Labour Market Reforms, Dualism and the Financial Crisis

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Outline

1. The nature of Labour Market Reforms
2. Aggregate Effects of Dual-track Reforms: some Theory
3. Empirical Evidence on Dualism
4. The Financial Crisis and Labour Adjustment
5. Putting the pieces together: Dualism and Finance
6. An Exit Strategy from Dualism

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Huge literature on labor market institutions. Theory has predictions on the effects of changes in the levels of each institution. Empirical work uses actual reforms to identify the effects of these institutions as natural experiments

However:

- Reforms rarely increase or reduce a one-dimensional institution for everybody as envisaged by the theoretical literature
- while they create long-lasting asymmetries
- Properties of these multi-tier regimes have yet to be fully understood

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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 eligibile population (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
- Structural reforms: either complete and discrete reforms

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The Taxonomy

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

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 -	

Two-Tier Reforms

- Two-tier reforms: less than 50% of potentially eligible population is involved

Reform area	Two-tier	Complete	Total per row	Of which two-tier
EPL	103	96	199	52%
UB	116	137	253	46%
AP	155	87	242	64%
ECI	74	50	124	60%
ER	49	16	65	75%

where EPL = employment protection legislation, UB unemployment benefits, AP activation policies, ECI employment conditional incentives and ER early retirement.

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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.
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A closer look at EPL

- Incremental reforms: involve variation of the relevant OECD indicator of less than 10% of the average period cross-country standard deviation in the level of the institution
- Two-tier reforms: as above less than 50% rule
- A trade-off between Size and Scope of Reforms?

as a percentage of the total nr of EPL reforms

Size	Scope: Two-tier	Scope: Complete
Discrete	8.5%	3.5%
Incremental	43.3%	44.7%

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Labor Market vs. Financial and Product Market Reforms

Reforms of Product, Financial and Labor Markets

Product Mkt Reforms	Decreasing the Wedge	Increasing the Wedge	Total	Of which Increasing
Discrete	31	0	31	100%
Incremental	8	14	22	57%
Total	39	14	53	74%
Of which discrete	79%	0%	58%	

Financial Mkts Reforms	Decreasing Wedge	Increasing Wedge	Total	Of which Decreasing
Discrete	52	0	52	100%
Incremental	42	0	42	100%
Total	94	0	94	100%
Of which discrete	45%	0%	45%	

Labor Mkt Reforms	Decreasing Wedge	Increasing Wedge	Total	Of which Decreasing
Discrete	16	12	28	57%
Incremental	23	18	41	56%
Total	39	30	69	57%
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How LM institutions are reformed: a summary

- Many LM reforms
- Sometimes undoing previous reforms: net changes in the values of the indicators conceal a lot of action
- Two-tier reforms majoritarian
- Trade-off between size and scope

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Setup: qualitative description

Equilibrium job search model. Free entry of firms, but match frictions create rents split according to Nash bargaining wage rule. Shocks to match productivity, x. Endogenous job creation and destruction. Four types of Institutions:

1. an exogenous firing tax T (not transfer) levied on termination of job-worker matches
2. an unemployment benefit $b = \rho\bar{w}$ offered as a replacement of the average wage, $\bar{w}$, at the rate $0 < \rho < 1$ throughout the entire unemployment spell (ρ measures the generosity of unemployment benefits)
3. an employment subsidy (or tax credit), $e < b$ also provided on a flow basis at continuing jobs.
4. a hiring-recruitment subsidy, $h < c$, reducing the flow costs of unfilled vacancies, c

Job creation and destruction margins are affected by these institutions either directly and indirectly, that is, via their effects on wages.

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Two-tier Regimes in the MP model

A two-tier reform of employment protection reduces firing taxes for entry jobs ($T_0 = 0 < T$), while leaving employment protection unaltered for continuing jobs.

New jobs last until they are hit by a productivity shock. If the new realization is below a reservation productivity specific to entry jobs, R_0 , the match is dissolved and ends with a flow into unemployment. If instead the new productivity realization is above R_0 , jobs are converted into permanent contracts, covered by the standard firing taxes, T

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Insider and Outsider Wages

Two-tier regimes generate two wage equations from Nash bargaining. The first wage equation determines workers pay in entry jobs or the wage of *outsiders* (dual workers), denoted by the subscript 0. The second wage equation applies to continuing jobs and provides *insider* wages at all productivity levels above the reservation productivity level. The difference between insider and outsider wages at the entry productivity level (x=1) is given by

$$w(1) - w_0 = (1 - \beta)w(\rho - \rho_0 + e_0) + \beta(rT)$$

Even for lower x, $w(x) > w_0$ in this setting. Partial equilibrium of two-tier reforms: increase wage differentials between entry jobs and continuing jobs.

