Unemployment, Inactivity and Economic Crisis: Stress Testing the Welfare Systems in Europe

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Abstract:

‘Stress testing’ is a common practice applied to financial institutions in which the sensitivity of the value of a portfolio to extreme shocks is assessed by varying key assumptions. Applied to welfare systems (Atkinson, 2009), it can be used to assess the impact of loss of employment on the living standards of the individuals that might be affected, and their families. As unemployment and inactivity rise, it becomes particularly relevant to understand the extent to which the incomes of those excluded from the labour market are protected by the tax-benefit system and to assess the cost pressures on the public budget of this decrease in labour market participation.

Building on Figari et al. (2011), this paper will examine the implications for the living standards of those most likely to lose their job over the first two years of the current economic downturn, exploring the interactions between the circumstances of individual families and the policy instruments in operation in different European countries. On the one hand there is large variety of systems of social protection for the unemployed in Europe, ranging from generous earnings related unemployment benefits with unlimited duration (e.g. Belgium) to flat rate, short-term low level amounts (e.g. United Kingdom). On the other hand the characteristics of those excluded from the labour market differ across countries. Our analysis makes use of EUROMOD, the EU-wide tax-benefit microsimulation model which simulates tax liabilities and benefit entitlements for the household populations of EU member states. A microsimulation approach allows us to calculate disposable incomes for the same set of households in different situations, taking account of the operation of taxbenefit systems and the ways in which they depend on the level of individual market income and personal/household characteristics.

In due course, survey data collected over the period of the economic downturn will provide evidence of the evolution of the income distribution and the incomes of families affected by the crisis. Analysis of panel data will show us how incomes change for the new unemployed. The approach taken here provides, in a timely fashion, an indication of these income changes, highlighting the direct cushioning effects of the tax-benefit system rather than those arising from other adaptive changes that the unemployed or other members of their households may make.

The people with the highest risk of becoming unemployed or inactive due to the current economic downturn are identified using the most recent Labour Force Survey data covering the first two year of the economic crisis. We select similar people in the EUROMOD input data by statistical matching and simulate the effect of their exclusion from the labour market on annual household income. EUROMOD’s flexibility allows us to do this to explore the implications of different scenarios. In particular, unemployment benefits are usually payable for a limited period only. So it is instructive to examine the effects of unemployment and inactivity on relative
income and poverty risk assuming different length of the spells out of the labour market. Moreover, a variety of policy options will be simulated to test the welfare resilience across countries.