

Dualism: Finance and the Great Recession

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In the last 20 years labor market flexibility has been at the centre of the policy debate. A lot of press coverage. It also attracted considerable interest by researchers, either economists or sociologists (a bit also political scientists). In this debate the status quo is typically compared with a labor market in which dismissals are less costly for **all workers**. Surveys eliciting preferences over flexible vs. rigid labor markets indicate that youngsters are more favorable to flexibility than older workers

However:

- Reforms actually implemented in most OECD countries rarely increase or reduce employment protection for everybody as envisaged by the public debate, by many researchers and by the public opinion surveys
- while they create long-lasting asymmetries between different categories of workers
- Effects of these asymmetric or **multi-tier reforms** are much different and have yet to be fully understood

Outline

- 1 The Nature of Reforms Increasing Flexibility
- 2 Framing a Dual Labor Market
- 3 Empirical Evidence on Dualism
- 4 What happens during Recessions and Upturns
- 5 The Financial Crisis and Dualism
- 6 The Legacy of the Great Recession
- 7 An Exit Strategy from Dualism

Two-tier and Marginal Reforms

Institutional **reform**: change in the design of an institution

- **Two-tier (vs. complete)** reform: focus on the scope/coverage; the reform is confined to a subset of the potentially eligible population (less than 50% of the potentially eligible population involved; alternatively its complete phasing in involves a very long transitional period)
- **Incremental (vs. discrete)** reform: focus on the size; the reform involves a small change in the overall institutional level-indicator (variation of the relevant OECD indicator of less than 10% of the average period cross-country standard deviation in the level of the institution)
- **Structural** reforms: either complete and discrete reforms

The Taxonomy

Size	Discrete Two-tier	Structural
	Incremental Two-tier	Incremental Complete
	Scope	

Tracking Reforms in Europe

A snapshot from Fondazione Debenedetti database (1):

Spain - EPL database

Year	Month	id	Number	Law	Description	Topic	Target
1980	3	ES077	1	Ley 51/1980, Basic Employment Law (Ley Básica de Empleo)	Regulations governing the contract of employment, making contracts of employment more flexible; permanently established workforce representatives as a way to regulate workers' participation; and consolidated the status of collective agreements, as opposed to Labour Ordinances, as the principal source of industry-wide and occupational provisions.	Trade union rights	employees
			2		Regulation on termination of employment contracts.	Individual dismissals - Procedural obligations	employees
1981		ES078	1	Real Decreto 1362/1981	Regulation of fixed-term contracts	Fixed-term contracts	Fixed-term contracts
1984	8	ES001	1	Ley 32/1984	Restrictions for fixed-term contracts are substantially relaxed. Legal norms that established the circumstances under which a fixed term contract could be stipulated are practically over rided by the principle of promoting employment through the extension of its use. The so called "Contrato temporal de fomento del empleo" (Temporary Employment Promoting Contracts - TEPC) has a maximum duration of 3 years and a minimum of 6 months. The limit to the maximum number of TEPC to be signed is eliminated.	Fixed-term contracts	Fixed-term workers

Tracking Reforms in Europe

A snapshot from Fondazione Debenedetti database (2):

Spain - EPL database

Topic	Target	Sign	Overall sign	Two-Tier vs. Complete	Two-Tier vs. Complete - Overall	incremental vs. discrete	Source	Other policy area?
Trade union rights	employees	increasing	increasing	complete	complete	incr	EMIRE	
Individual dismissals - Procedural obligations	employees	increasing		complete				
Fixed-term contracts	Fixed-term contracts	decreasing	decreasing	two-tier	two-tier	incr	NATLEX	
							IBERLEX - Base de datos -	

EPL reforms

- There were 201 EPL reforms (on average, 14 per country) but only 8 were structural
- A trade-off between Size and Scope of Reforms?

number of EPL reforms from 1980 to 2009 in the EU15 countries

Size	Discrete	18 (9.0%)	8 (4.0%)
	Incremental	85 (42.2%)	90 (44.8%)
		Two-tier	Complete
		Scope	

Examples

Examples of Two-Tier reforms:

- The battery of reforms of EPL carried out in Italy in the 1997-2003 period expanded the scope of fixed term contracts, introduced Temporary Work Agency, increased the potential duration of fixed-term contracts and introduced new types of atypical contracts leaving regulations on the dismissals of workers with open-ended contracts unchanged.
- The 1989 reform of the British UB system reduced replacement rates for the short-term claimants, by increasing the length of the minimum waiting period required for eligibility to benefits for this category of workers only.

