# Europe's austerity policies may have created less unemployment in countries with liberalised labour markets.

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*Austerity policies have been linked to rising unemployment in European countries, but what effect have policies aimed at liberalising labour markets had during the crisis?* **Alessandro Turrini** *finds that contrary to expectations, austerity policies may have been responsible for creating more unemployment in countries with stronger employment protection legislation. One potential reason for this is that while countries with more regulated labour markets have not experienced as many redundancies from austerity, they have also had far lower job creation levels.*

Debates over the growth and employment implications of fiscal austerity in the EU have been raging over the last couple of years. Could fiscal consolidation become self-defeating? Are tight fiscal policies responsible for the growing unemployment problem in EU countries hit by the debt crisis? These two issues have been at the heart of discussions.

What is largely neglected in the current debate is that a number of EU countries hit by the debt crisis have simultaneously carried out major fiscal retrenchments and labour market reforms aimed at stimulating job creation and addressing the problem of segmentation between temporary and permanent contracts (Greece, Italy, Portugal, Slovenia, Spain). This policy approach raises a fundamental question: is the employment impact of fiscal consolidation more harmful when reforms easing employment regulation are taken at the same time?

To address the above question, I have estimated the impact of fiscal consolidations across European countries on unemployment and job market flows. The results show that fiscal consolidations do produce a significant impact on cyclical unemployment, but effects are mostly transitory. Each GDP percentage point of fiscal consolidation measures increases unemployment on average by almost one tenth of a percentage point. Such a figure is broadly consistent with available estimates of GDP fiscal multipliers (summarising the impact of consolidation on economic activity) and Okun coefficients (translating changes in economic activity into changes in the unemployment rate). By separating the effect of government revenues and expenditures, it turns out that the impact is larger for expenditures, while it is smaller and not statistically significant for revenues.


Credit: Andrea Comas (CC-BY-SA-3.0)

**Does labour regulation matter?**

In order to shed light on whether labour market regulation matters for the impact of fiscal consolidation on unemployment, I carry out the same analysis separately for the group of EU countries with relatively strict employment protection regulation, and the group of countries where employment protection legislation (EPL) is relatively less stringent. Interestingly, it turns out that fiscal consolidations produce a somewhat larger effect in labour markets characterised by a higher degree of employment protection.

The conclusion that fiscal consolidation is more harmful in labour markets which have a higher degree of regulation is counter-intuitive, but an explanation could be found in the different behaviours of job creation and job destruction. It is well-known from existing theory and evidence that strict employment protection legislation is associated with lower separation rates, but also with a lower probability for the unemployed to find a new job. It could be the case that in high-EPL countries fiscal policy shocks destroy less jobs, but also lead to a stronger reduction in the rate at which new jobs are created, with a possibly overall strong effect on cyclical unemployment.

With a view to testing this hypothesis, I have estimated the impact of fiscal policy on job separation and job finding rates. As expected, the impact of fiscal policy shocks on job separation rates is much stronger in low-EPL countries, while the high-EPL countries suffer from a stronger reduction in the rate at which new jobs are created. Since a reduced job-finding rate corresponds to a longer average duration of unemployment spells, fiscal policy shocks also tend to raise the share of long-term unemployment in high-EPL countries.

The evidence suggests that while in regulated labour markets fiscal consolidation is unlikely to be less harmful in terms of its impact on the unemployment rate, there are reasons to expect it to be more harmful in terms of unemployment composition. High employment protection legislation is associated with a stronger reduction in job creation and a higher incidence of long-term unemployment. The results appear to be relatively robust with respect to the measurement of fiscal consolidation and have relevant policy implications.

Overall, the findings cast doubt on the idea that the strategy followed by EU countries that reformed employment protection legislation while tackling government deficits was necessarily detrimental for employment. The massive increase in unemployment in countries such as Spain, Greece and Portugal is mostly linked to the major contraction in domestic demand amid debt crises and rebalancing. It is not clear that maintaining the existing employment protection legislation would have resulted in a better employment performance over the medium term because job creation may have suffered.

It needs to be stressed, however, that such an assessment involves major difficulties, notably linked to the necessity of constructing an appropriate “counterfactual” that permits evaluating employment developments under alternative policy frameworks, keeping all remaining conditions equal. An additional difficulty is linked to the fact that the effects of EPL reforms may take time to materialise and that these effects are strongly linked to the design of the specific reforms. For instance, the impact on job destruction is expected to be more limited in cases where reforms reducing EPL are applied only to newly hired workers (as was the case for example for most of the recent reforms undertaken by Spain and Portugal).

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Alessandro Turrini is Head of Unit in the Directorate General for Economic and Financial Affairs of the European Commission. He currently deals with labour market analysis and policy and was previously dealing with issues such as fiscal policy and exchange rates. He studied at Bocconi University and LSE and obtained a PhD from the University of Louvain. He was assistant professor at the University of Bergamo, consultant for the OECD and the United Nations, lecturer at Bocconi University, and research affiliate at CESPRI-Bocconi, Centro Studi Luca D’Agliano, Mila, CEPR, London. He currently teaches at the free University of Brussels and is a policy fellow at IZA, Bonn.

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