Shaping Earnings Volatility: Labour Market Policy and Institutional Factors

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What is the impact of labour market institutions on earnings instability (measured by variance in transitory earnings inequality)

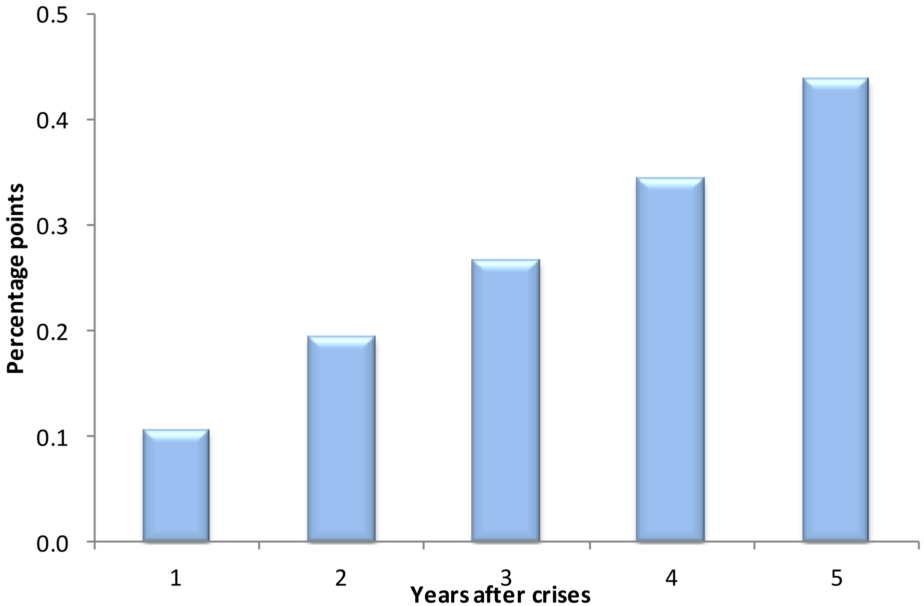
- Important question, innovative paper, interesting results
- Work on similar question carried out at OECD, but with different methodology
  - Ahrend, R., J. Arnold and C. Moeser (2011)," The Sharing of Macroeconomic Risk: Who Loses (and Gains) from Macroeconomic Shocks", *OECD Economics Department Working Papers,* No. 877.
- Comparison of results

Methodology of the OECD analysis

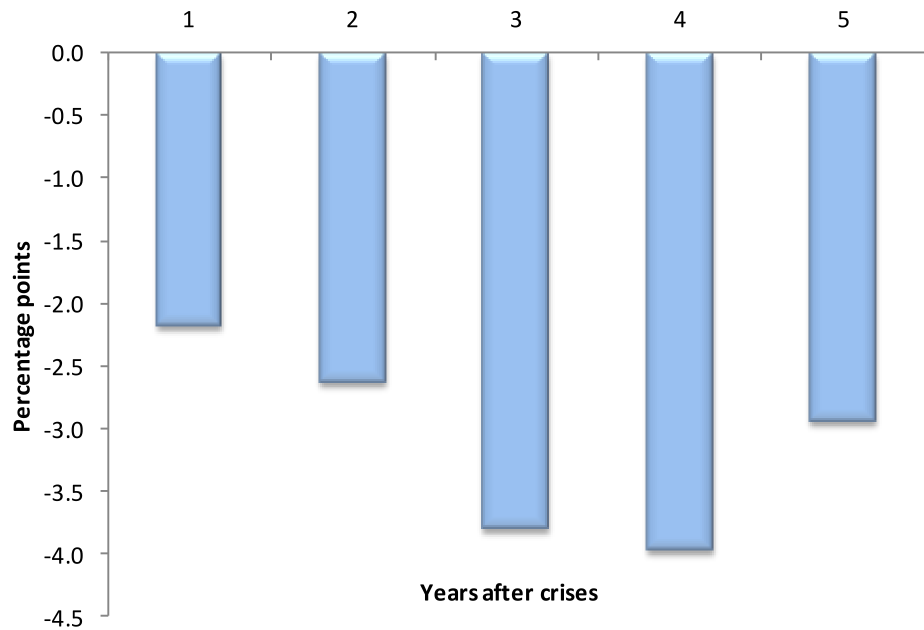
- Analysis based on roughly 30 years of data prior to recent crisis for 40 OECD and BRIICS countries.
- Identify various types of shocks such as financial crises, or commodity price, exchange rate, and fiscal shocks.
- For a given shock, estimate across countries the average relative impact over the five-year period following its occurrences for various income, wealth, age, gender, and education groups.
- Explore whether the distributive impact of a shock on certain groups depends on the institutional features of the country considered.