A model: qualitative description

Extension of standard equilibrium job search model. It takes time to create jobs (matching of workers and vacancies). Jobs are destroyed whenever their productivity falls below a given threshold level.

Unemployment is an equilibrium phenomenon. Job creation and destruction margins affected by employment protection either directly and indirectly, that is, via their effects on wages.

Dualism between entry jobs (fixed duration) and continuing jobs (when entry jobs are converted into jobs lasting until productivity gets too low). Entry jobs are destroyed more frequently than continuing jobs (reservation productivity is higher). They are also paid less other things being equal.

The Long-run Effects of Two-tier Reforms

A two-tier reform of employment protection reduces firing taxes only for entry jobs. This:

- increases both hiring and separations on entry (fixed-term) jobs
- makes it more difficult to convert fixed-term into permanent contracts
- increases wage differentials between entry (fixed-term) and continuing jobs.

Notice that the effects on separations, conversion rates of fixed-term into permanent contracts and on wage differentials across types of contracts are not present when reforms are complete.

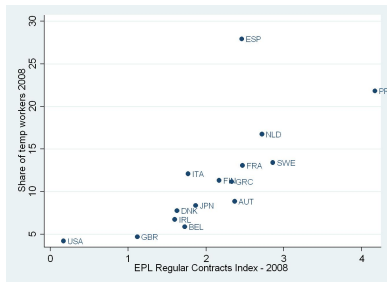
The Size of the Asymmetry

Moreover, the larger the asymmetry created by the reform between fixed-term and permanent contracts:

- the larger the share of employment in fixed-term contracts
- the lower the probability of converting fixed-term into permanent contracts
- the larger the wage differentials between entry (fixed-term) and continuing jobs.

Effects of stricter EPL on dualism

$$\rho = 0.81$$



Strictness of EPL for Permanent Contracts and Share of Temporary Contracts in Total (Dependent) Employment

$$\rho = -0.72$$



Strictness of EPL for Permanent Contracts and Transition Probability from Temporary to Permanent Contracts

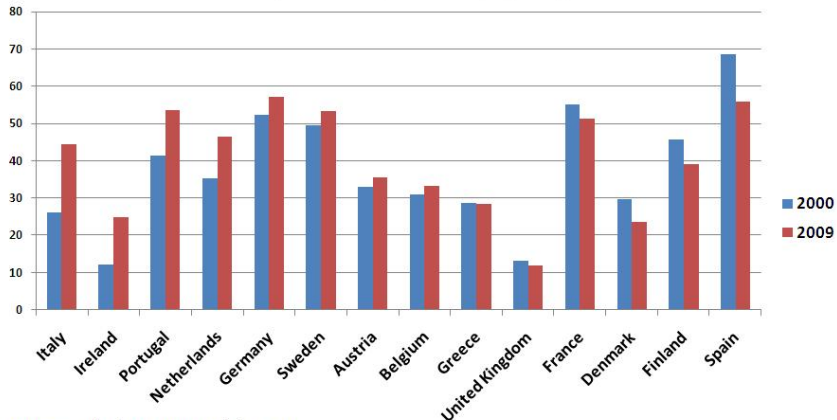
Wage premium on permanent contracts

	Wage premium for permanent contract	Yearly Probability of Transitioning from a Temporary to a Permanent Contract
Austria	20.1	47.4
Belgium	13.9	40.4
Denmark	17.7	
Finland	19.0	22.7
France	28.9	13.6
Germany	26.6	
Greece	20.2	31.3
Ireland	17.8	46.3
Italy	24.1	31.2
Netherlands	35.4	
Portugal	15.8	12.1
Spain	16.9	28.3
Sweden	44.7	
United Kingdom	6.5	45.7

Source: European Community Household Panel and European Union Survey of Income and Living Conditions.

Dualism for the Under25

Share of Temporary Employment
(as a % of Dependent Employment)



Source: Oecd, Labour Force Statistics, 2011

Dualism over the Cycle

- Increase in volatility of employment and unemployment.
- Decline in labor productivity
- Temporary job creation (honeymoon) effect during expansions.