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Comparing Two-tier and Complete Reforms

Key differences with respect to complete reforms:

- $\rho \Uparrow$ accompanied by reduction of ρ_0 does not necessarily increase u (flexicurity)
- $T \Uparrow$ increases turnover
- $e \Uparrow$ may increase job destruction (for entry jobs)
- Less ambiguity in signing their effects on u.

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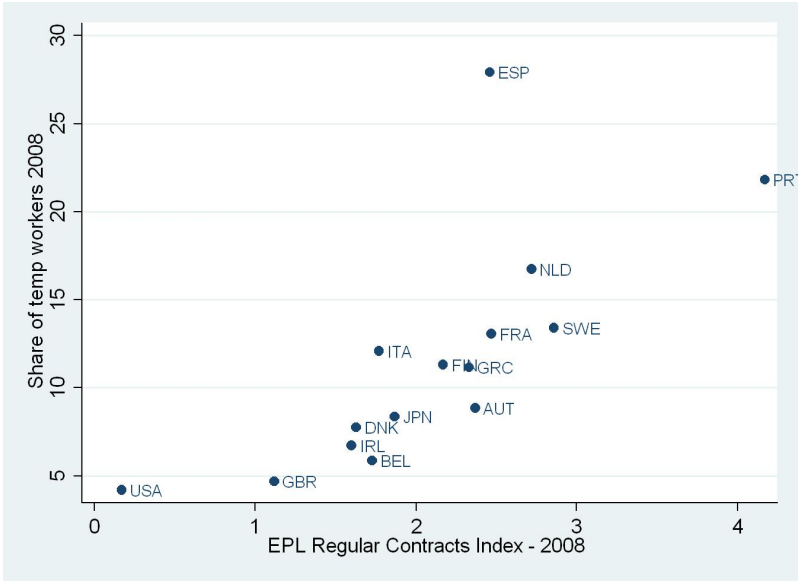
How relevant is dualism?

$\rho = 0.81$



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

Two-tier wage structures: Premium of Permanent Contracts

$$\log w_i = \alpha + \beta_1 \, EDU_i + \beta_2 \, EDU_i^2 + \gamma_1 \, TEN_i + \gamma_2 \, TEN_i^2 + \mu \, PERM_i + \varepsilon_i$$

	Premium temporary-permanent μ	**St. Err.**	**Obs.**
Austria	20.1***	0.023	9867
Belgium	13.9***	0.017	7948
Denmark	17.7***	0.015	8009
Finland	19.0***	0.011	8940
France	28.9***	0.016	15260
Germany	26.6***	0.010	25448
Greece	20.2***	0.013	6978
Ireland	17.8**	0.069	1583
Italy	24.1***	0.008	30177
Luxembourg	27.6***	0.018	7889
Netherlands	35.4***	0.021	15845
Portugal	15.8***	0.016	7550
Spain	16.9***	0.007	22626
Sweden	44.7***	0.036	5412
United Kingdom	6.5*	0.037	7000

Complete Reforms with a long phasing-in

- Transitional dynamics may depart significantly from steady state outcomes of complete reforms.
- Immediately increase in volatility of employment and unemployment.
- Temporary job creation (honeymoon) effect.

