Unemployment Determinants in Europe: Analytical Essay

In many Central and Eastern European Countries, high unemployment level is still regarded as one of the main agendas for policy makers. A lot of effort has been put into determining the reasons for unemployment in this region to develop policies and structures to decrease its level (Pesliakait?, 2016). The demand for labor is inversely proportional to wages and subsequently the unemployment rate is also inversely proportional to the labor demand. As pointed out by Pesliakait? (2016), there are two types of key indicators that determine unemployment, namely, structural or institutional factors and non-structural factors.

Structural unemployment can be defined as the unemployment pattern an economy would face in the absence of shocks i.e. natural rate of unemployment (Orlandi, 2012). Institutional factors such as unemployment benefit system, tax wedges, employment protection legislation, etc. influence wages. Pesliakait? (2016) explains that the unemployment benefit system and policies are crucial institutional factors that affects unemployment of the local economy. The unemployment benefit system acts as a replacement for income. A generous system will fail to motivate people to take upon a job in the labor market. If the difference between income while employed and while unemployed is low, workers will be unable to justify the advantages of having a job. Benefit replacement ratio may be defined as the ratio of allowed benefits while unemployed to the gross earnings earned while employed. Higher benefit replacement ratio encourages workers to remain unemployed for longer period. However, if the coverage of the benefit system is low and the system is strictly implemented, this may not have a profound effect on an aggregate level. Labor market policies if designed and implemented efficiently reduce the unemployment rate in the long run. These policies and institutions serve as means for job creation, self-employment promotion, assistance to the unemployed to search for jobs and acquire education and training. Policy makers also implement early retirement schemes or reduced working hours to control labor supply and decrease high unemployment levels. But ultimately, labor demand determines the unemployment rates.

Additionally, high labor taxes also play a vital role in determining the unemployment rate of an economy (Pesliakait?, 2016). If workers and trade unions lack bargaining power, the tax burden shifts on them with no change in the unemployment rate. On the other hand, if the workers and trade unions have a high bargaining power, the employers will be on the heavy side of the tax wedge and their labor costs will increase. This can be done by enforcing a link between net wage and productivity (Orlandi, 2012). Naturally, with increase in labor costs, the demand for labor goes down which leads to rise in unemployment rates. It is also the case that trade unions with their high bargaining power push to increase the minimum wage of the workers already employed at the cost of high rate of unemployment.

Non-structural factors or macroeconomic shocks effect the rate of unemployment through the imperfections in the labor market. Imperfections such as labor market inflexibility and wage rigidity lead to an imbalance of the labor market which then results to high level of unemployment. These macroeconomic shocks are categorized into four types (Bassanini & Duval, 2006):

Total factor productivity (TFP) shocks: The change in productivity demand and wage growth

may not always be aligned. The demand for highly productive workers may lead to high unemployment rate of unskilled workers and vice versa. This increases the overall unemployment of the economy.

Terms of trade shocks: Increase in the wedge between consumer and producer prices result in the rise of price of imports which subsequently leads to higher wage pressure and unemployment.

Real interest rate shock: The effect of interest rate on unemployment is also pronounced when the interest rates are higher. High interest rate results in capital being expensive to obtain, investments drop down significantly and capital tends to be saved. To balance this out, the number of workers is kept as low as possible, resulting in an increase in unemployment. Longer period of low interest rate leads to risk of unsustainable development (Orlandi, 2012).

Labor demand shock: Change in the production practices in the economy, for example, from a labor-based system to a highly automated, technology-based system will have similar devastating effect on the unemployment rate. Similarly, decline in the gap between wage rate and the marginal product of labor can also be viewed as a labor demand shock (Bassanini & Duval, 2006).

Apart from these determinants, the following factors exist that require specific econometric treatments and vary on a case by case basis (Bassanini & Duval, 2006):

Housing policy and home ownership: Societies with lower internal and external migration rates are likely to have higher rate of home ownership. This may lead to inflexibility of workers in terms of mobility which results in higher unemployment rates.

Minimum wages: High tax wedge has a deep impact on unemployment when the minimum wage is high. Minimum wages lead to a surplus in labor supply which leads to elevated unemployment rates.

Active labor market policies (ALMP): Average ALMP expenditure per unemployed can be found to be significantly corelated with country fixed effects. ALMPs are used to motivate and train workers to increase the probability of finding employment.