Distributional impact of macroeconomic shocks

A. Average increase in poverty rates following financial crises



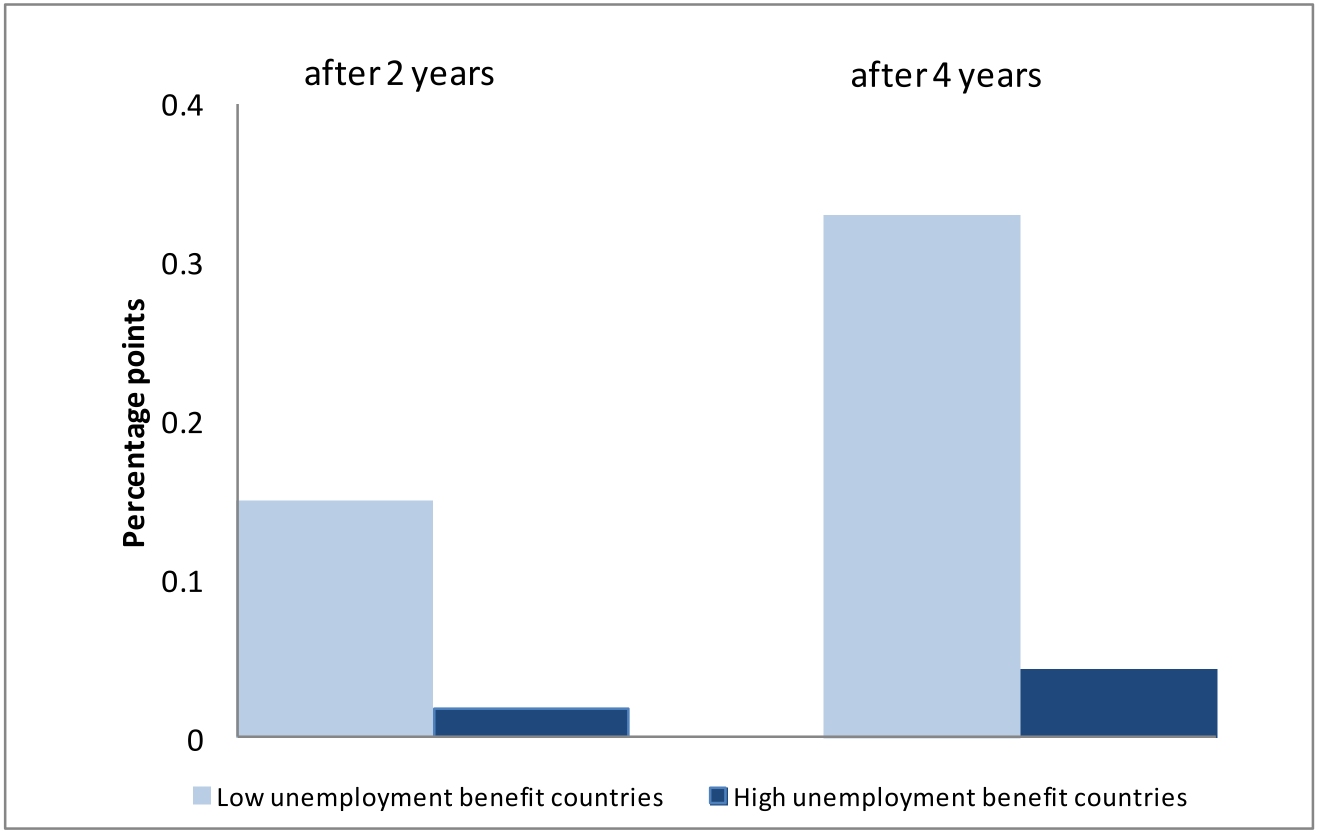
B. Decline in youth employment following financial crises (gap with overall change in employment)