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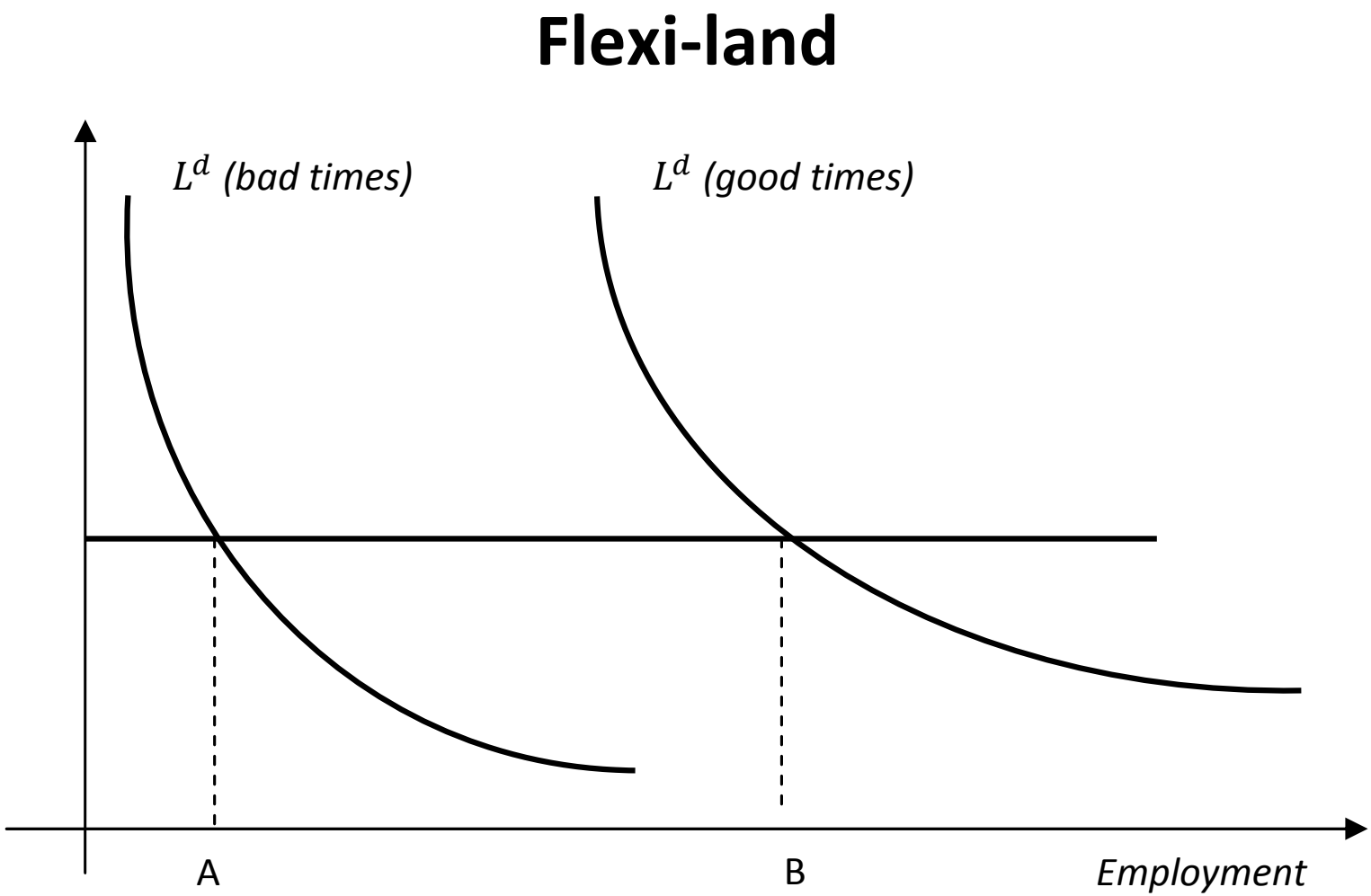
