LABOUR MARKET LIBERALIZATION AND WORKERS' LIVING CONDITIONS

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MACROECONOMIC EFFECTS OF LABOUR MARKET COMPETITION THEORETICAL BACKGROUND

- The debate about labour market flexibility and its effect on growth and employment is at the core of the controversy between neoclassical and Keynesian theory (Roncaglia 2014)
- In **the neoclassical view**, workforce demand is a decreasing function of the real wage. It reflects the entrepreneurs' optimal choice or the equality between the marginal product of labour and the workers real remuneration. Competition in the labour market, in the presence of unemployment will encourage labour intensive techniques, increase labour demand and favour the efficient working of the general equilibrium model (Mankiw, 1993)
- The **Keynesian view** refers to unemployment as the result of aggregate demand and its distance from the equilibrium of full employment. Competition in the labour market, in the condition of underemployment, lowers wages, decreases workers purchasing power and therefore the ability of the economic system to reach the full employment equilibrium. Besides the direct effects, higher wages are said stimulate productivity since they force entrepreneurs to invest in more productive techniques, with the aim of increasing their profit share (Kaldor 1989).

LABOUR MARKET COMPETITION INSIDE THE EUROPEAN FRAMEWORK

Labour market flexibility is one of the main pillars of the European policy framework, as it is perceived as an instrument to promote growth and convergence among countries.

In line with the theory of the optimal currency area (Mundell, 1961), labour market liberalisation was perceived as a necessary support to the efficient working of a market economy in a globalised world.

In the absence of labour market flexibility, the economic system produces below its potential level (Alonso et al. 2004), the capital accumulation is compromised (Bertola, 1994) and the compression of profits disincentives the process of investment (Daveri and Tabellini 2000).).

The 2007 financial crisis and the subsequent rise in unemployment across European countries 'accelerated' the processes of liberalisation and de-regulation of the labour market in the attempt to minimise job losses (Bianco et al., 2017; Choudhry et al., 2012).

Taking into account the possible consequences on general living conditions, the European employment strategy is based on a mix of flexible labour markets, social protection and active labour market policies – known as "flexicurity" - to avoid the worsening of general living conditions and long-run unemployment (Junker et al. 2015).

LABOUR MARKET FLEXIBILITY AND GROWTH RECENT LITERATURE

- In recent times, these positions about the direct relation between labour market flexibility on one side and growth and unemployment on the other have been subject to revision (Bassanini and Duval 2009, Brancaccio et al 2018, O'Higgins 2012).
- Consolidated institutions such as the World Bank, the OECD and the IMF questioned previous results: using the Employment Protection legislation (EPL) index, calculated by the OECD, the World Bank concluded that the impact of lower workers' protection on GDP growth and employment tends to be nonsignificant or modest (World Bank 2013). Similar results can be derived from IMF and OECD reports (IMF, 2016; OECD 2016) according to which the macroeconomic effects of a greater flexibility in the labour market cannot be considered as positive even in the long run.

LABOUR MARKET FLEXIBILIY AND INEQUALITY RECENT LITERATURE

- Literature started to investigate the connection between labour market flexibility and inequality. Freeman (2008) hypothesises – through a comparison of some labour market indicators – that differences in macroeconomic performances across countries cannot be attributable to dissimilar degree of flexibility that rather appear to increase dispersion of earnings. This relation called the "Freeman conjecture" has been tested by Campos and Nugent (2015) who confirmed that a more protected labour market reduces inequality, despite no effect being detected on GDP growth
- The introduction of measures, allowing excessive use of atypical contracts, not renewed in the case of an economic downturn, worsen the working and living conditions of specific categories, such as young people and unskilled workers (Crettaz, 2011; Emmenegger et al., 2012; Choudrhry et al., 2012). The use of non-standard and atypical contracts (fixed term or part-time) favours the creation of low-wage jobs, increasing precariousness within the labour market (Giesselmann, 2014; Lucifora et al., 2005; Amuedo-Dorantes and Serrano-Padial, 2010). Relaxing hiring and firing legislation can help employment outcomes only if the country provides generous social protection and active labour market policies (Hemerijch and Eichorst, 2008)

AIM OF THE PAPER

- The aim of this paper is to investigate the effect of flexibility in the labour market on workers' living conditions from a macroeconomic perspective

- The number of workers living below the poverty threshold is connected to a labour market regulation index
- The eventual presence of a connection will provide information about the link between competition in the labour market and growth.