Financial crises have increased poverty rates and disproportionally affected youth employment

The role of institutions

Increase in poverty rates following financial crises



Generous unemployment benefits have mitigated crisis-driven increases in poverty

The role of institutions under adverse shocks

	Income Inequality	Poverty	Relative labour market prospects of "marginal groups"
More generous unemployment benefits	mitigate deterioration	mitigate deterioration	amplify deterioration for young people
Higher tax wedges on labour			amplify deterioration for young people and seniors
More stringent job protection	(shelters income share of middle classes)	mitigates deterioration	mitigates deterioration for seniors; amplifies it for young people
Broader reach of minimum wages			amplifies deterioration for young people and (for some shocks) for seniors
Stronger unions	mitigate deterioration		mitigates deterioration for prime-age workers ; amplifies it for the young
More pro-competitive product market regulation	mitigates deterioration	mitigates deterioration	mitigates deterioration for young people

Conclusion

- Even though Sologon/ O'Donoghue and Ahrend *et al.* use totally different approaches, they obtain results that are very close.

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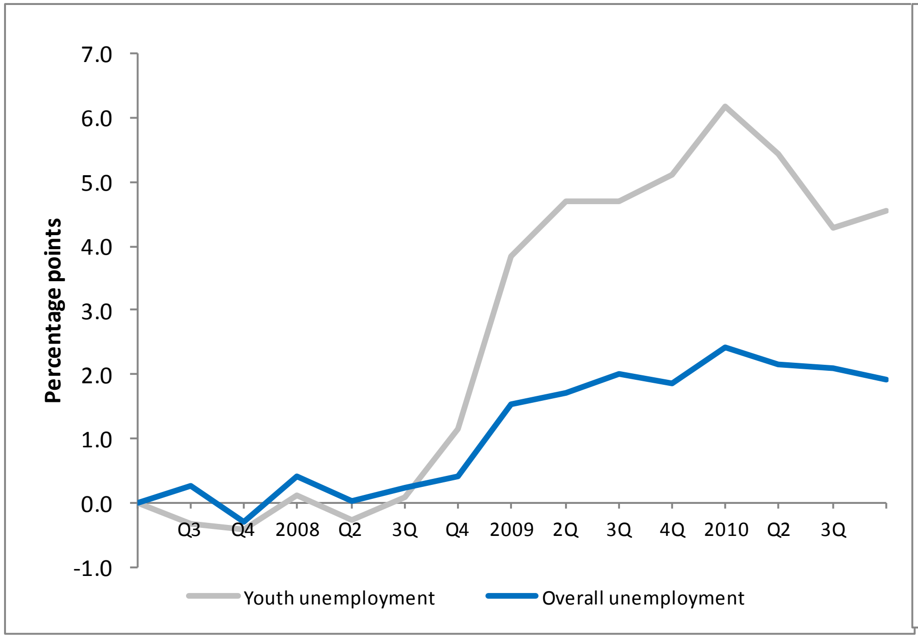
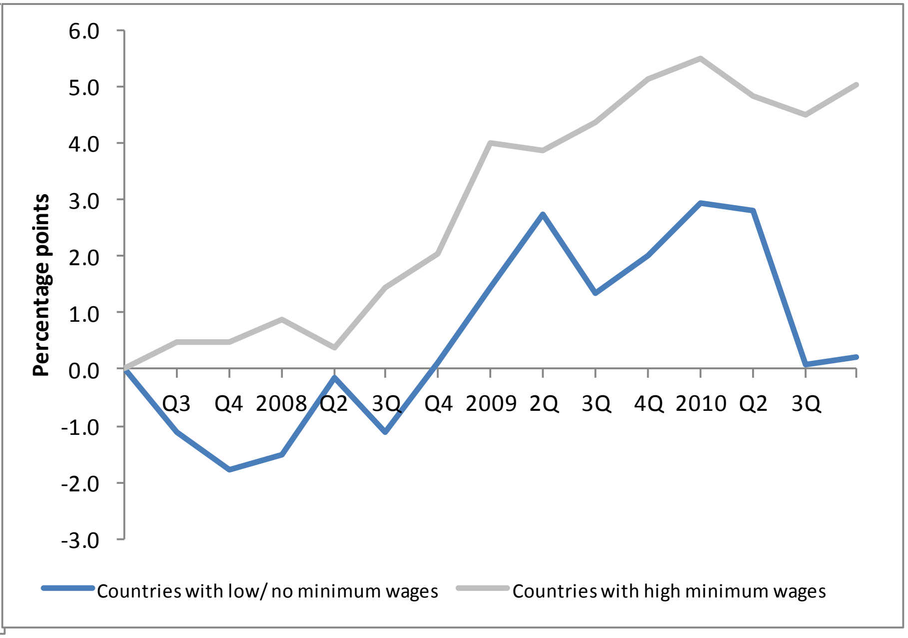
Introduction

