

# The Political Economy of Flexicurity

**Bocconi**

**Tito Boeri**



(Università Bocconi, IGIER and Fondazione RDB)

Università Commerciale  
Luigi Bocconi

**J. Ignacio Conde-Ruiz**

(FEDEA – Prime Minister’s Office)

**Vincenzo Galasso**

(IGIER, Università Bocconi and CEPR)

## MOTIVATION

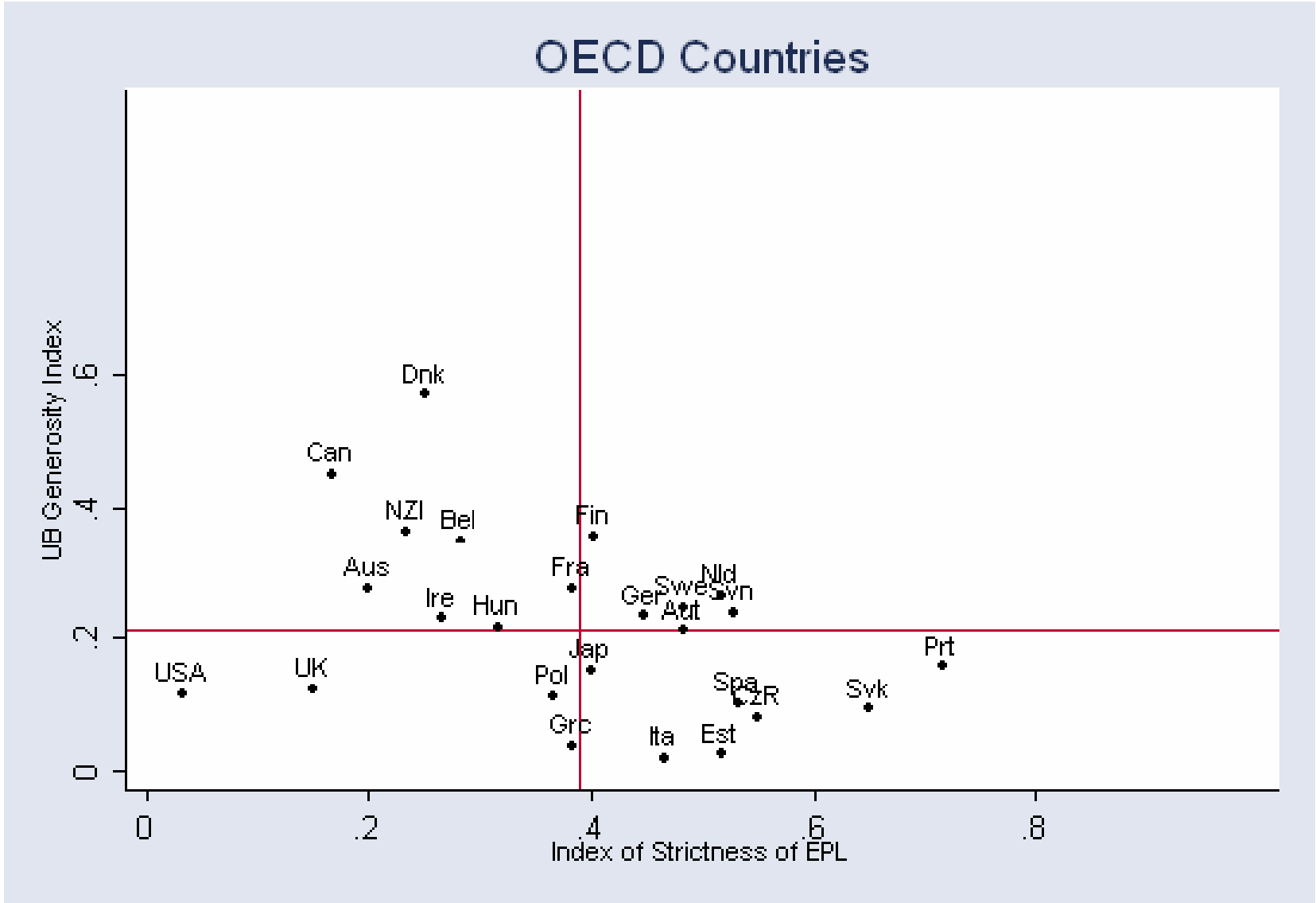
Two common ways of protecting individuals against the risks of being unemployed are:

- to support incomes of unemployed *people* (UB and ALMP)
- to protect *jobs*, imposing legal restrictions against dismissals (EPL)

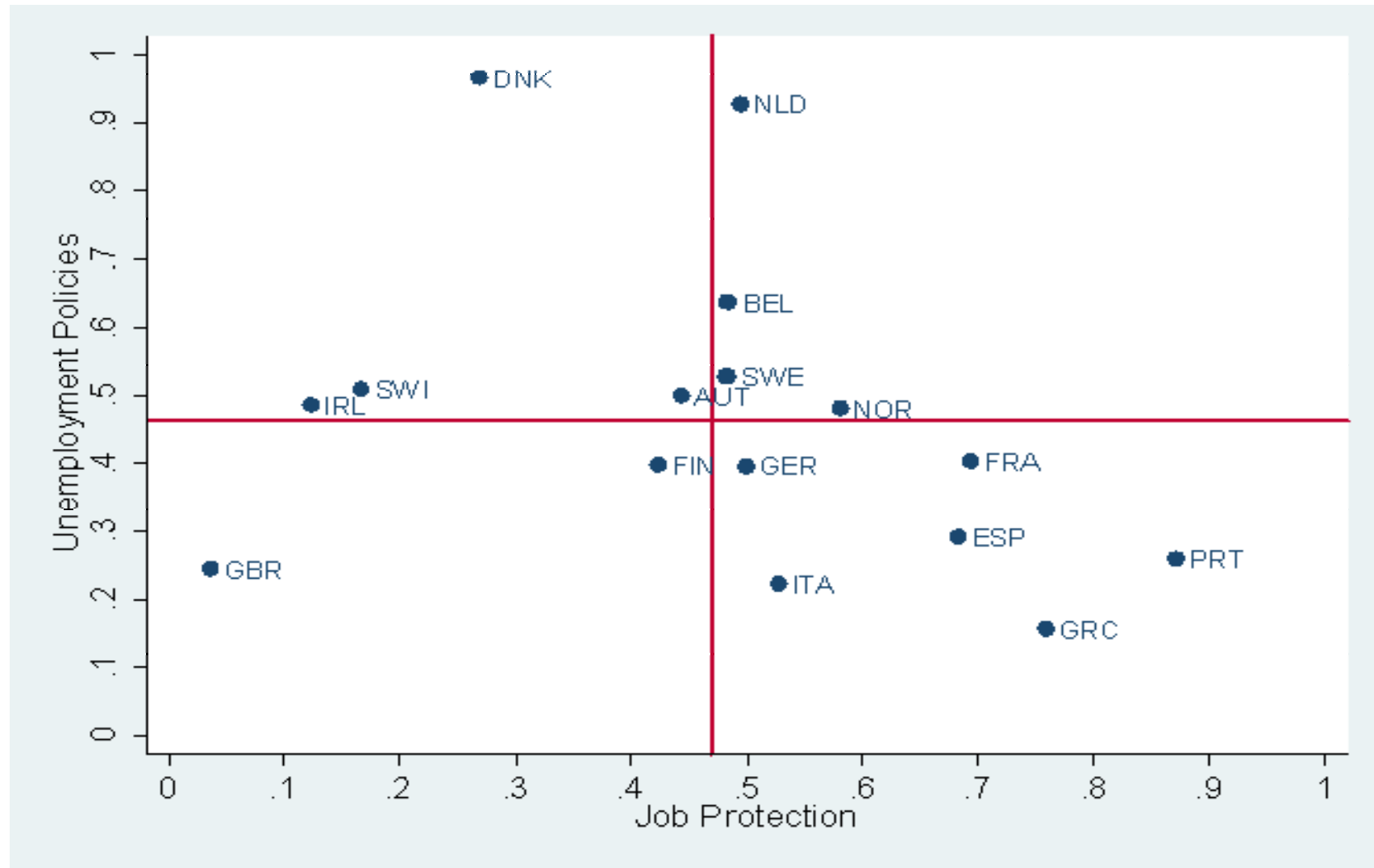
In a cross-section of European countries there exists a trade-off between job protection and support to the unemployed:

- Countries which adopt stronger dismissal restrictions, tend to enjoy smaller unemployment insurance programs, and viceversa *flexicurity* involves high UB (and ALMP) and low EPL.

# The Trade-off



## European countries



## The Trade-off (without the UK)

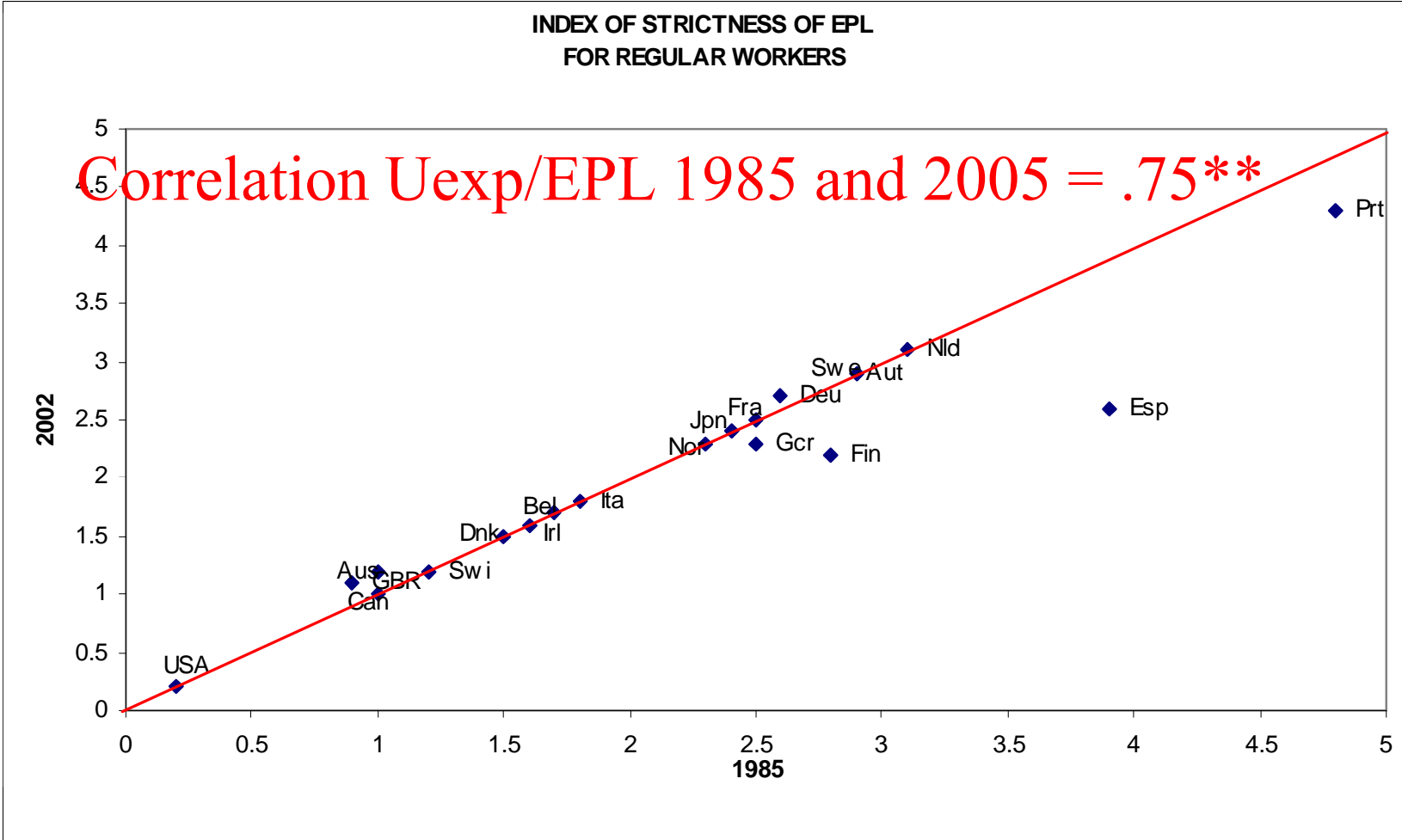
EPL correlated with	Working-age population	Male prime-age (25 to 45)
Uexp	-.53*	----
UBcov	-.51*	-.71**
UBrr*UBcov	-.41	-.66**
** significant at 99      * significant at 95 nr of observations =15		

# Flexicurity is politically correct

- Lisbon strategy (2000): “need to improve the *adaptability* of workers and enterprises.”
- Integrated Guidelines (2002): “Member States are asked to promote *flexibility combined with employment security*”
- 2006 Spring European Council: “need to develop comprehensive policy strategies .... reforming labour market and social policies under an *integrated flexicurity approach*.”
- 2007 Recommendations of the Flexicurity Group
- European Parliament deliberations with the agreement of social partners. Support of the ETUC.

# A Stable Trade-off

EPL for regular workers: late 2002 vs. 1980s



## AIM OF THE PAPER

Explain the existing trade-off between Unemployment Support and Job Protection

Why do countries resort to so much different institutional configurations to protect individuals against labor market risk?

Answer based on political-economic explanations and analysis of the redistribution operated by these institutions



## RELATED LITERATURE

- Pissarides, 2001. *Substitutability*. If severance payments and notice periods (EPL) are chosen optimally to maximize welfare of risk-averse agents, then no role for UB
- Blanchard and Tirole, 2003. Advocate use of layoff taxes to finance experience-rated UI and reduction in the use of judicial system in layoffs. Convergence of EPL to UB. Full insurance is possible.
- Missing explanation: why cross-country heterogeneity in the design and scope of EPL and UB?
- Algan and Cahuc (2006): cultural factors. Civic attitudes.