The Honeymoon Effect(Boeri and Garibaldi, 2007)

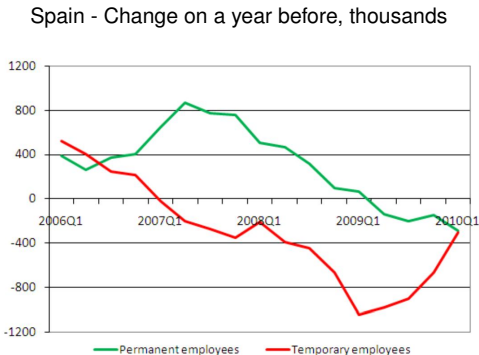
Pre-Reform EPL Strictness and Post-Reform Temporary Employment

Country	Time Period	EPL strictness (Regular Index)	EPL Strictness (Temporary Empl.)	Temporary Emp. Growth ΔETt (000)	Contribution of Temporary Jobs $\Delta ETt/E_0$
Belgium	1987-1996	1.68	4.63	22.7	0.66
	1997-2005	1.71	2.63	135.3	3.54
	Δ	0.03	-2.00	112.6	2.89
Italy	1987-1997	1.77	5.38	402.9	0.02
	1998-2005	1.77	2.82	823.2	4.11
	Δ	0	-2.56	420.3	4.09
The Netherlands	1987-1995	3.08	2.38	340.1	5.79
	1996-2005	3.06	1.45	288.8	3.80
	Δ	-0.02	-0.93	-51.3	-2
Portugal	1987-1996	4.56	3.34	-168.9	-4.10
	1997-2005	4.29	2.94	431.8	10.09
	Δ	-0.27	-0.40	600.6	14.19
Spain ¹	1981-1984	3.83	-	0	0
	1985-1995	3.67	3.66	3377.1	28.5
	Δ	-0.16	-	3377.1	28.5
Sweden	1987-1996	2.88	3.28	-138.9	-3.22
	1997-2005	2.86	1.63	189.2	4.82
	Δ	-0.02	-1.65	328.1	8.04

¹ For Spain, 1981-1984, the EPL index is the overall index, as in Nickell (2006)

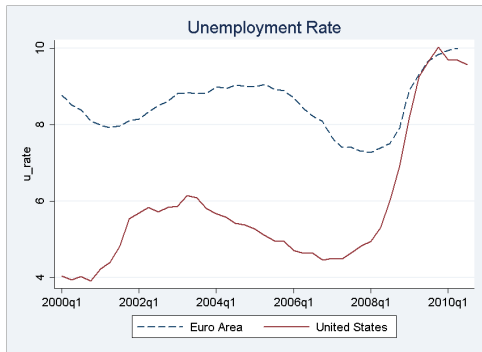
During Downturns

Job destruction concentrated on fixed-term contracts. Other workers are largely insulated from the adjustment.



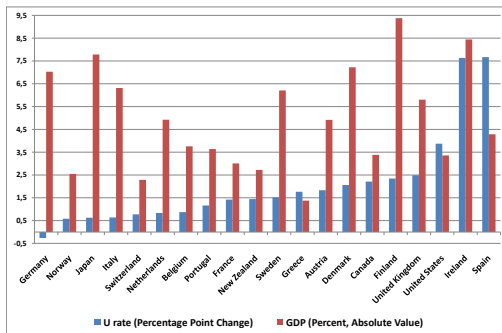
Source: S. Bentolila, Banco de España and IMF Conference, Madrid 2010.

US more responsive than reformed Europe



Source: OECD

Within EU heterogeneity also conditioning on Output. Not only Dualism



Source: WEO, 2010

Why? Nature (financial) of the Crisis?

- Not enough research on the links between financial crises and labour market dynamics
- More on (steady state) interactions between financial and labour frictions
- Rendon (2000), Belke and Fehn (2002), Arellano et al. (2010) easy access by firms to financial markets as a substitute for labour market flexibility
- Financial market liberalization complementary to labour market deregulation (Boeri, Galasso and Conde-Ruiz, 2006; Wasmer and Weil, 2003)
- Almost nothing on dualism and financial crises (Caggese and Cunat (2008) on hiring of temps and liquidity constraints; also Brunello (2005) on Japan)

Financial Crisis and Dualism: A Job Destruction Effect

- Financial deepening reduces churning and employment volatility. Reduces demand for EPL
- As firms do not adjust employment to transient shocks
- Yet, what happens when a highly leveraged firm experiences a financial shock and liquidity is suddenly pulled back?
- The lack of liquidity can force firms to liquidate projects as well as jobs, thus enhancing job destruction
- It is a **labor demand** effect. Stronger the lower the cost of employment reductions at the margin
- Dualism and high leverage is a dangerous mix

