

Fiscal consolidation in reformed and unreformed labour markets: A look at EU countries

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Since the outburst of the Great Recession, unemployment is surging to worrying levels in Europe. The implementation of major fiscal consolidations in such a context has stimulated debate on the growth and employment impact of consolidation measures, with implications for the coordination of timing and modalities of budgetary adjustment across EU countries (e.g., Corsetti, 2012).

Despite these concerns, a number of EU countries have recently put in place both ambitious fiscal consolidation plans and major labour market reforms. In particular, the Employment Protection legislation (EPL) systems of Southern European countries have been shaken by reforms aimed at stimulating job creation and tackle the problem of labour market segmentation while severe budgetary cuts to reassure markets and put public finances on a sustainable footing were also implemented.

Against this background, this paper aims at addressing a number of questions: to what extent continued fiscal consolidation across Europe would impact on unemployment? Which type of consolidation, expenditure or revenue-based, would be most employment-friendly? Does the impact of fiscal consolidation on unemployment come mostly from the job destruction side or does job creation play a relevant role as well? How do employment protection reforms interact with fiscal consolidation in determining unemployment and labour market flows? Are budgetary cuts more harmful when dismissals are less costly?

Results show that fiscal consolidation, notably government expenditure cuts, have a significant although temporary impact on unemployment, which comes both from an increase in job destruction and a reduction in job creation. Interestingly, this unemployment impact does not differ much between high or low-EPL countries. There are considerable differences instead for what concerns job market flows, with fiscal consolidation in high-EPL countries having a less strong impact on job destruction but also leading to a more pronounced reduction in job finding rates and, therefore, to a higher share of long-term unemployment.