THE STYLIZED REPRESENTATION

THE PREMISES

- The connection between labour market competition and workers' living condition depends on the effect of labour market competition on growth
- It is ambiguous due to a contradictory wage role inside the production relations.
- On one hand, more flexibility means lower wages and lower manufacturing costs and therefore, greater competitiveness on foreign and internal markets. The subsequent increase of profits promote capital accumulation and the convergenge toward the full employment level (Bertola 1994, Daveri and Tabellini 2000)
- On the other hand – reducing remuneration – more flexibility provides less purchasing power to the workers and a contained aggregate demand. Badhuri and Marglin (1990) Aggregate demand reduces also because of the lower incentives to capital accumulation aiming at reducing labour as production factor (Kaldor (1989), Dutt et al. (2015))

A STYLIZED REPRESENTATION

THE EQUATIONS

$$WP=\alpha-\beta w-\gamma g \quad (1)$$

$$g=\vartheta-\mu w \quad (2)$$

$$w=\rho-\sigma LMRI \quad (3)$$

Substituting (3) in (2) and then in (1) we have

$$WP=\alpha+\gamma\vartheta+\rho(\beta-\mu\gamma)+\sigma(\beta-\mu\gamma)LMRI$$

The impact of Labour market liberalization on the percentage of working poor is

$$dWP/dLMRI=\sigma(\beta-\mu\gamma)$$

with $0<\sigma<\infty$

$$dWP/dLMRI<0 \text{ if } (\beta-\mu\gamma)<0 \text{ or if } \beta<\mu\gamma$$

$$dWP/dLMRI>0 \text{ If } (\beta-\mu\gamma)>0 \text{ or } \beta>\mu\gamma$$

The increase in liberalisation in the labour market increases the number of working poor if β – the effect of wage – is greater than the interaction term $\mu\gamma$ representing the joint effect of growth on the number of poor people– directly through the last term of Equation (1) and indirectly through wages (Equation (2)) – on the variable WP. In the special case of a positive sign of the parameter μ, as in the Kaldor (1989) hypothesis between wage and capital accumulation, it always holds that $\sigma(\beta+\mu\gamma)>0$

EMPIRICAL ANALYSIS

- The sample contains 15 European countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the UK, in the time span 2005–2016.
- **PMG estimator**
- it is considered to be consistent for estimating dynamic heterogeneous panels (the sample of 15 European countries), as the long-run dynamics are supposed to be equal across groups, while in the short run, the process of adjustment may vary across panel members (Pesaran, Shin and Smith, 1997, 1999; Blackburne and Frank, 2007).
- The empirical technique applied relies on the existence of a long-term relationship among the variables and on a process of adjustment in the short run (ECM).
- Allows for cross sectional dependence among variables (unobservable common shocks such as the financial crisis)
- Requires cointegration
- It detects the existence of a stable relationship, even in the presence of a reduced number of explanatory variables

THE EMPIRICAL MODEL

- Main relationship

$$WP_{i,t} = \alpha_i + \lambda_i WP_{i,t-1} + \beta_{i,0} LMRI_{i,t} + \beta_{i,1} LMRI_{i,t-1} + \varepsilon_{i,t}$$

- Adjustment process

$$\Delta WP_{i,t} = \phi_i (WP_{i,t-1} - \vartheta_i - \vartheta_{1,i} LMRI_{i,t}) - \beta_{i,1} \Delta LMRI_{i,t} + \mu_{i,t}$$

$-1<\phi_i<0$ must hold for the goodness of the model

POVERTY INDICATORS

Dependent variables

- **workers' 'monetary poverty' (WMP)**

Monetary poverty is measured by the indicator 'people at risk of poverty after social transfers'. It is the share of the total population with an income below the at-risk-of-poverty threshold of 60% of the national median equivalised disposable income after social transfers.

- **workers' 'severe material deprivation' (WSMD)**

Severe material deprivation is a measure of physical poverty. The indicator is the percentage of workers that cannot afford at least four of the following nine items: 1) to pay their rent, mortgage or utility bills; 2) to keep their home adequately warm; 3) to face unexpected expenses; 4) to eat meat or proteins regularly; 5) to go on holiday; 6) a television set; 7) a washing machine; 8) a car and 9) a telephone (Eurostat, 2016)

Both indicators are calculated for employed people older then 18 expressed in percentage of the total population

WHY TWO INDICATORS?

