negative trade shock are considerably larger.

- Trade shock increases *P* and has a larger 'depressive' effect on aggregate productivity and employment:
  - Larger fall in household consumption and investment & relatively large increase in the return to capital
  - Effects are reversed in the case of a negative foreign demand shock that reduces both *P* and *r*

Implications

Different negative international shocks to trigger

- Different adjustment mechanisms
- Different short-run consequences for labour markets
- Different redistributive effects

Impact of Shocks on aggregate measures before and after reforms

- Shocks have similar *qualitative* responses in all post RPs
- Similar qualitative responses as in benchmark case

➢ Different RPs →different *quantitative* impacts on shock propagation

➢ **Reforms of *liberal WS* (lower flexibility & higher protection) →Greater volatility in response to shocks**

Post-RPs Unempl & GDP responses are larger than pre-reform ones in all cases

- Highest Unemployment volatility is post-RP3,which is characterised by a higher degree of unemployment income support and a higher firing cost
- Lowest unemployment volatility is post-RP1

- Redistributive effects of shocks
  - Most pronounced post-RP2
  - Least pronounced post-RP4
  - A trade shock has a more distinct quantitative impact that separates the benchmark, post-RP2 and post-RP3 from post-RP1 and post-RP4

Implications

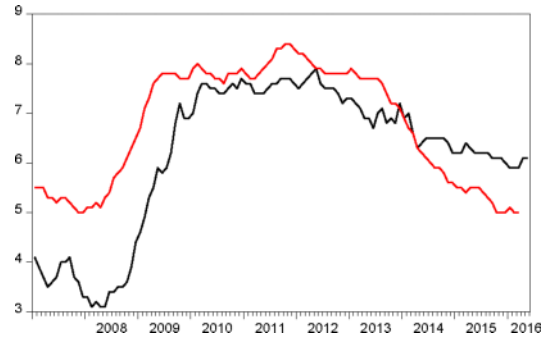
- Qualitative responses under all post-RPs similar and quantitatively very close, BUT
- RPs likely to increase volatility to shocks
- Contrary to conventional wisdom, a higher firing cost and greater unemployment protection do not offer greater shield from negative exogenous shocks
- Reforming a ***liberal*** welfare state in the direction of *flexicurity* that combines generous unemployment support with ALMPs can improve labour market outcomes and increase the level of economic activity in the long-run

- Counterintuitively, these reforms result in a higher volatility

> Theoretical results are not at odds with stylised facts

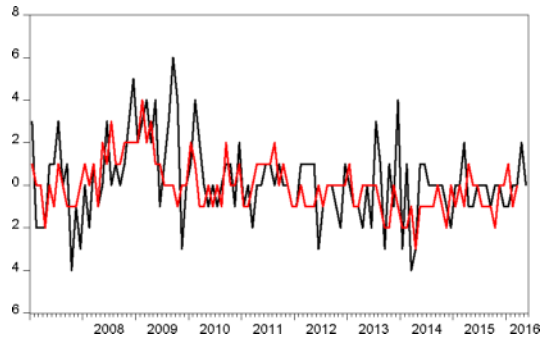
Unemployment and GDP Time Series in Denmark and the UK

Monthly Harmonised Unemployment Rate



UK

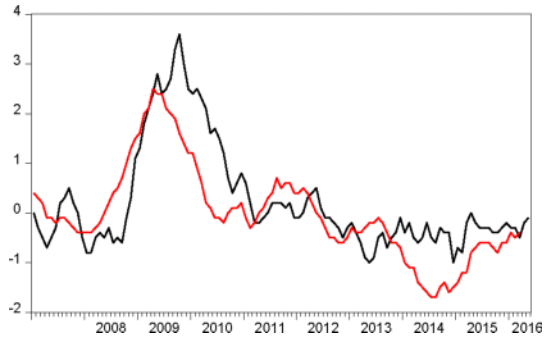
Monthly Harmonised Unemployment Rate (monthly change)



UK

SD=[0.186 0.121]