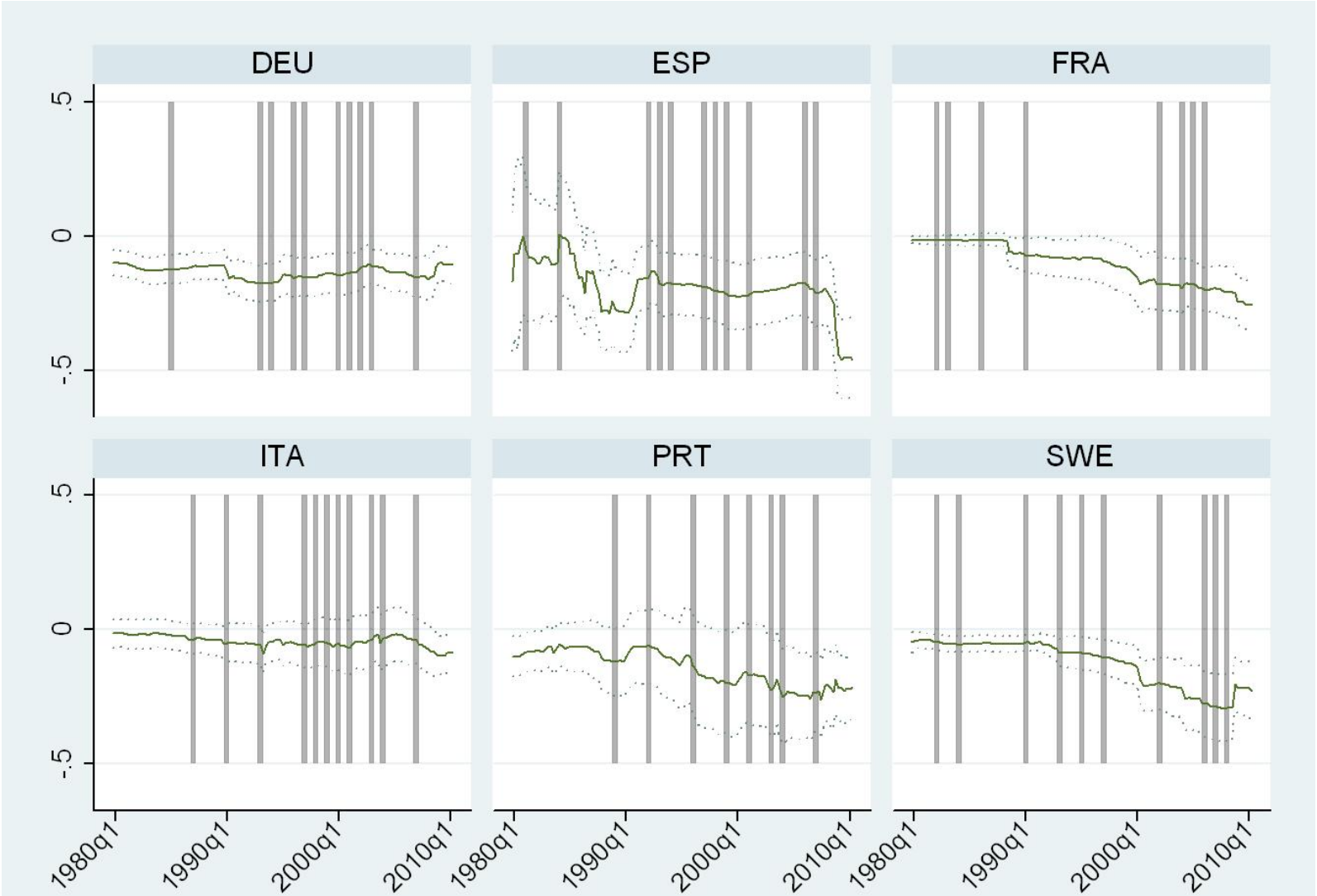
The Honeymoon Effect