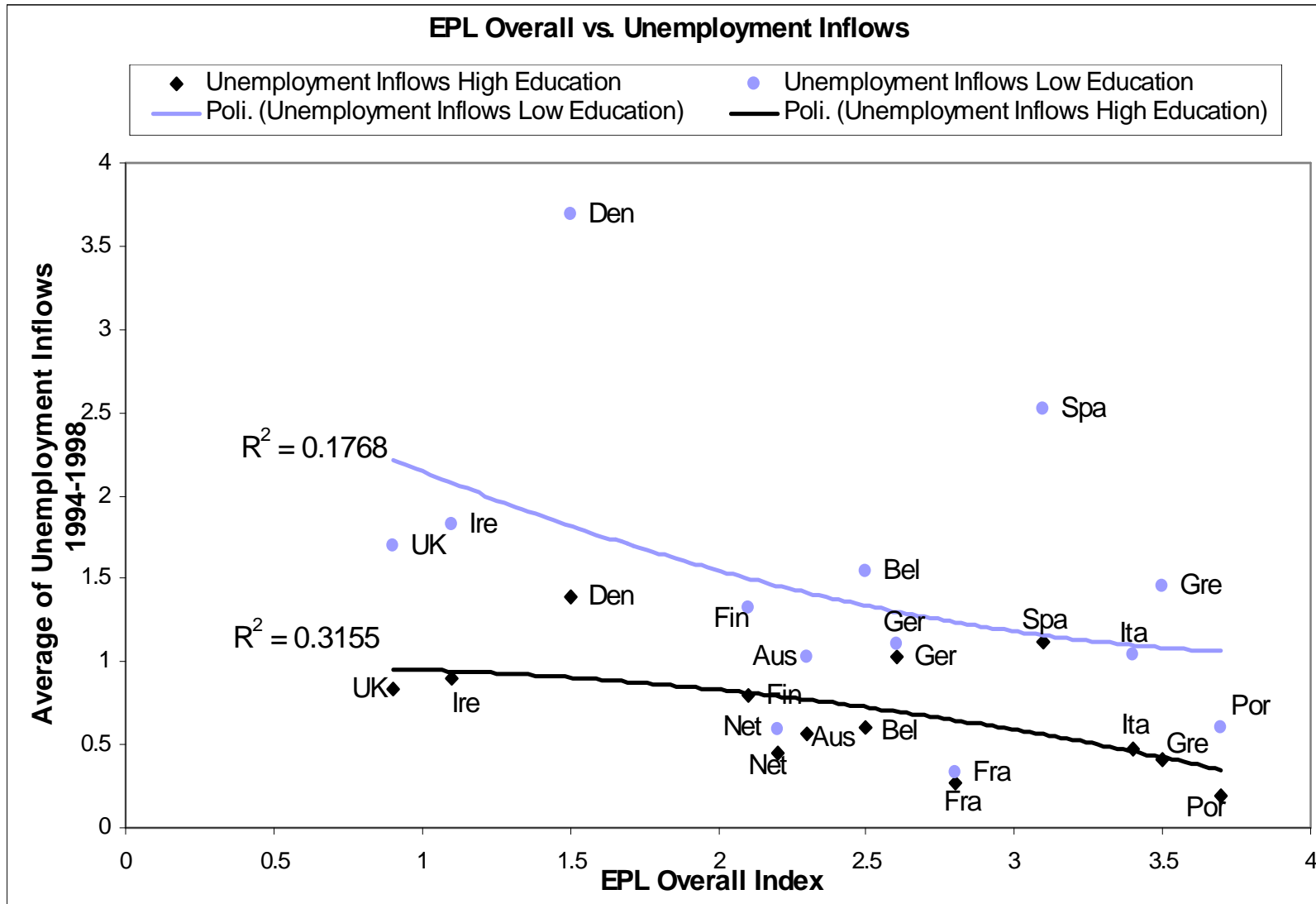
## OUR EXPLANATION

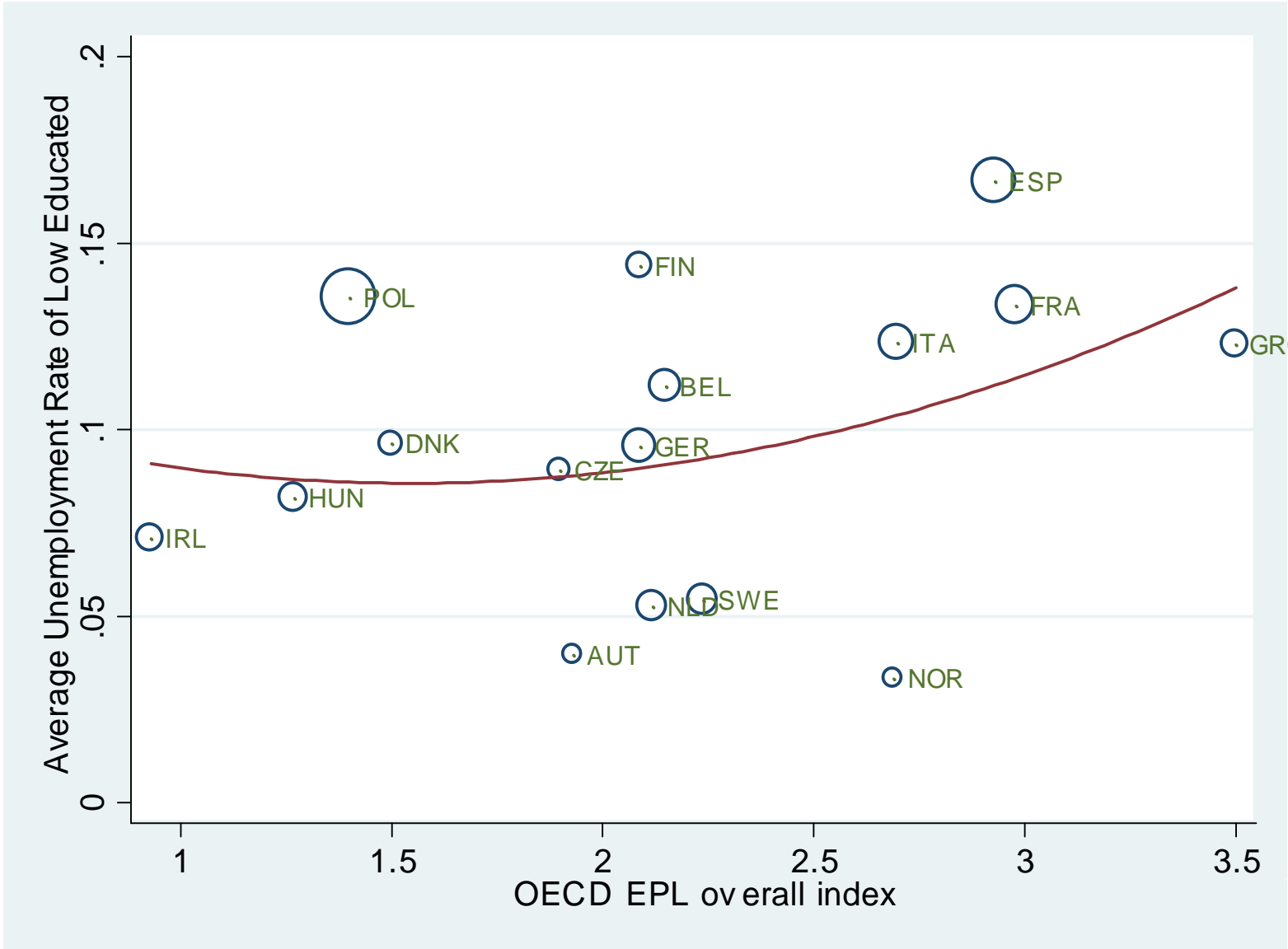
➤ *Double heterogeneity*: UB and EPL protect against unemployment risk (*insiders-outsiders*), but they also redistribute from the *rich to the poor* (in different manners). Class struggle in addition to protection of incumbents.