Monthly Harmonised Unemployment Rate (annual changes)

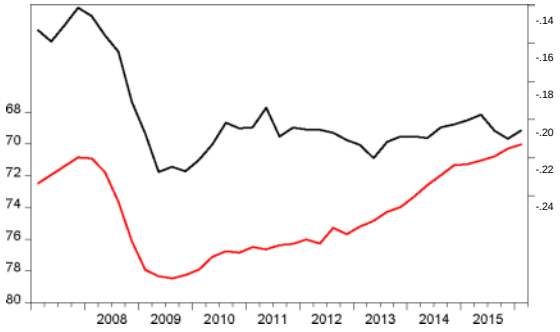


- Denmark UK

SD=[1.06

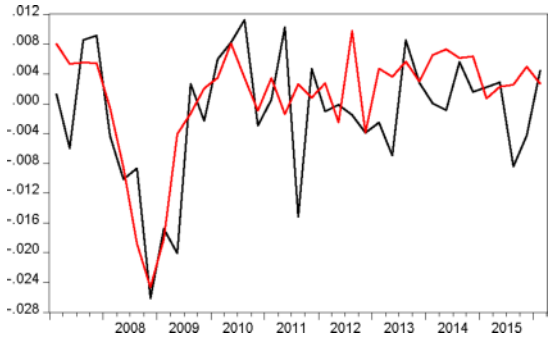
0.94]

Quarterly Real Per Capita GDP (logs)



- Denmark UK (left axis)

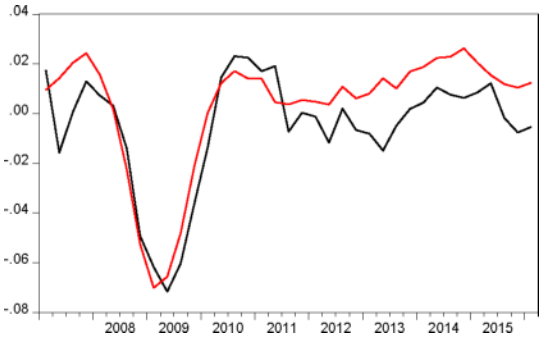
Quarterly Real Per Capita GDP (quarterly log changes)



Denmark UK

SD=[0.0088 0.0065]

Quarterly in Real Per Capita GDP (annual log changes)



UK

SD is the standard deviation of the series

> Consistent with our theoretical predictions

- *U* rate in UK is higher than in Denmark (with the exception of the 2014-2016 interval)
- Volatility of *U* is higher in Denmark
- Danish GDP characterised by a higher volatility than the UK's

Caution - our model:

- Not an 'inter-country' but a pre/post-reform between comparison
- Stylised model cannot fully capture the differences between the two economies' welfare and labour market systems (e.g. different nature of job creation in the two countries

Conclusions

> *Flexicurity* reforms to a *liberal* WS, combining

- *Greater* income support for the unemployed
- *Stronger* firing restrictions
- *Greater* expenditure on ALMPs to enhance employability and job creation

Can improve labour market outcomes and increase the level of economic activity

> Counterintuitively, reforms - by increasing productivity and reducing outsourcing - tend to redistribute household income away from labour and towards capital and profit income

> Negative international shocks

- Reduce vacancy creation
- Increase aggregate unemployment
- Are not distributionally neutral

> Dynamic adjustments of the economy following once-and-for-all external shocks differs pre- and post-reform

> Even when resulting in lower steady-state unemployment, reforms lead to a higher volatility in employment and GDP ... despite the fact that they may reduce flexibility of the labour market relative to a liberal welfare state regime

Comments:

- ✓ Thanks to the Authors and the Chairman of the session for giving me the opportunity to learn from the paper.
- ✓ I thoroughly enjoyed the paper, though could not pay much attention to the model, but did try to understand the results.
- ✓ My only comment is about the assumptions of the model: that how realistic these are. How would the results change if some of these are not satisfied?
- ✓ Perhaps the result point out that RP4 could be best, but how far it is easy to implement RP4.