"Unemployment, Inequality, and Institutions, Revisited"

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Extended Abstract

For a long time now economists have been interested in understanding the impact of labor policies and regulations on unemployment and inequality. One of the central questions in this literature is whether strict labor regulations generate a trade-off between wage inequality and unemployment. Institutions are a natural candidate to explain the marked differences in unemployment-inequality outcomes across otherwise similar developed economies. In addition, the rise in unemployment brought by the Great Recession has renewed the debate on which are the right set of labor policies to face major aggregate shocks.

This paper revisits the impact of institutions on wage inequality and unemployment from a cross-country perspective. It does so, however, by pooling micro-level data over many years across developed nations.

Most of the early empirical studies analyzing the impact of institutions on either unemployment or inequality relied on aggregate cross-country data. However, several of the results from this literature have been found to be sensitive to changes in the data and/or the econometric specifications adopted (Baccaro and Rei, 2007; Howell et al., 2007). A related group of studies has directly tested whether the interaction between technological change and institutions explains why on average the U.S. has experienced low unemployment and high inequality, while the opposite occurs in many European countries (Card et al., 1999; Mortensen and Pissarides, 1999; Puhani, 2008; Bičáková, 2014). The evidence arising from this literature provides mixed support for this hypothesis.

The recent literature has shifted towards single-case studies where the causal impact of policies can be better established through natural experiments and randomized trials. While this new wave of studies has generated many important findings, it suffers from the disadvantage of offering conclusions that apply under very specific contexts. This in turn limits their ability to offer insights on the interactions between different sets of policies and institutions.

By pooling survey data across countries and years, this paper takes a middle-way approach between macro and case-level studies. There are several advantages of doing this. In contrast to the macro cross-country literature, we can explore the heterogeneous responses across population groups to policies and aggregate changes in the economy.[1] In contrast to single-case studies, we obtain results that apply to a wider set of contexts and we are able to analyze the interactions and complementarities between institutions. Ultimately, it is precisely the combination of cross-country data that helps us understand how different institutional regimes lead to the unemployment-inequality outcomes observed across developed nations.

The empirical approach followed consists of estimating the relationship between the unemployment of different groups of the population and institutions and aggregate factors. In the case of inequality, we

[1] Few papers in the cross-country literature explore this heterogeneity. Some exceptions include Kahn (2000); Bertola et al. (2007); Gal and Theising (2015) and Piton and Rycx (2018).

use Recentered Influence Function regressions (Firpo et al., 2009) to analyze how institutions and other macro variables relate to individual wages, and through them shape inequality in the market.

The set of institutions we study include employment regulations, the minimum wage, the generosity of unemployment insurance, various measures related to unions and collective bargaining, labor taxes, active labor market policies, and regulations in product markets. In addition to these policies, we analyze the impact of aggregate factors such as technological change, trade, and output fluctuations.

A number of messages arise from our findings. First, some institutions contribute to creating a trade-off between unemployment and inequality. In particular, the generosity of unemployment insurance, union presence, taxes, and product market regulations all contribute to such trade-off. However, other institutions affect unemployment and inequality without necessarily leading to such pattern.

Second, our results uncover a great deal of heterogeneity in the responses of employment and wages across population groups. For instance, we find that a greater labor tax wedge increases unemployment among unskilled females, while at the same time it reduces inequality by lowering the pre-tax wages of skilled workers. In fact, the heterogeneity in responses is the norm, rather than the exception.

Third, institutions do not act in isolation, but rather they interact with one another. An interesting illustration of this is the finding that the disemployment effects of taxes are moderated under an environment with a generous safety net that includes unemployment insurance benefits, as well as vigorous active labor policies. This precise combination of high taxes with a safety net can explain why Nordic economies have managed to have low levels of inequality together with moderate unemployment.

Finally, our estimations indicate that institutions also mediate the impact of aggregate shocks in the economy. In particular, we find that the institutional setting found in Southern European economies magnifies the adverse impact of output downturns on unemployment. In contrast, the institutions in the United States mitigate the impact of such downturns. This finding implies that the dismal unemployment outcomes observed in Southern European economies following the 2008 crisis was not only due to their larger output contraction, but also to their institutional setting which amplified the negative employment effects of an output downturn.

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