Example of two-tier reforms of Epl (Boeri and Garibaldi, 2007)



Two-tier Reforms and Unemployment Volatility

Estimating Okun's Law Betas: $\Delta u_t = \alpha + \beta \Delta y_t + \varepsilon_t$



Two-tier Reforms and Employment Volatility

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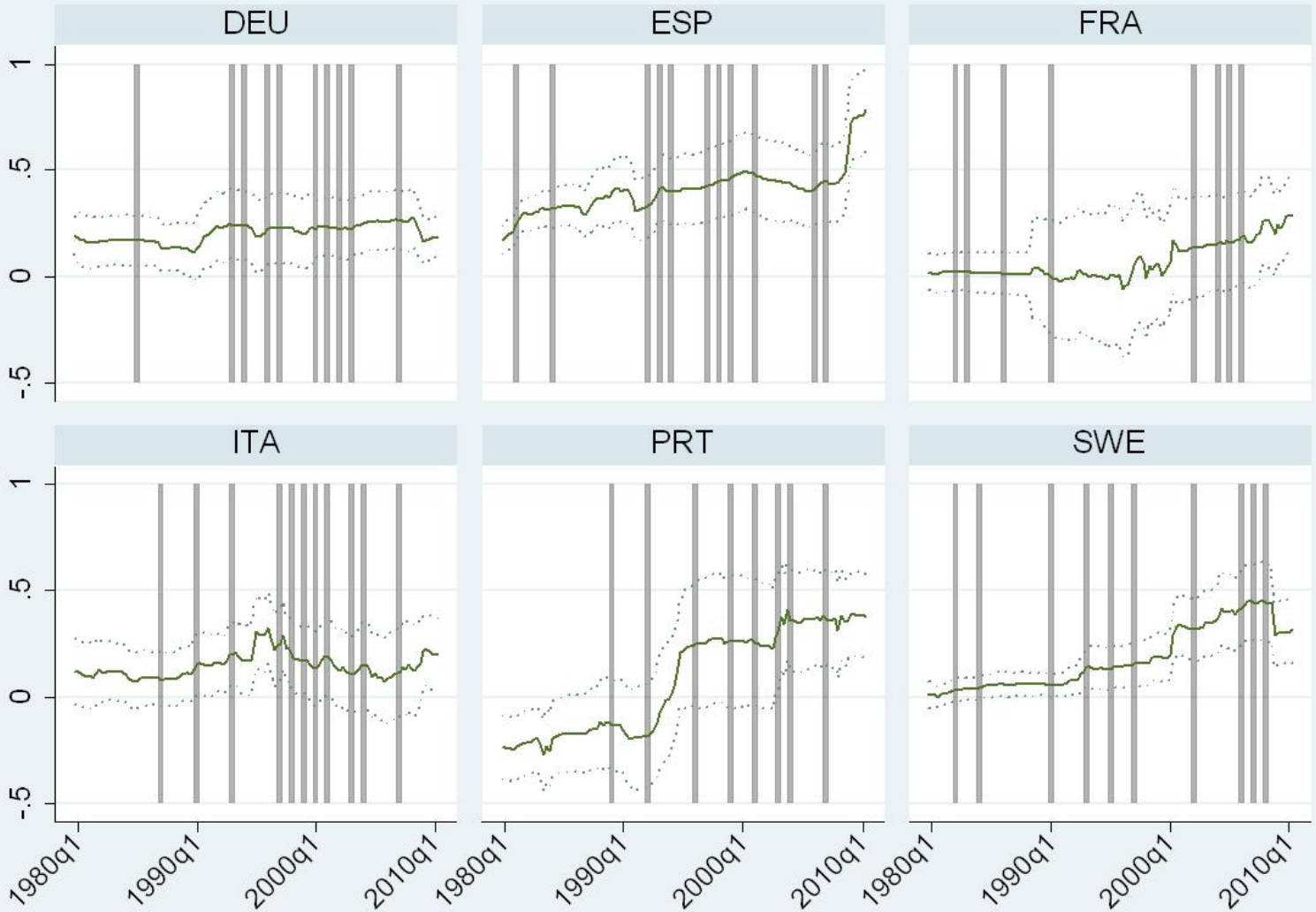