A. Increase in unemployment with respect to 2nd Quarter 2007



B. "Excess" increase in youth unemployment with respect to 2nd Quarter 2007 (gap with overall change in unemployment)



Young people have been particularly badly hurt by the recent financial crisis, and especially so in countries with high minimum wages

Methodology of the empirical analysis

- Empirical approach as in Teulings and Zubanov (2009), similar to Cerra and Saxena (AER, 2009).
- Estimate impact on distributional variable of interest for each of the five years after occurrence of shock.
- E.g. equation for the year after the shock (t+1):

$$Y_{it+1} - Y_{it} = \alpha + \sum_{j=0}^{3} \beta_j \Delta Y_{it-j} + \gamma_1 SHOCK_{it} + \delta_1 SHOCK_{it} * INST_{it} + \varepsilon_1 INST_{it} + \bar{\theta} \cdot \overline{COVAR}_{it} + \mu_t + \eta_{it}$$

  - Y_{it} distributional variable of interest.
  - COVAR: set of covariates that control for possible cross-country differences (including population, GDP p.c., foreign asset position, geographical remoteness, share of commodity exports).
  - μ_t time fixed effects.
- Focus on the coefficients γ and δ measuring the response of the distributional variable to a shock and to the interaction of the shock with institutional settings.

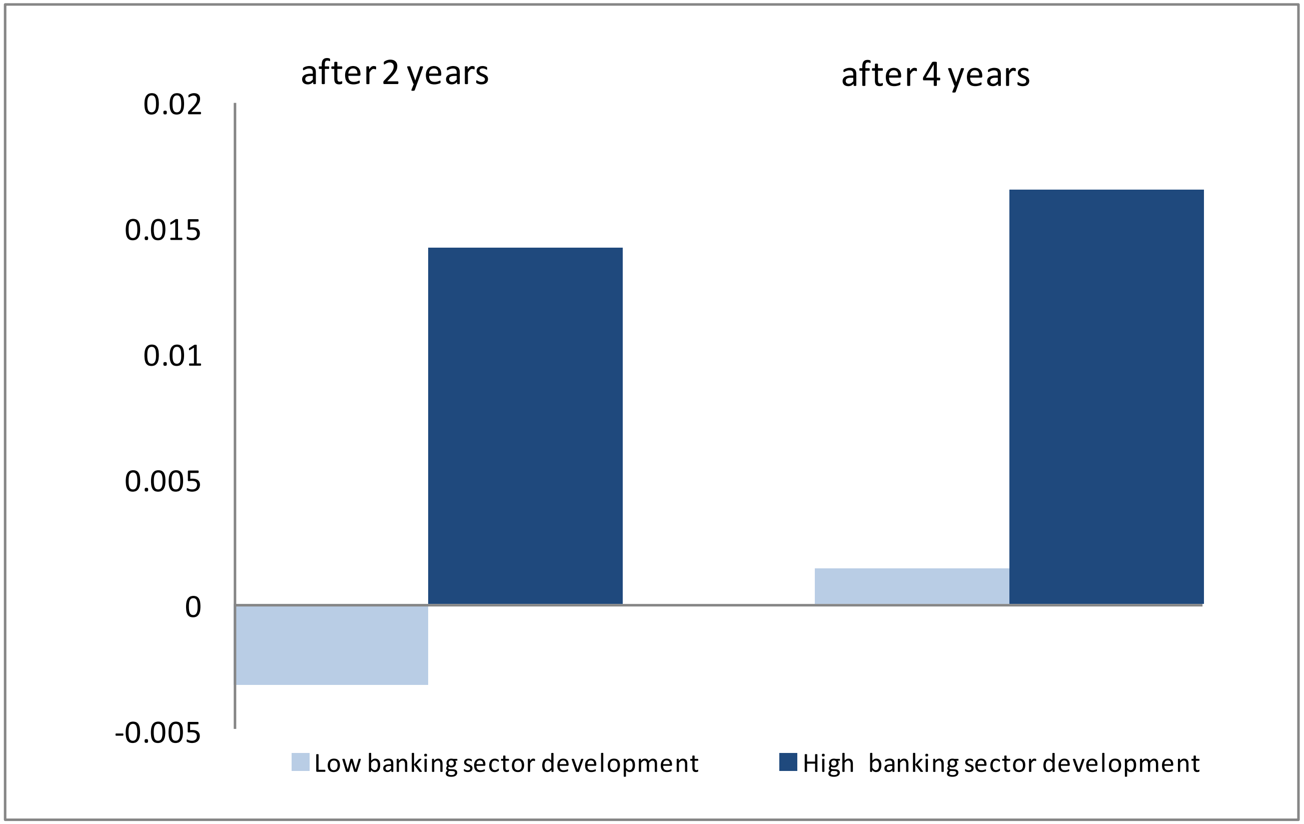
Distributional impact of macroeconomic shocks