- **WMP** 'number of workers at risk of poverty after social transfers' is close to a **measure of inequality**, as monetary poverty is measured with respect to other people and is highly influenced by GDP dynamics (Kenworthy, 2011; Darvas et al., 2014).
- the 'workers severe material deprivation' **WSMD** indicator is a measure of **absolute poverty**, as it is calculated on the basis of the availability of specific physical assets (Crettaz, 2015). It can be considered as the number of people with a very low real GDP per capita

- The difference between the two indicators is particularly relevant when considering EU countries and the differences in living conditions since WMP is country specific, while WSMD has the advantage of being comparable across nations (Fusco et al., 2011; Nolan and Whelan, 2010).

Source: Eurostat (http://ec.europa.eu/eurostat/web/income-and-living-conditions/data/).

THE LABOUR MARKET COMPETITION INDICATOR

The LMRI index is an unweighted average of the following six measures which can be considered as exogenous since they are dependent on institutional features of each country: 1) hiring regulations and minimum wage; 2) hiring and firing regulations; 3) centralised collective bargaining; 4) working hours regulations; 5) mandated cost of worker dismissal and 6) conscription. The values range from one to ten. The higher the value is, the higher the degree of flexibility in the labour market.

When compared with the EPL index, the LMRI provides features more suitable for our analysis:

1) the LMRI index refers to *de jure* and *de facto i*nformation, therefore capturing the explicit and implicit institutional settings of each country.

2) the EPL index in its first version available prior to 2008 does not include a set of information related to recent labour market reforms (such as legislation concerning dismissals and temporary work).

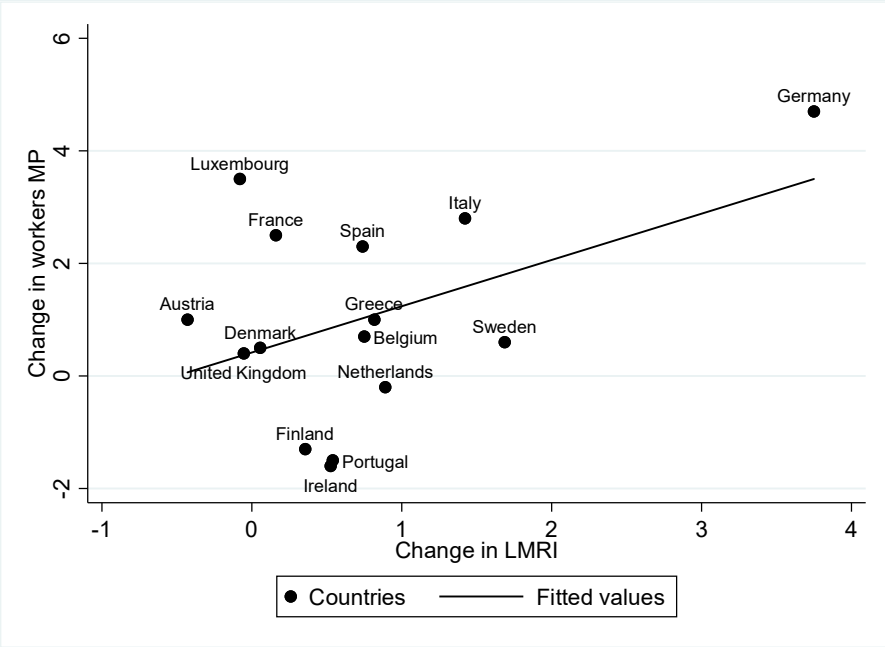
3) Finally the series available registers little variability therefore compromising its explanatory power of the multidimensional changes occurred in the European labour market in the last twenty years.

