

European youths in the crisis: substitution vs. income effect

Abstract:

The economic and financial crisis that erupted in 2008 had adverse effect on the labour market outcomes for most of the European population. Most countries faced large increases in unemployment and in particular youth unemployment. Low job creation and rigid labour markets have been blamed for the relatively more adverse effects of the crisis exerted on the young. However, little evidence has been given to support the reaction of the young to the adverse conditions their households are facing due to the crisis.

The main aim of this paper is to explore the response of youths to negative effects of the crisis on their families in Europe. It is assumed that the recession could have affected young people's participation on the labour market in two different ways:

- (i) they could have decided to prolong or stay in education instead of participating on the labour market and thus increase their chances for future employment (when the economy recovers) or
- (ii) they could have decided to increase their participation on the labour market because the recession affected their household income when some other (older) household members were left without their job.

So, in the first case we have the **substitution effect**, i.e., young people are substituting labour market participation (and potential unemployment) for education. The main assumption here is that the education may be more attractive when the youth labour market is weak. This can also be called the **human capital effect** since by staying in education youths are actually increasing their human capital. In a way, this also represents the **discouraged worker effect** as young people are discouraged to participate in the labour market in harsh economic conditions and thus search for alternatives. The second case represents the so-called **income effect**: due to lower income in the household more youths decide to search for a job, i.e., participate on the labour market. This effect is usually known as the **added worker effect**.

The abundant literature on added worker effect is concentrated on the response of wives to husbands' job loss, being the dominant mechanism of households' adaptation to adverse conditions. However, we argue that recent crisis has also induced behavioural changes within youth population, so youths could be 'secondary' workers in the household who decide to participate on the labour market when the household income decreases due to job loss of another (primary worker) household member. That is, they substitute their leisure/education/inactivity for work because of the drop in income of the household. The added worker effect results when the **income effect dominates the substitution effect** in an individual's decision whether or not to participate in the labour market. So, although the prospects of earnings (and employment) are decreasing in the time of the recession, the negative income effect is stronger than 'the relative decline in the 'expected' wage rate of the secondary worker'. Also, this would mean that the expected welfare benefits of the household are smaller than the potential earnings of the secondary worker.

By using the EU Labour Force Survey data, we explore the probability of young adults changing their labour market status from (i) inactivity to activity; (ii) inactivity to employment; (iii) inactivity to unemployment in response to different changes in their parents' labour market status, i.e.: (i) both parents losing the job; (ii) one of the parents losing the job, (iii) both parents becoming inactive, (iv) one of the parents becoming inactive, (v) both parents remaining unemployed. Estimated probit models initially include European economies for which the comparable dataset was created during the 2002-2014 period. Furthermore, we divide the sample into low unemployment and high unemployment countries, to incorporate the notion that youth decision making process might be systematically different when faced with unfavourable local economic conditions.

This, rather novel, approach in studying the problem of youth unemployment in Europe can be of a great value for both the academics and practitioners. Deeper insights about the process of decision making of youth population to participate or not to participate on the labour market should further improve policy initiatives from both the EU and national level, while at the same time preserving academic discussion on the patterns of youth participation in the labour force.

Key words: youth unemployment, added worker effect, discouraged worker effect, European economies

JEL classification: J22, J64