	Income Inequality	Poverty	Relative labour market prospects of "marginal groups"
Financial crises	N	N	N (young, seniors, women)
Fiscal consolidations	N	N	N (young, seniors)
Fiscal expansions	P	P	P (young, seniors)
Exchange-rate devaluations	N		N (young, seniors)
Exchange-rate appreciations	P		
Commodity-price increases		N	N (young)
Commodity-price declines	N		

N – negative impact, P – positive impact

The role of institutions

Change in GINI coefficient following devaluation shocks



Financial development has amplified the redistributive effects of shocks

The role of institutions under adverse shocks I

	Income Inequality	Poverty	Relative labour market prospects of "marginal groups"
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The role of institutions under adverse shocks II

	Income Inequality	Poverty	Relative labour market prospects of "marginal groups"
More pro-competitive product market regulation	mitigates deterioration	mitigates deterioration	mitigates deterioration for young people
Greater openness to trade / FDI	mitigates deterioration		mitigates deterioration for young people
Greater openness to capital flows	amplifies deterioration		
Financial development	(amplifies declines in income shares of low and high incomes)		mitigates deterioration for young people

OECD

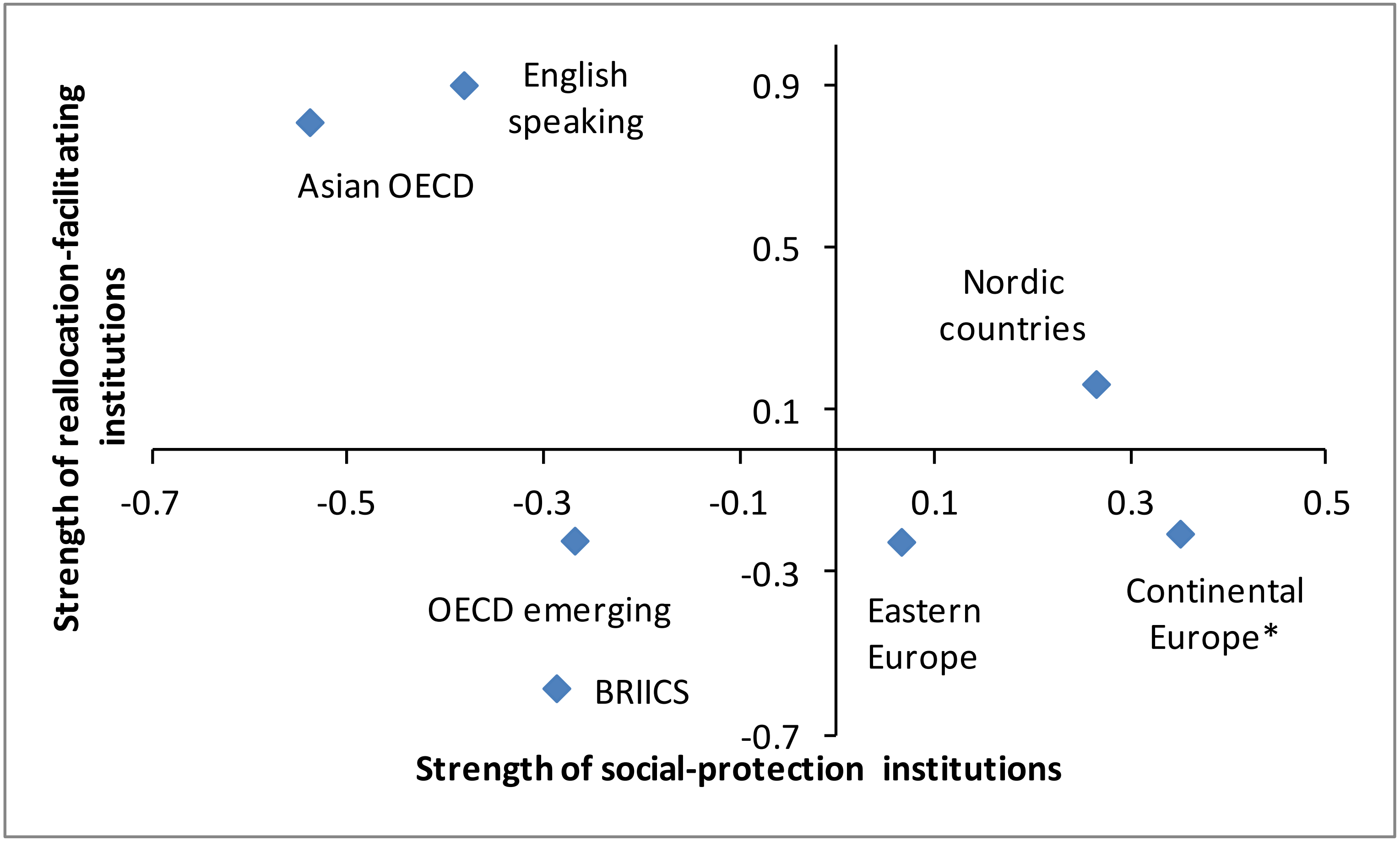
Four models of income risk sharing

- Analysis highlights two broad types of institutions that facilitate income risk sharing, namely "social-protection" and "reallocation-facilitating" institutions.
  - Social-protection institutions include unemployment benefits, EPL, minimum wages or strong unions.
  - Pro-competitive product market regulations and low tax wedges are examples of risk-sharing institutions that likely work by facilitating reallocation.