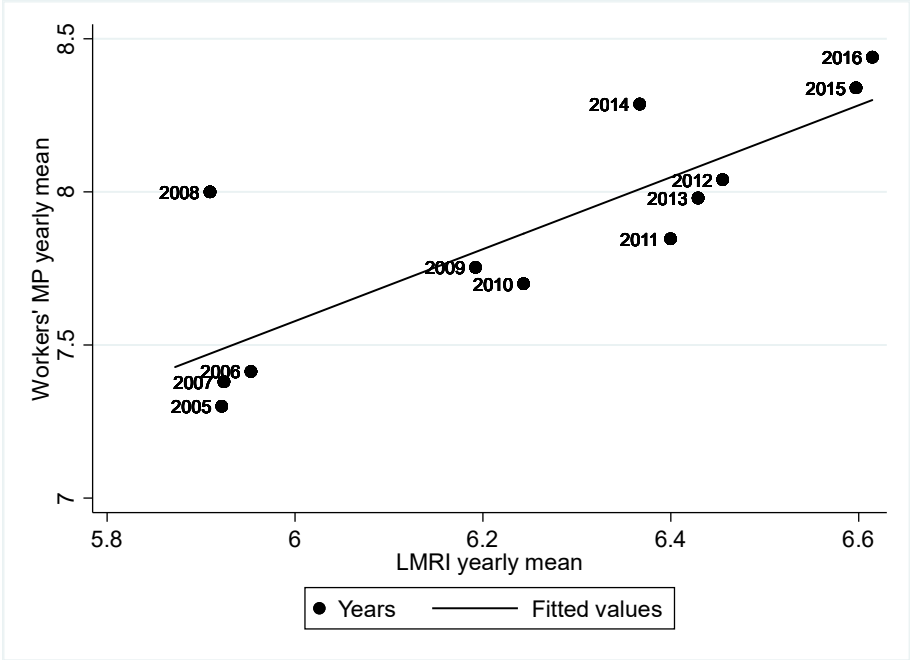
However, it must be taken into account that the LMRI index seems to be somewhat distorted since it is calculated with the sole aim of presenting the degree of freedom in each country (Aleksynska & Cazes 2014).

Source: Fraser Institute

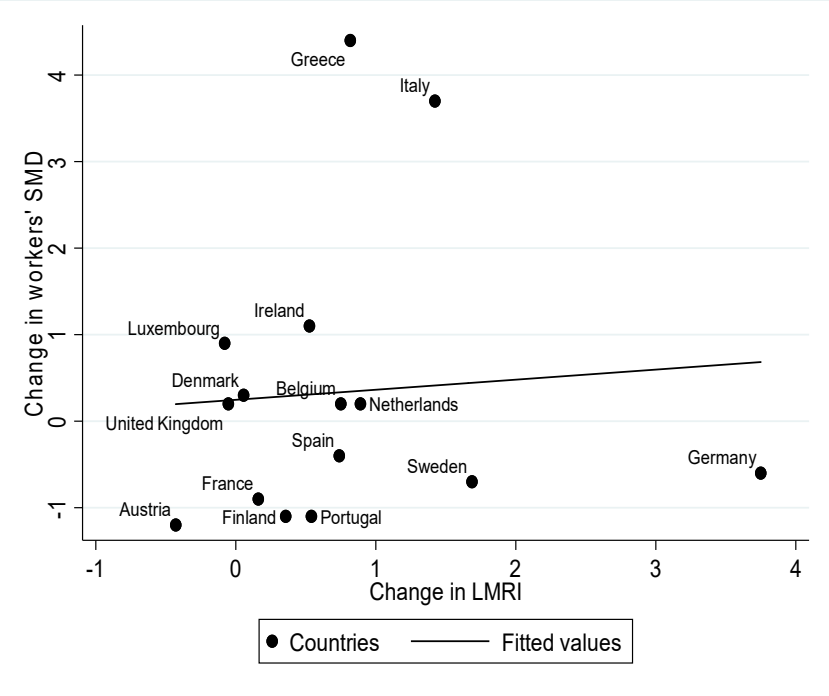
https://www.fraserinstitute.org/economicfreedom/dataset?geozone=world&year=2016&page=dataset

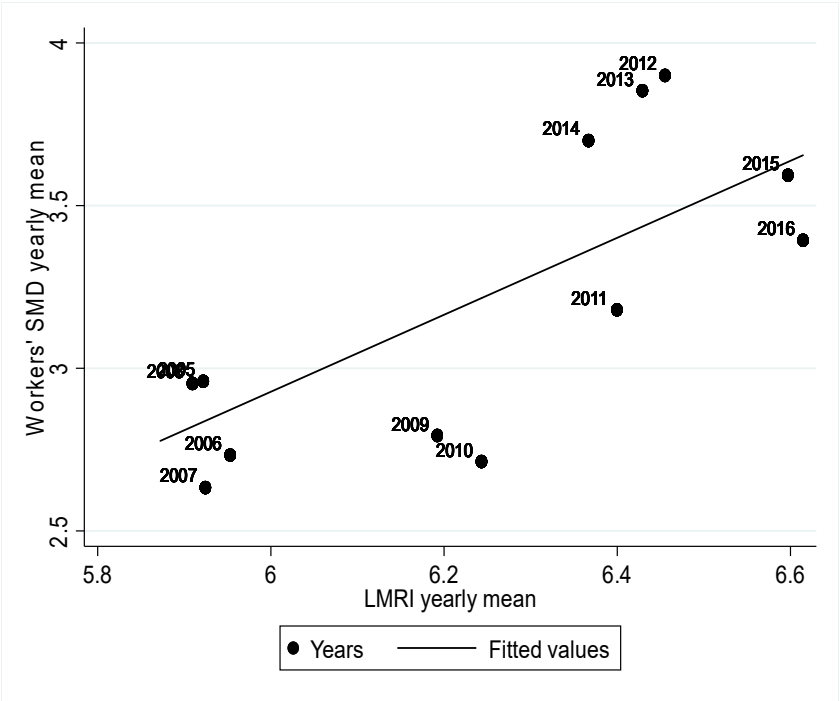
Workers' monetary poverty and LMRI: country dynamics and yearly mean (2005-2016)