## WHY IS EPL REDISTRIBUTIVE?

- ***Red tapes* matter the most for EPL:** OECD (1999) and Cazes, Boeri and Bertola (2000) suggest that the *difficulty of dismissal*, accounts for most of the reduction in the dismissal rate associated with a more strict EPL. Unavoidable involvement of judges somewhere due to moral hazard.
- ***Red tapes* typically constitute a fixed cost.** If the value of the workers' productivity is close to zero, EPL protects mostly low ability workers, as firms are more willing to fire costly workers.

# REDISTRIBUTIVENESS OF EPL





## Explicit redistribution of UBs

**Table 2: Progressiveness of Unemployment Benefit System**

Country	67/100	67/150
Australia	1.45	1.96
Austria	1.00	1.00
Belgium	1.32	1.80
Canada	1.06	1.51
Czech Republic	1.00	1.00
Denmark	1.38	1.79
Finland	1.22	1.52
France	1.06	1.15
Germany	1.02	1.00
Greece	1.48	2.09
Hungary	1.35	1.71
Iceland	1.35	1.86
Ireland	1.40	1.83
Italy	0.93	1.09
Japan	1.17	1.40
Korea	1.06	1.50
Luxembourg	0.99	0.97
Netherlands	1.14	1.37
New Zealand	1.43	2.04
Norway	0.98	1.23
Poland	1.44	2.14
Portugal	1.04	0.96
Slovak Republic	0.95	1.24
Spain	1.10	1.58
Sweden	1.06	1.49
Switzerland	1.14	1.13
UK	1.40	2.03
USA	1.00	1.18

## OUR EXPLANATION

- *Double heterogeneity*: UB and EPL protect against unemployment risk (*insiders-outsiders*), but they also redistribute from the *rich to the poor* (in different manners).
- The mix of these two policies is determined in the political system
- More education of the workforce increases UB and reduces EPL
- More progressiveness in the UB system also increases UB and reduces EPL

## ROAD MAP

1. A Simple Economic Environment
2. Labor Market Institutions
3. Voting Game
4. Politico-Economic Equilibria and the trade-off EPL-UB
5. Empirical Implications
6. Conclusions and further research

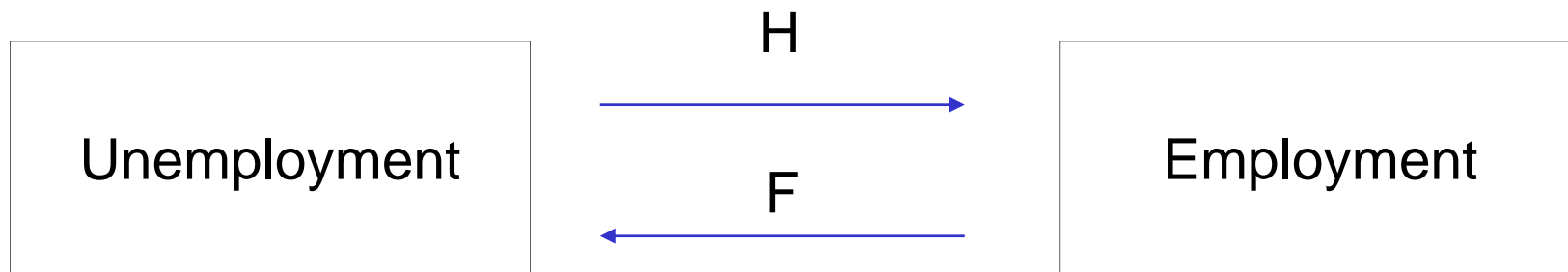


## ECONOMIC ENVIRONMENT

- ✓ Infinitely lived agents with logarithmic preferences over consumption:  $v(c) = \ln(c)$
- ✓ No savings
- ✓ Two types of agents: low ( $l$ ) and high ( $h$ ) ability,  $\rho_l > \rho_h$  with different wages,
- ✓ Wage setting for low skill individuals, high skill wages determined in the competitive market
- ✓ Production function: 
$$Y = (L_l)^\alpha (L_h)^{1-\alpha}$$
$$L_l = l_l(1 - u_l) \text{ and } L_h = l_h(1 - u_h)$$

## ECONOMIC ENVIROMENT

- ✓ Labor Market Dynamics: Agents may be employed (Insider) or unemployed (Outsider).



- ✓ **in-flow rate (Firing):  $F^j(s)$**  and **out-flow rate (Hiring):  $H^j(s)$**

where  $s$  is the degree of EPL

$$u^j = \frac{F^j}{F^j + H^j} \quad \frac{\partial u^j}{\partial F^j} \geq 0; \frac{\partial u^j}{\partial H^j} \leq 0$$

## LABOUR MARKET INSTITUTIONS

### Unemployment Insurance $(b^j, \tau)$

- Program taxing, at  $\tau$ , the *insiders* and providing a transfer,  $b^l, b^h$
- Balanced budget every period
- Separate Programs: initially no redistribution  $\phi=0$