- On this basis, four broad groups of countries can be identified :

Four models of income risk sharing

- countries providing income risk sharing mainly via social-protection institutions:
  - the large majority of continental-European countries (Switzerland most notable exception).
- those relying mainly on reallocation-facilitating institutions:
  - English-speaking and Asian OECD countries.
- countries where neither class of institutions are developed:
  - typically OECD and non-OECD emerging economies (eastern-European countries halfway between continental Europe and the emerging economies).
- countries relying strongly on both of them:
  - Nordic countries.

Four models of income risk sharing



A stylised classification of risk-sharing models across the OECD and the BRIICS

Conclusion

- Institutions are found to shape the distributional effects of macroeconomic shocks.
- Some of the institutions that improve risk-sharing are also good for growth or jobs, thereby providing obvious directions for reforms. Examples are well-designed short-time working schemes, competitive product markets, low tax-wedges on labour, and prudent fiscal policy.
- Others, such as minimum wages or stricter job protection, can come at a cost, and particular care is therefore needed in designing them.

References

- Ahrend, R., J. Arnold and C. Moeser (2011),” The Sharing of Macroeconomic Risk: Who Loses (and Gains) from Macroeconomic Shocks”, *OECD Economics Department Working Papers*, No. 877.
- Ahrend, R., C. Moeser and T. Monacelli (2011),”Redistribution and the Role of Institutions: A DSGE Analysis”, *OECD Economics Department Working Papers*, No. 884.
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