Financial (Housing) Crisis and Dualism: A Job Creation Effect

- Bulk of Job Creation related to startups more than to expansion of existing units.
- Startups are very risky: one out of ten survives 5 years after birth. Higher perception of risk drives resources away from startups. Less new projects. Just some temporary gap filling related to attrition.
- Also less spinoffs and quits to new projects: workers need financial markets and mortgages to finance new projects and mobility (real estate investment)
- During a financial crisis, real estate prices drop, workers face risk of negative equity and mobility is reduced
- This mobility effect of finance can increase unemployment at given vacancy rates. Likely to be more serious when jobs are offered only in temporary contracts
- It is a **job reallocation** effect

The JD Effect: High-leverage and Dualism as a nightmare

Elasticity of Employment to Output	(1)	(2)
Leverage (Debt to Sales)	-0.02**	-0.01**
FC Financial-related Recession	0.0943***	0.1249***
EPL reg share TEMP	-0.0795***	-0.0802 0.011**
Leverage*TEMP*FC		0.030**
Leverage*lowEPL*FC	0.02***	

Including country and sector fixed effects. Source: IMF data

The JD-JR Effect: Mobility, Mortgages and Dualism

Probability of Moving for Job-Related Reasons	(1)	(2)
Age	-0.0259*** (0.0004)	-0.0259*** (0.0004)
Female	-0.0003 (0.0104)	0.0000 (0.0104)
Education	0.1710*** (0.0068)	0.1710*** (0.0068)
HH size	-0.1810*** (0.0043)	-0.1800*** (0.0043)
Perm. Contr.	0.5350*** (0.0183)	0.552*** (0.0185)
Crisis Dummy	0.0397 (0.0490)	-0.0077 (0.0504)
Mortgage*Crisis	-0.3620*** (0.0204)	-0.3600*** (0.0204)
Constant	-1.7090*** (0.0428)	-1.6080*** (0.0453)
Country FE	yes	yes
Year FE	no	yes
Obs.	1,038,982	1,038,982

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

Note: crisis dummy includes both recessions with financial crisis and house bust

All new Hires are Temporary

Percentage decrease (increase) of the stock of employees during (after) the crisis.

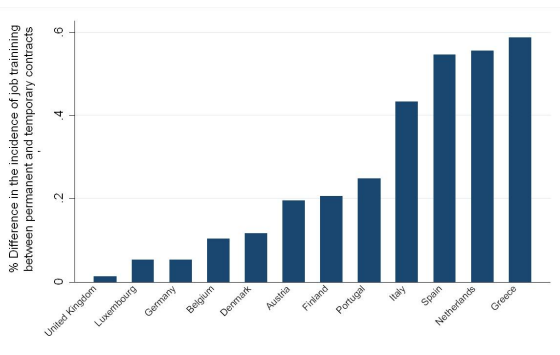
	Share of Temporary Workers over Total Employment 2008Q3	Fixed-Term Job Losses as % of Total Job Losses during the crisis	Fixed-Term New Jobs as as % of Total New Jobs after the crisis
EU	14.26%	34.19%	87.65%
Greece	12.19%	11.92%	261.71%
Spain	29.53%	76.94%	113.20%
France	14.26%	12.81%	139.66%
Italy	13.63%	54.30%	169.20%

Note: recession period is defined following a peak-to-trough approach looking at total employment. For the EU, France and Italy, 2008Q3-2010Q1; for Greece and Spain, 2008Q2-2010Q1

Source: Eurostat

Dualism: Underinvestment in Human Capital

Much less training is offered to fixed-term workers compared to permanent contracts.



Source: ECHP

Lost Generations. Longer term Effects

Evidence of "scarring" effect of unemployment at the beginning of a career

- Ellwood (1982): poor start induces lower lifetime wages and lower employment opportunities
- Mroz e Savage (2006): unemployment at 22 implies earning 30 per cent lower at 25. At age 30-32 below -2-3 per cent
- Kletzer and Fairlie (1999): wage losses over the lifetimes 8 per cent for men and 13 per cent for women
- Gregg and Tomlinie (2001): wage losses 13-21 per cent
- Arulampalam (2001): increase in risk of new job losses
- Bell and Blanchflower (2009) von Wachter (2009): health effect even 20 years after

Summarizing

- Huge Job Losses when High Leverage is accompanied with low EPL or large share of Dual Workers
- Job Losses of Dual Workers very serious problem because of limited access to unemployment benefits
- Hiring currently almost only on short-time work with potential loss of human capital

Dualism during and after FC

- More volatility of employment
- Automatic stabilizers do not operate efficiently
- Higher social costs of recessions
- Reduced Human Capital Investment after financial recessions: hiring on temporary contracts offering no on-the-job training, lower education wage premia, lower incentives to investment also in formal education
- A Lost Generation? Example of the cohorts entering the labour markets in Japan and Sweden after the financial crises of the 1990s

We do not want an Exit from Finance!