$$b^l = \frac{\tau w^l (1 - u^l)}{u^l} + \phi \frac{\tau w^h (1 - u^h)}{u^l}$$

$$b^h = (1 - \phi) \frac{\tau w^h (1 - u^h)}{u^h}$$

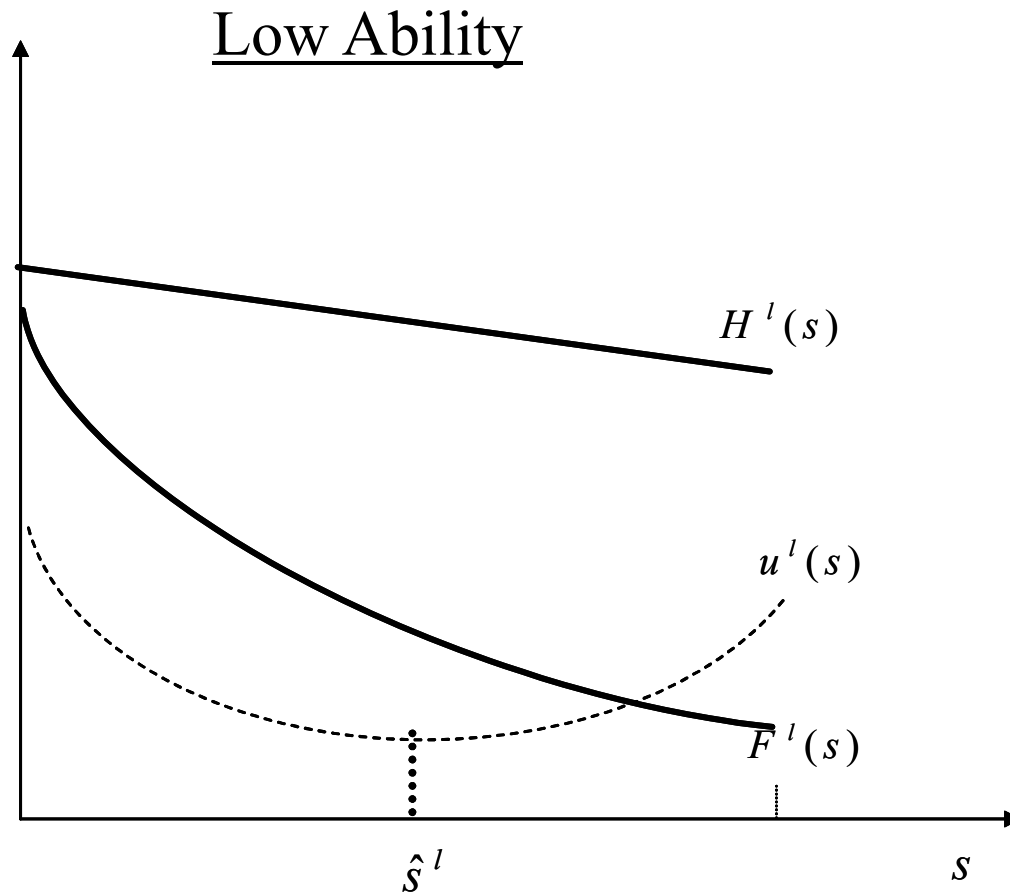
# LABOUR MARKET INSTITUTIONS

## Employment Protection Legislation

- EPL as difficulty of dismissal
- Severance Payment Component of EPL is disregarded. Pure tax. No transfer from employer to employee.
- Redistributive Aspect: EPL as a regulation, protecting mainly the low ability
- HP: No effect on high ability

# LABOUR MARKET INSTITUTIONS

## Employment Protection Legislation $0 < s < 1$



Unemployment Flows

HP: Firing:  $F^l(s) > F^h$

HP: Hiring:  $H^l(s) < H^h$

## LABOUR MARKET INSTITUTIONS & WAGES

- NB Wage Setting for Low Skill Individuals.

$$w^l = (1 - \beta)b^l + \beta \frac{(1 - \delta)}{\delta} \psi(s)$$

with  $\psi'(s) > 0$  for  $s < \tilde{s}_l = \arg \max \psi(s)$

- Equilibrium Wage in a competitive labor market for high skill individuals.

$$w^h = \frac{(1 - \alpha)^{1/\alpha}}{(1 - u^h)^\alpha} (1 - L_l(s))^\alpha$$

$$\hat{s}_l = \arg \max w^h$$

## INDIVIDUAL PREFERENCES

$$V_i^j(s, \tau) = (1 - \theta_i^j) \ln((1 - \tau)w^j) + \theta_i^j \ln(b^j)$$

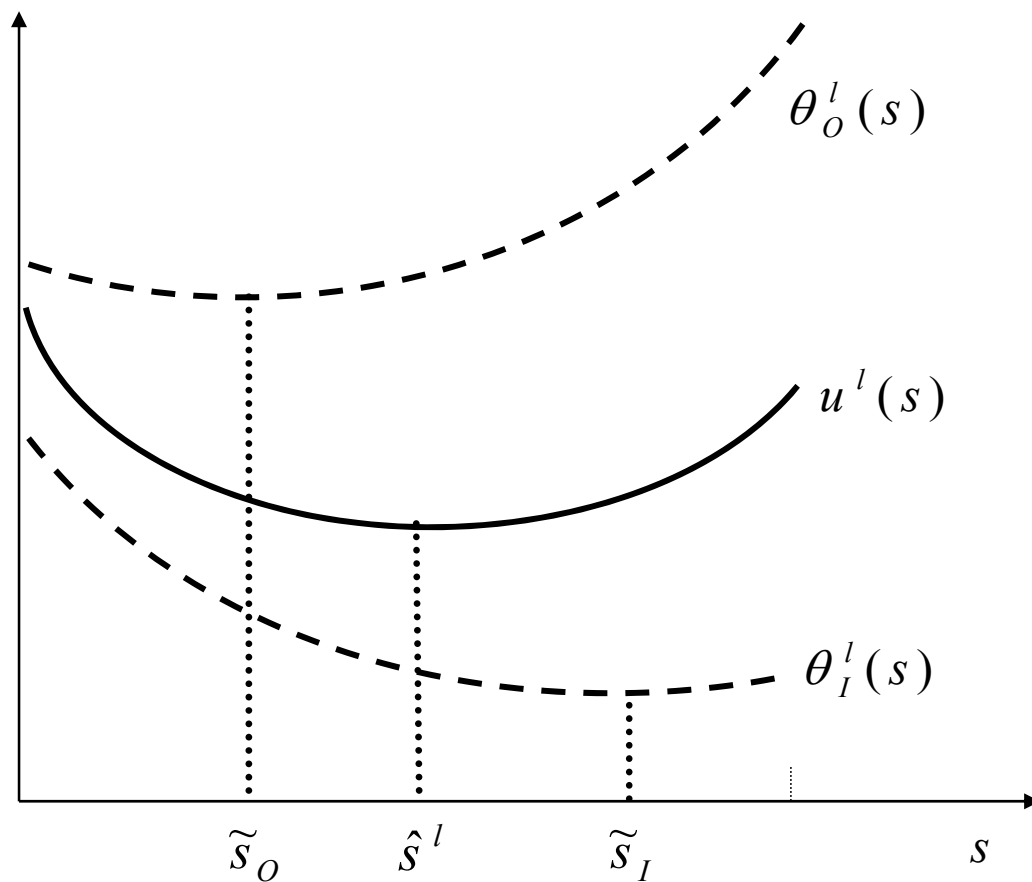
where:

$$\theta_o^j(s) = \frac{1 - \beta + \beta F^j}{1 - \beta + \beta (F^j + H^j)} \quad \text{and} \quad \theta_i^j(s) = \frac{\beta F^j}{1 - \beta + \beta (F^j + H^j)}$$

represents the *discounted* proportion of time that a type-j agent who is currently an outsider/insider will spend unemployed.