Workers' severe material deprivation and LMRI: country dynamics and yearly mean





ϕ_i

In-work poverty and labour market freedom: PMG Estimation results

	Independent variable WMP	Independent variable WSMD
Long run		
LMRI	0.468*** (0.148)	0.451*** (0.126)
Short run		
ϕ_i :	-0.562*** (0. 089)	-0.436*** (0.089)
ΔLMRI	−0.230 (0.268)	0.089 (0.079)
Intercept	3.104*** (0.982)	− 0.148 (0.234)
Obs.	180	
Countries	15	
Note: ***, **, and * reject the null at 1%, 5% and 10% respectively: Standard errors are presented below the estimated coefficients.		

In-work poverty, labour market freedom and GDP growth: PMG Estimation results

	Independent variable WMP	Independent variable WSMD
Long run		
LMRI	0.499***	0.523***
	(0.143)	(0.131)
GDP_{-1}	-0.015	-0.017
	(0.023)	(0.020)
Short run		
ϕ_i :	-0.557***	-0.426***
	(0.099)	(0.098)
ΔLMRI	−0.284	0.082
	(0.279)	(0.087)
ΔGDP	-0.023	-0.009
	(0.014)	(0.019)
Intercept	3.020***	-0.315
	(0.982)	(0.225)
Obs.	180	
Countries	15	
Note: ***, **, and * reject the null at 1%, 5% and 10% respectively: Standard errors are presented below the estimated coefficients.		

IS LABOUR MARKET FLEXIBILITY A CAUSE OF CONCERN JUST FOR WORKERS?

European institutions strongly recommend to focus on employment and social performance with the belief that social security is not just a matter of importance for employees, but it should be assured, in the context of globalization and ever increasing technological progress, for the whole labour force. The European employment strategy is based, therefore, on a mix of flexible labour markets, social protection and active labour market policies – known as "flexicurity" - to avoid the worsening of general living conditions and long-run unemployment (Junker et al. 2015).

Following the European institutions recommendations, the higher labour market flexibility should be accompanied by income support measures to avoid the possibility that those who lose their jobs slide into poverty. One would expect that, despite the negative consequences on workers living conditions of a higher labour market flexibility, the population as a whole does not suffer from a reduction in income.

Poverty, labour market freedom and GDP growth: PMG Estimation.

	Dependent variable MP	Dependent variable SMD
Long run		
LMRI	0.978*** (0.146)	0.853*** (0.256)
GDP_{-1}	-0.198*** (0.034)	-0.248*** (0.048)
Short run		
ϕ_i :	-0.341*** (0.080)	-0.366*** (0.128)
ΔLMRI	−0.093 (0.163)	0.087 (0.198)
ΔGDP	-0.015 (0.017)	-0.030 (0.038)
Intercept	3.134*** (0.764)	-0.065 (0.252)
Obs.	240	180
Countries	15	
Note: ***, **, and * reject the null at 1%, 5% and 10% respectively: Standard errors are presented below the estimated coefficients.		

CONCLUSIONS

Labour market flexibility is the receipt European institutions suggest implementing to counteract asymmetric shocks and promote resilience during the negative phases of the cycle. The outcomes of this measure on unemployment depend on the supposed prevalence of supply side over demand side effects on the rate of growth and on income support measures implemented by single countries.

Labour market policy changes introduced to promote growth seem to increase poverty among workers, both when considered in relative and absolute terms.

When considering the population as a whole, these results seem to be amplified, therefore casting doubts on the efficacy of the instrument of higher labour market competition on the objective of growth.

Demand side effects seem to prevail

Income support measures seem to be not enough to avoid the increase of the number of poor