Pre-Reform EPL Strictness and Post-Reform Temporary Employment

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)

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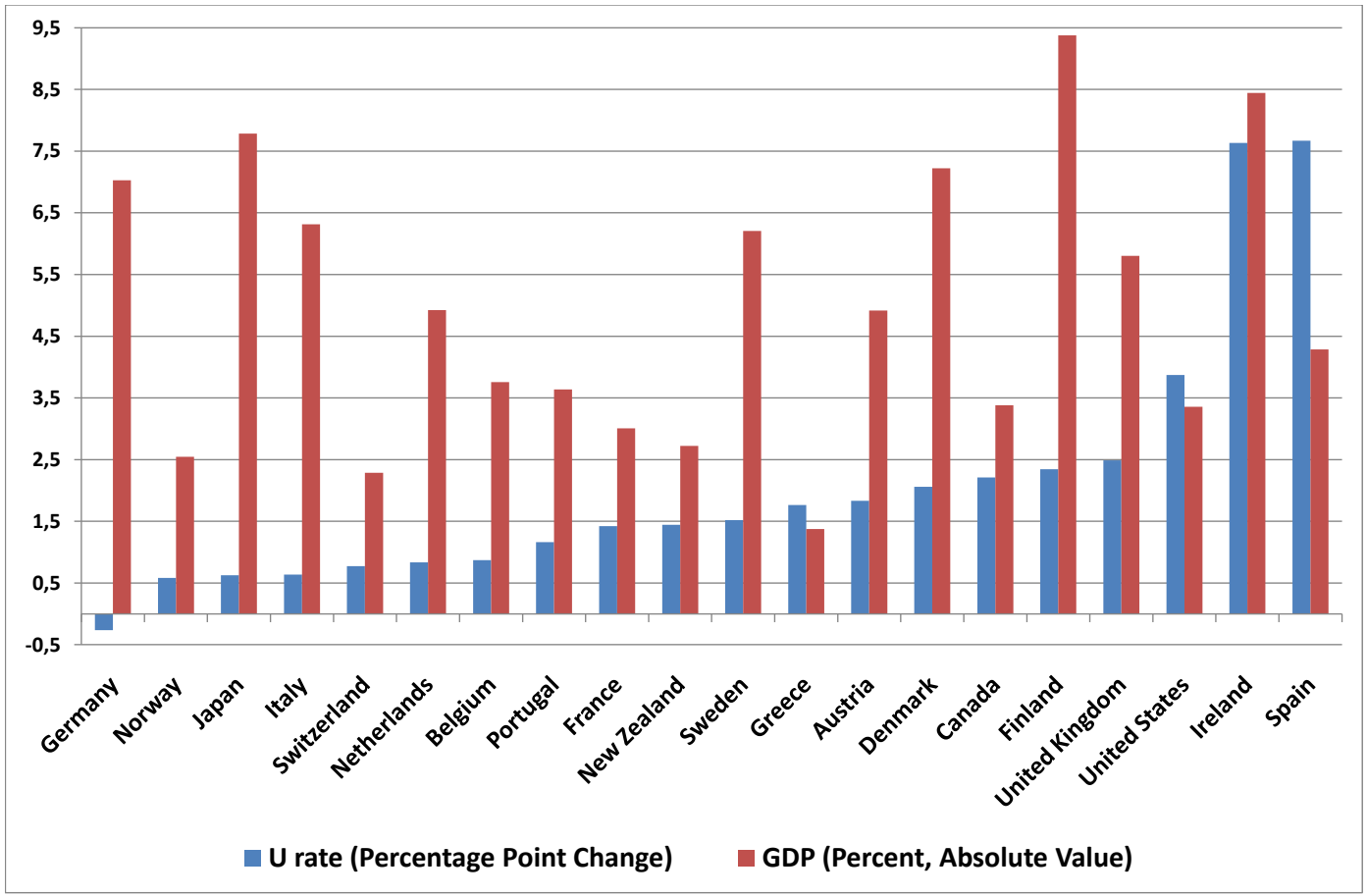
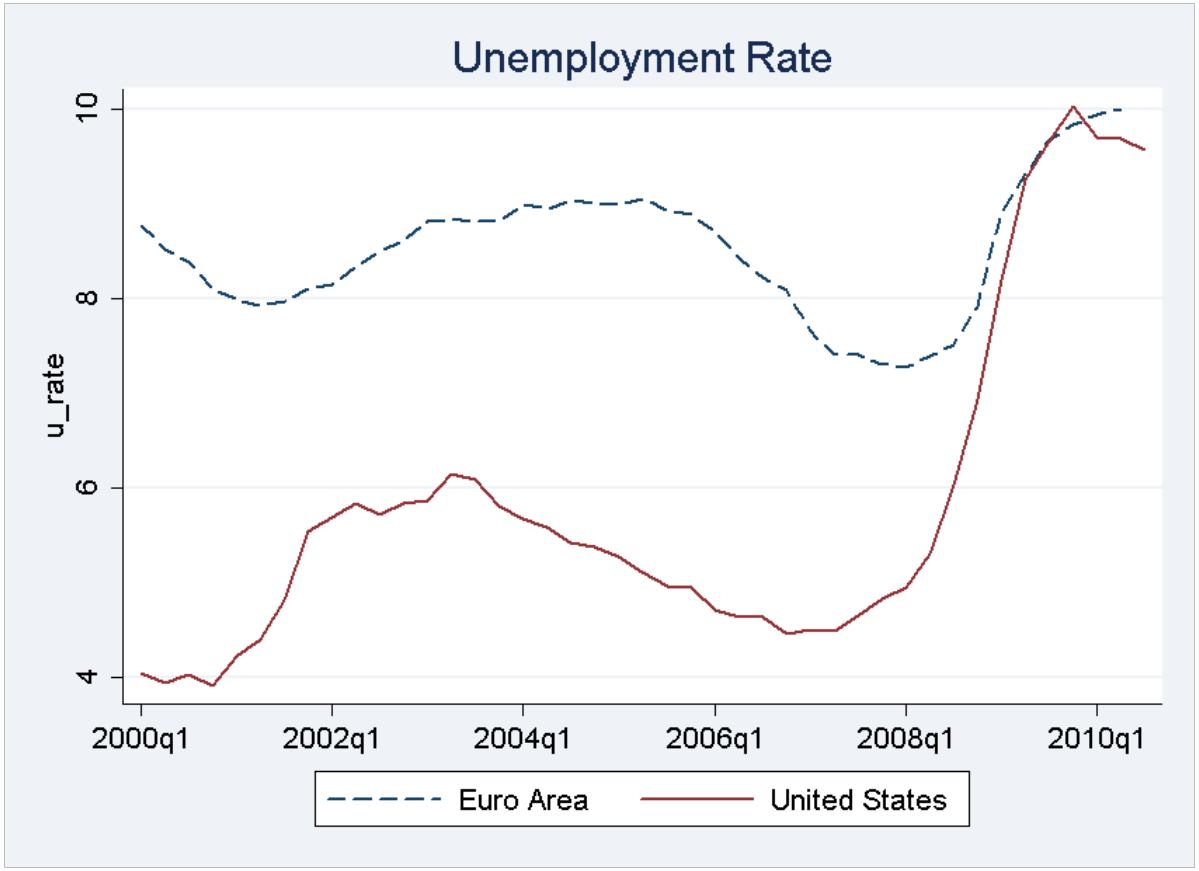
Much Different Unemployment Response also conditioning on Output