$$\theta_o^j(s) \geq \theta_i^j(s)$$

# INDIVIDUAL PREFERENCES



$$w^l(b^l, \psi(s))$$

$$\tilde{s}_I = \arg \max \psi(s)$$

$$s_b \in (\hat{s}_l, \tilde{s}_I) = \arg \max b_l$$

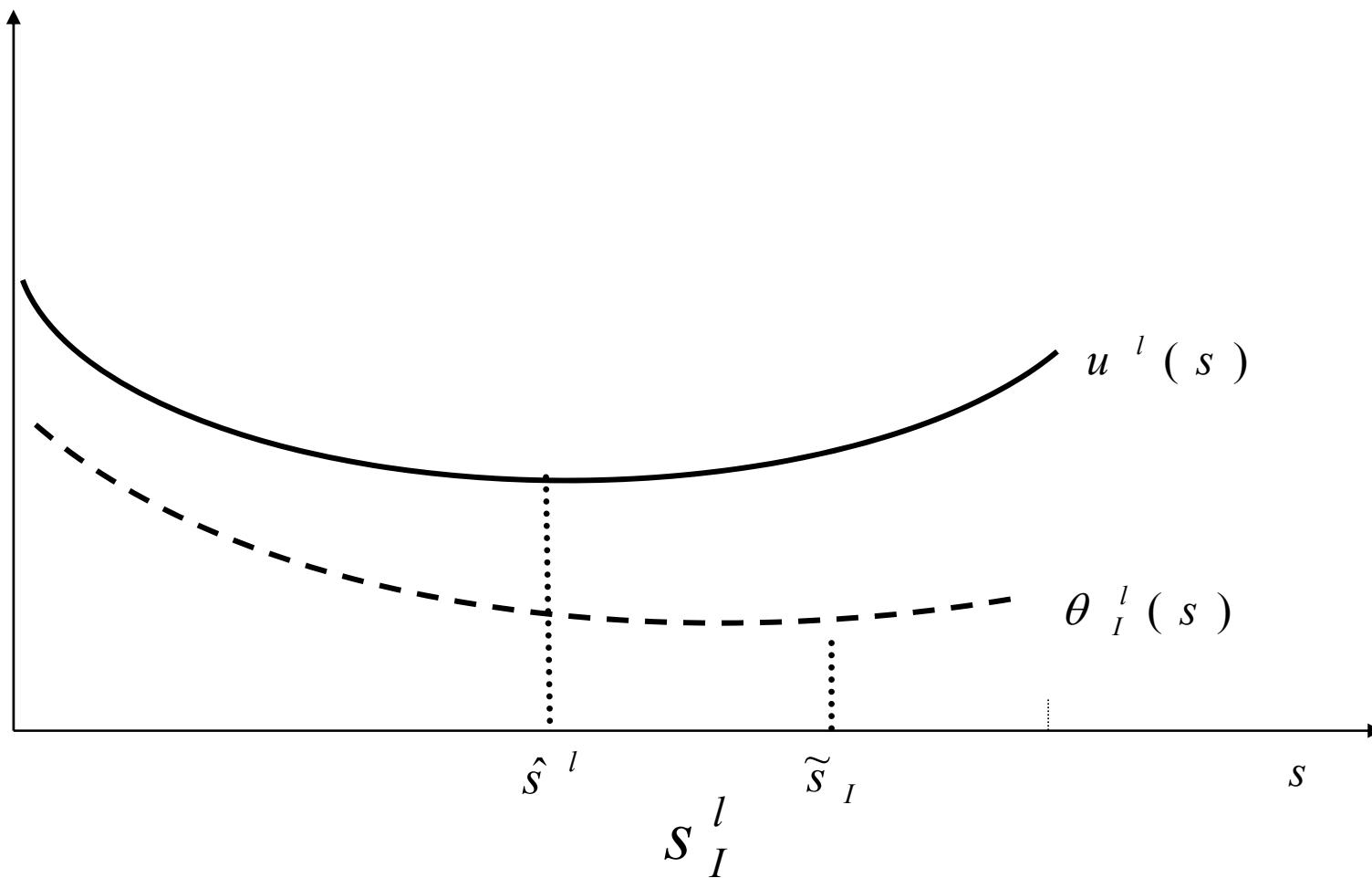
$$\hat{s}_l = \arg \max w^h(s)$$



## MULTIDIMENSIONAL POLITICAL GAME

- ✓ *Multidimensional Voting Game* may lead to *Condorcet* cycle and lack of equilibria.
- ✓ We restrict to steady state analysis and assume that the voting game takes place once and for all. (No dynamic aspects of the game).
- ✓ The Low Ability Insider's decision may emerge as equilibrium outcome of two different voting games:
  1. *Issue-by-issue voting* (Shepsle, AJPE 1979).
  2. *Party-Unanimity Nash Equilibrium* (Roemer, Econ 1999).