- Access to finance reduced unnecessary layoffs in the US (secular fall of temporary layoffs)
- Caggese, Cunat (2008): Financially constrained firms have a larger proportion of fixed-term contracts (higher volatility of total employment)
- Reducing access to finance we cannot exit from dualism as liquidity constraints induce small firms to offer only temporary contracts
- Further example that expected financing constraints matter in hiring decisions

We do not want an Exit from (Contributory) Social Insurance!

- Strengthening of contributory nature of social security is a key condition for sustainability under Ageing Populations and Migration to Welfare
- Policy Response of paying social transfers out of General Government revenues create huge moral hazard problems. Example of the ever increasing STW (Cassa Integrazione) in Italy
- Social Protection to temporary workers should be offered by addressing the Dualism induced by Two-tier Reforms, not by undoing Reforms of Social Security (UB, Pensions, etc.)

We need Smart Reforms

Removing temporary contracts would mean reducing also employment creation in the recovery after having experienced the negative side of dualism. Better to go beyond dualism, working on employers' incentives. Need to balance two forces

- Let firms enjoy flexibility at entry. On the labour demand side, firms benefit from a labour market where experimentation is allowed
- Set a well defined path to stability for workers, through a long run entrance with an open-ended labour contract
- Flexibility is important in the entry phase. Problem of asymmetric information
- Tenure tracks to stable jobs

Contrato Unico, Contratto Unico di Inserimento, Contrat Unique

Proposals developed in Spain (Bentolila, Dolado and 100 academic economists), France (Blanchard-Tirole, Cahuc-Kramarz) and Italy (Boeri and Garibaldi): tenure track to stable jobs with protection increasing with tenure. Differences according to national regulations.

Il Contratto Unico di Inserimento

Italian draft bill differentiates entry through experimentation from genuinely fixed term jobs. Open ended contract with two phases:

- *Entry Phase* (up to the third year): the worker has the right to severance payments proportional to tenure (independently of firm size): dismissal without just cause requires up to six months in severance payments (5 days of severance every month). Entry phase lasts three years
- *Stability Phase* (from third year onward): current legislation (for dismissal without just cause: reinstatement right in firms above 15 employees and six months severance in small firms)
- Fixed term contracts and de-facto dual workers (yet self employed in the books) only with higher salaries (top decile of the current distribution of wages for these contracts) and higher contributions to unemployment benefits

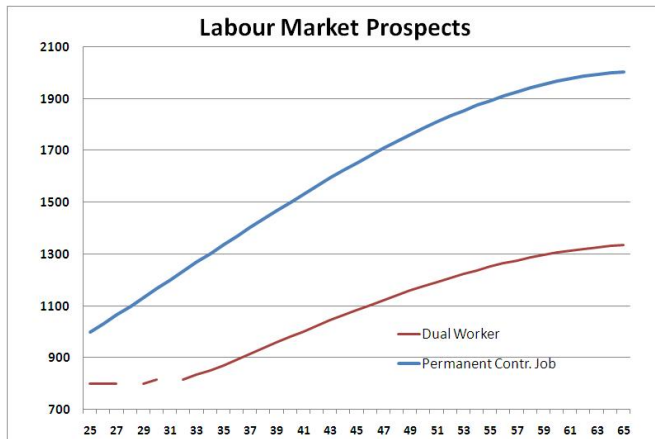
Complementarity with other Reforms

Reforms of collective bargaining increasing the importance of plant-level bargaining and productivity-related pay. Reward less seniority and more productivity. The steeper is the wage tenure profile, the larger is the loss associated to an increase in mobility.

Reforms of Pensions. Increase in Retirement Age as a way to reduce taxes on labor. Increase in net wages at entry. Shift to a sustainable (contributory) system however increases the costs of temporary employment.

Some Simulations

example of Italy. Pensions for Temporary and Permanent Workers



25-28 y.o.: Temporary Job (Co.co.pro.)
29: Unemployed
29-31: Fixed Term Job
32: Unemployed
33-35: Fixed Term Job
35-65: Permanent Job

Source: Boeri and Galasso, 2010.

Pension reforms make Reforms of Labor Contracts even more necessary

Dualism is a threat for future pensions since

- it increases gaps in contributory periods
- it reduces the probability of getting a stable job
- it lowers entry wages that are very important in determining pension benefits