US more responsive than reformed Europe



Why? Hints from Economic Theory?

- Not much 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)

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The Job Destruction Effect

- Financial deepening reduces churning and employment volatility
- 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

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- 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)
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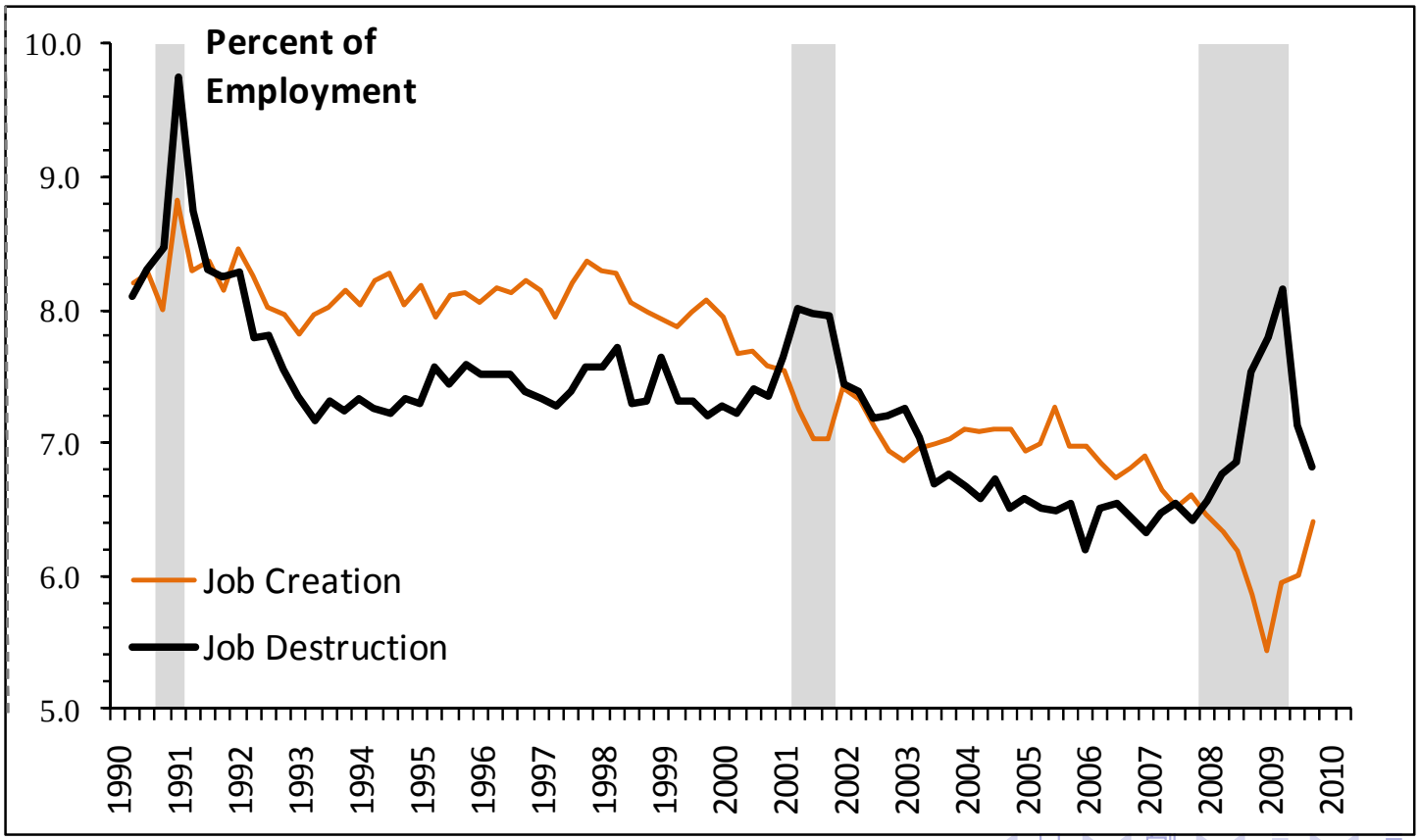
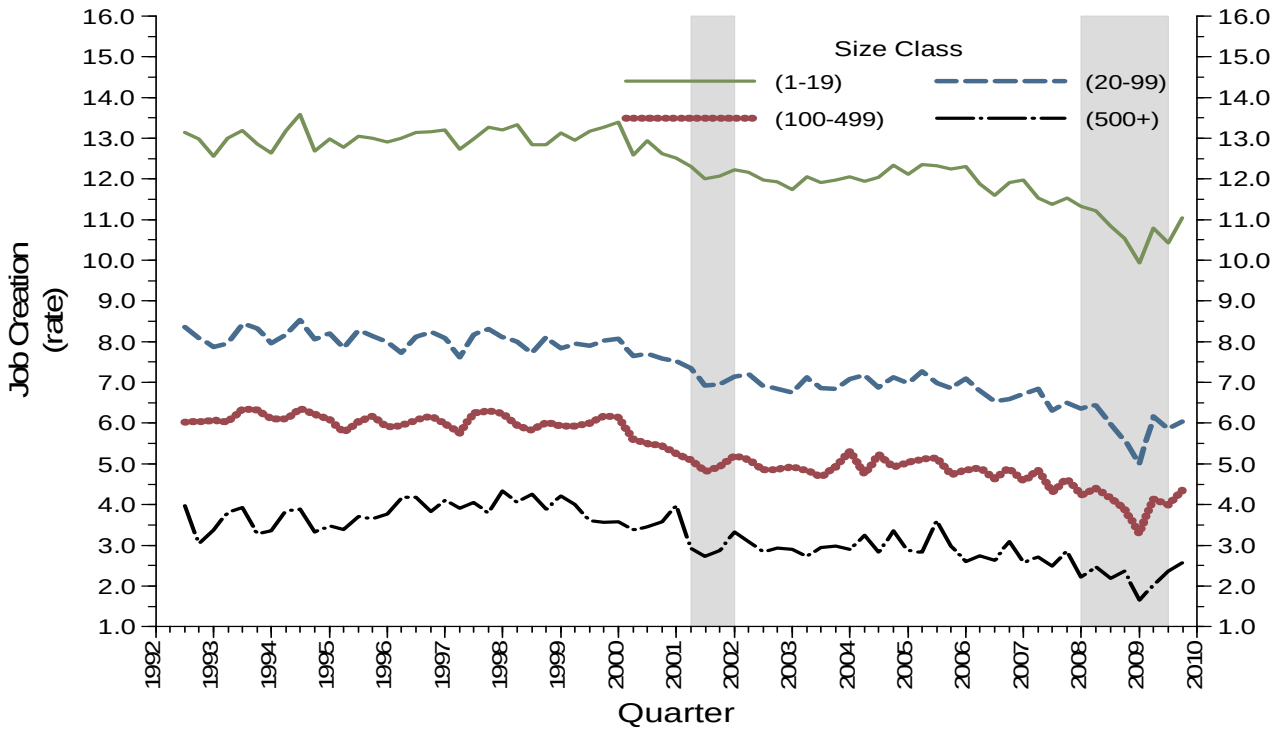
During Financial Deepening Decline in Job Turnover in the US