# LOW ABILITY INSIDERS' DECISION OVER EPL (s)



## LOW ABILITY INSIDERS' DECISION OVER UB ( $\tau$ )

$$V_i^j(s, \tau) = (1 - \theta_i^j) \ln((1 - \tau)w^j) + \theta_i^j \ln(b^j)$$

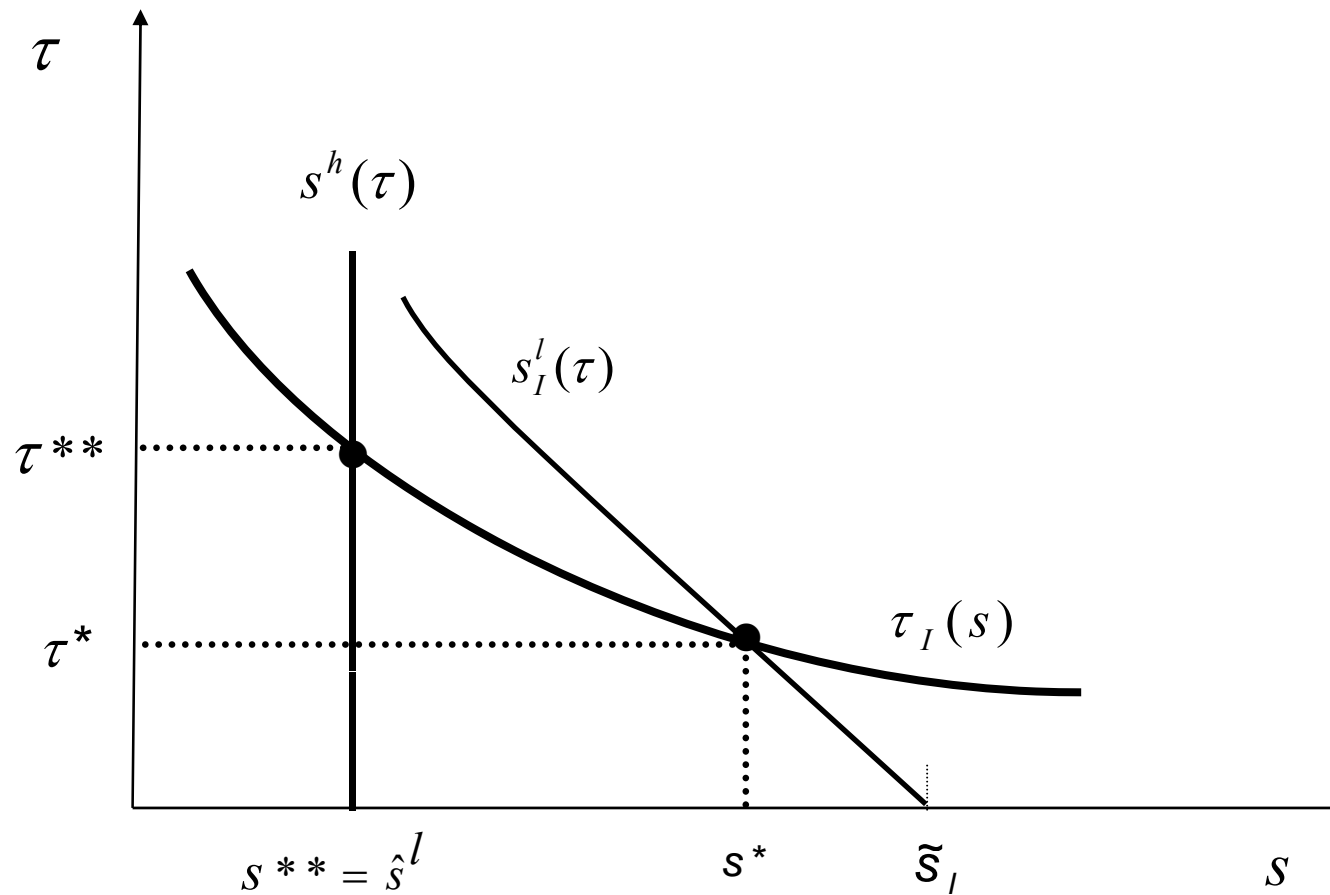
✓ **Trade off:** Current and Future Contributions & effect on Wages via UB in the wage setting (lower the greater is  $\beta$ )

✓ More EPL (in the range) reduces the proportion of time expected to be spent unemployed (and affects wages and UB) and induces

lower taxes:

$$\frac{\partial \tau_I^l(s)}{\partial s} < 0$$

## LOW ABILITY INSIDERS' DECISIONS



## What Explains the cross-country Trade off?

- Complementarities in production. Skilled workers' productivity (and hence wage) increases with employment of the unskilled. They vote for more EPL than unemployed unskilled, even if they are not directly affected by it.
- Degree of Redistribution ( $\phi$ ) of the UB systems makes UB more convenient to Low Ability:

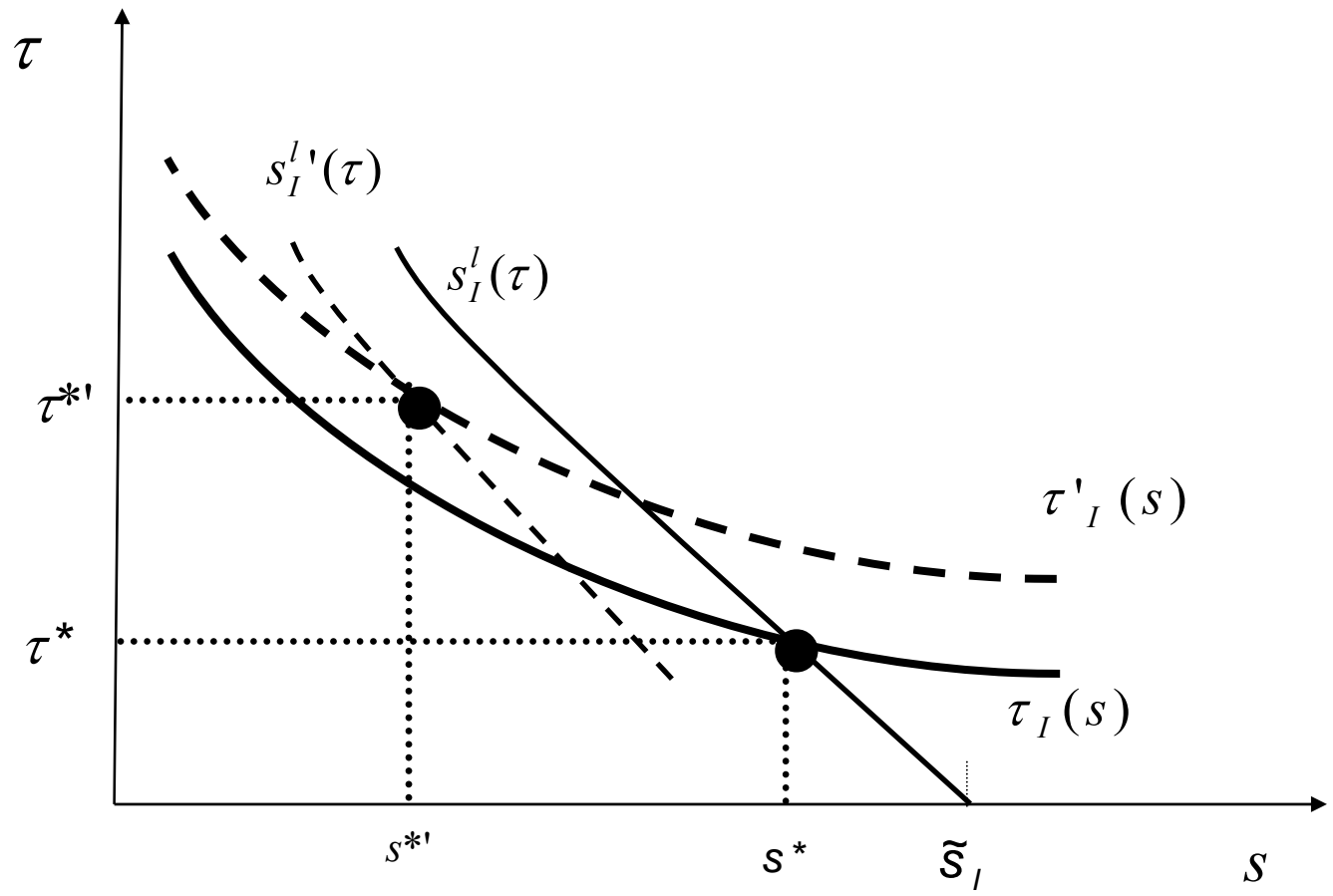
## What else can Explains the cross-country Trade off?

- Consider an environment with **no insurance motive** for UB because capital markets allow for self-insurance. In particular, assume a linear utility (and an exogenous Laffer curve  $\tau(1-\tau)$  limiting the taxes charged to the high skill types).
- With no insurance motive, demand for UB due to **redistribution** from the high to the low skill individuals ( $\phi > 0$ ).
- For large enough  $\phi$ , low skill individuals (**both insiders and outsiders**) support UB, while high skill individuals (both insiders and outsiders) oppose UB.
- Redistribution affects also the voting on EPL for the low skill individuals as it makes high skill wages relevant for the low skill. They partially internalize the cost of high EPL on the wages of the high skill.

