Labor Market Institutions and the Cost of Recessions

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Abstract

This paper studies the effect of two labor market institutions, unemployment insurance (UI) and job search assistance (JSA), on the welfare costs of recessions. The paper develops a tractable incomplete-market model with job search and idiosyncratic as well as aggregate labor market risk. It uses the tractability of the model to provide a theoretical and quantitative analysis of the link between labor market institutions and the welfare cost of recessions. The theoretical analysis shows that JSA reduces the welfare costs of recessions, but that UI increases the welfare costs of recessions if the effect of UI on search incentives is strong enough. The paper also provides a quantitative application to the German labor market reforms of 2003-2005, the so-called Hartz reforms. Specifically, the paper considers the Hartz III reform, which improved JSA, and the Hartz IV reform, which reduced UI. According to the baseline calibration, both reforms reduced the welfare cost of recessions substantially.

Keywords: Labor Market Institutions, Cost of Recessions

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