## A political feasibility theorem: redistribution and the trade-off

- Consider the equilibrium featuring the low skill insiders as a median voter both on EPL and on UB
- A Higher Degree of Redistribution of the UB systems ( $\phi$ )
  - makes UB more convenient to Low Ability. Hence,  $t$  increases: more UB
  - make EPL more costly to low ability, because (i) it reduces the wages of the high ability, and thus the redistributive transfer; and (ii) with more UB individuals demand less protection, i.e., lower EPL.
- Hence, higher redistribution allows to move to an equilibrium with less EPL and more UB

# REDISTRIBUTION AND THE EPL-UB TRADE-OFF





## EMPIRICAL RELEVANCE

Our model implies:

- education of the working age population negatively correlated to EPL per given UB
- estimates of the tradeoff based “panel” of European countries (4 five years averages from 1987 to 2002)
- dependent variable:  $\log(1+U_{\text{exp}}/EPL)$

# Descriptive statistics OECD

Variable	1985					2000				
	Obs	Mean	Std. Dev.	Min	Max	Obs	Mean	Std. Dev.	Min	Max
ln(1+Uexp/EPL)	13	4,02	0,43	3,02	4,54	16	4,04	0,57	2,53	4,78
Uexp	13	10559,04	6497,31	1597,85	26638,81	16	22753,94	16787,67	2507,77	59010,98
epl overall	13	2,52	1,04	0,60	3,82	16	2,22	0,85	0,68	3,67
epl regular	13	2,36	0,83	0,95	3,88	16	2,29	0,81	1,12	4,33
mkt capitalization	13	35,08	24,90	5,83	92,08	16	112,21	78,88	15,44	317,03
low edu	13	44,18	12,62	23,60	66,10	16	34,86	13,37	10,10	61,10

VARIABLES	(1) ln_ub_eplall	(2) ln_ub_eplall	(3) ln_ub_eplreg	(4) ln_ub_eplreg
m_attitudes	0.299 (0.234)		0.458 (0.286)	
m_openk	0.005 (0.003)	0.007* (0.003)	0.003 (0.004)	0.004 (0.004)
low_edu	-0.034*** (0.007)	-0.034*** (0.007)	-0.029*** (0.008)	-0.031*** (0.008)
m_mkt	0.008*** (0.002)	0.010*** (0.003)	0.009*** (0.003)	0.010*** (0.003)
eu15	0.341 (0.465)	0.188 (0.541)	-0.080 (0.567)	-0.160 (0.619)
eur_nms	-0.427 (0.499)	-0.402 (0.577)	-0.921 (0.608)	-0.842 (0.660)
oecd_noneu	0.027 (0.443)	0.089 (0.521)	-0.507 (0.540)	-0.455 (0.596)
Constant	2.475*** (0.564)	2.387*** (0.599)	2.726*** (0.687)	2.776*** (0.685)
Observations	75	89	75	89
$R^2$	0.851	0.794	0.785	0.723
Number of countr_id	23	25	23	25

Standard errors in parentheses  
\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

## 54 countries with UB and EPL

	1985-2002				
Variable	Obs	Mean	Std. Dev.	Min	Max
$\ln(1+UB/EPL)$	72	2,17	1,86	0,05	5,36
Uexp	26	12355,98	9662,43	1514,80	35061,40
epl overall	28	2,16	1,03	0,21	3,88
epl regular	28	2,18	0,88	0,17	4,53
mkt capitalization	83	33,86	37,58	0,27	166,60
low edu	77	55,58	21,75	8,40	97,65

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Argentina	Greece	Philippines
Australia	Hong	Poland
Austria	Hungary	Portugal
Belgium	India	Romania
Bolivia	Indonesia	Russia
Brazil	Ireland	Senegal
Canada	Israel	Singapore
Chile	Italy	Spain
China	Jamaica	Sri Lanka
Colombia	Japan	Sweden
Denmark	Kenya	Thailand
Dominican Republic	Korea	Uganda
Egypt	Malaysia	United Kingdom
Finland	Mexico	United States
France	Netherlands	Venezuela
Germany	Norway	Zimbabwe
Ghana	Pakistan	
Greece	Peru	

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## Regression 54 countries 1985-2002

	ln(1+UB/EPL)	
	(1)	(2)
attitudes		0.489 (0.497)
high_income	2.086*** (0.456)	1.858*** (0.500)
low_edu	-0.028*** (0.010)	-0.024* (0.012)
openk	-0.008** (0.003)	-0.010** (0.004)
constant	3.365*** (0.709)	3.367*** (0.817)
Observations	209	126
R squared	0.544	0.347

# Size of the effects

- Regression over EU: a 10 per cent decrease in the share of the population with primary or lower levels of education increases the Uexp/EPL tradeoff by 0.28 of the standard deviation of this measure.
- Regression over 54 countries: a 10 per cent decrease of LOWEDU increases the UB/EPL tradeoff by 0.23 of the STDEV.

## THE OU(K)TLIER

	UK	EU
U exp per Unemployed	6585	17112
Coverage	0.36	0.75
UB*Coverage	0.03	0.32
GRR to 1 year	0.19	0.54
EPL overall	0.62	2.62
EPL regular	0.98	2.44
<b>Progressiveness UB</b>	<b>2.03</b>	<b>1.15</b>
<b>Cap_Mkts</b>	<b>127.88</b>	<b>54.77</b>
<b>Low. Edu.</b>	<b>38.5</b>	<b>39.54</b>



## REFORMS involve more progressiveness of UBs

	$\Delta\text{EPL}_{\text{reg}}$	$\Delta\text{U}_{\text{exp}}$	$\Delta\text{UB}_{\text{prog}}$
<b>Spain</b>	<b>-0.36</b>	<b>0.08</b>	<b>0.03</b>
Greece	0.00	0.00	-0.03
<b>Finland</b>	<b>-0.14</b>	<b>0.03</b>	<b>0.03</b>
Denmark	0.00	0.20	-0.02

$\Delta\text{U}_{\text{exp}}$ : change in expenditure (in UB and ALMP) per unemployed.

$\Delta\text{UB}$  Progressiveness: change in the ratio of the replacement rates at two earning levels (150 per cent to 2/3 of the wage of the average production worker).

## CONCLUSIONS

- ✓ In this paper we have shown that different institutional configurations can be interpreted as political-economic equilibria.
- ✓ The trade-off between EPL &  $U_{exp}$  may be explained by conflicting interests of Insiders-Outsiders & Low-High Skilled.
- ✓ More educated labor force leads to more unemployment policies and less job protection.
- ✓ More progressive UB systems can also induce more flexicurity without changing the median voter. Important when better capital markets allow for self-insurance.
- ✓ Temps as a way to change majorities? Do rules allow for that?
- ✓ Our empirical results are encouragingly in line with the implications of the model.