The Fall and Rebound was stronger for SMEs



Highly leveraged sectors experienced more variations in JC and JD in this recession

		High Leveraged Manufacturing	Low Leveraged Trade	Δ Δ
Delta JD	Financial recession	27.81%	4.46%	*23.35%*
	Non-financ. recession	14.37%	3.56%	*10.81%*
	Δ	*13.45%*	*0.91%*	***12.54%***
Delta JC	Financial recession	-20.45%	-16.10%	*-4.36%*
	Non-financ. recession	-18.85%	-8.86%	*-9.99%*
	Δ	*1.61%*	*7.24%*	***5.63%***

Source: Business Employment Dynamics, 2000-2010. Notes: Financial related recession 2008q1-2009q2; Non-financial recession 2001q2-2001q4. Delta are calculated with respect to the period preceding the recession (same time span).

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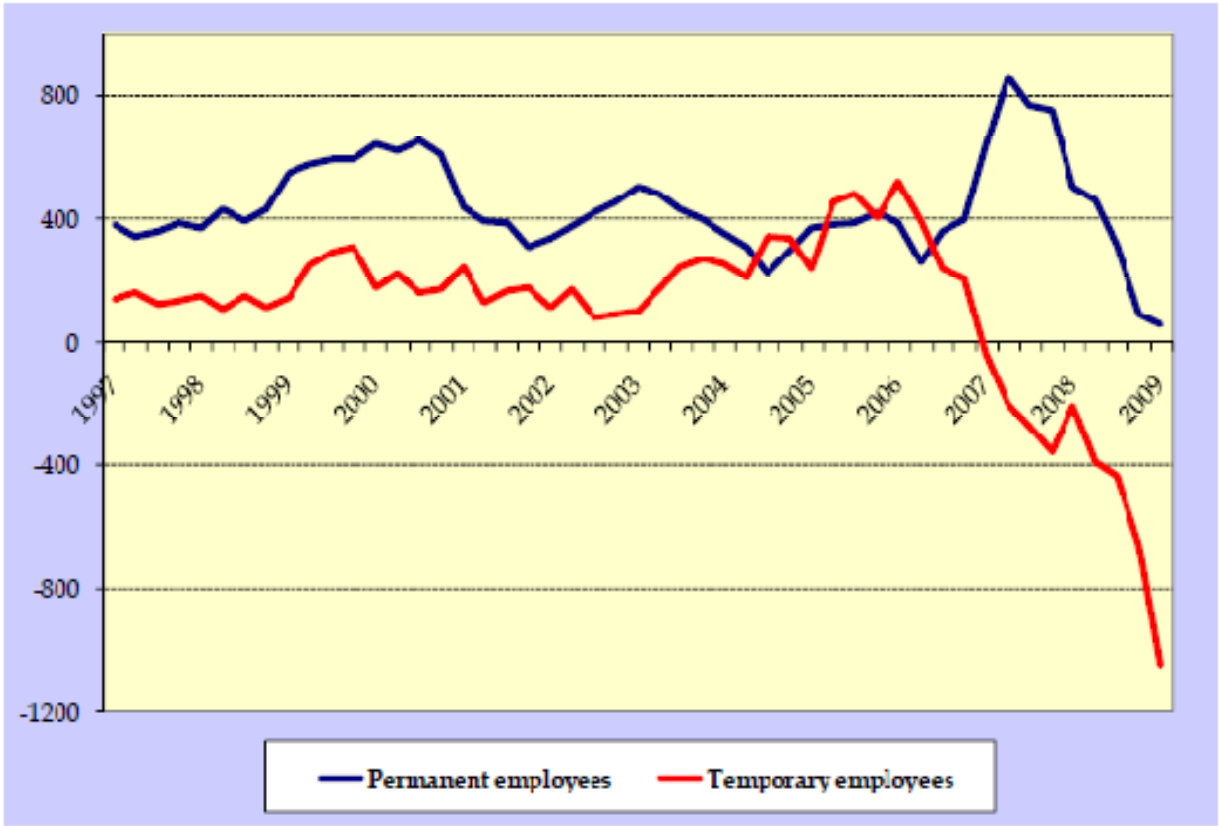
The Nightmare Case: High-leverage and Dualism (or low EPL)

	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	-0.0795***	-0.0802
share TEMP		0.011**
Leverage*TEMP*FC		0.030**
Leverage*lowEPL*FC	0.02***	

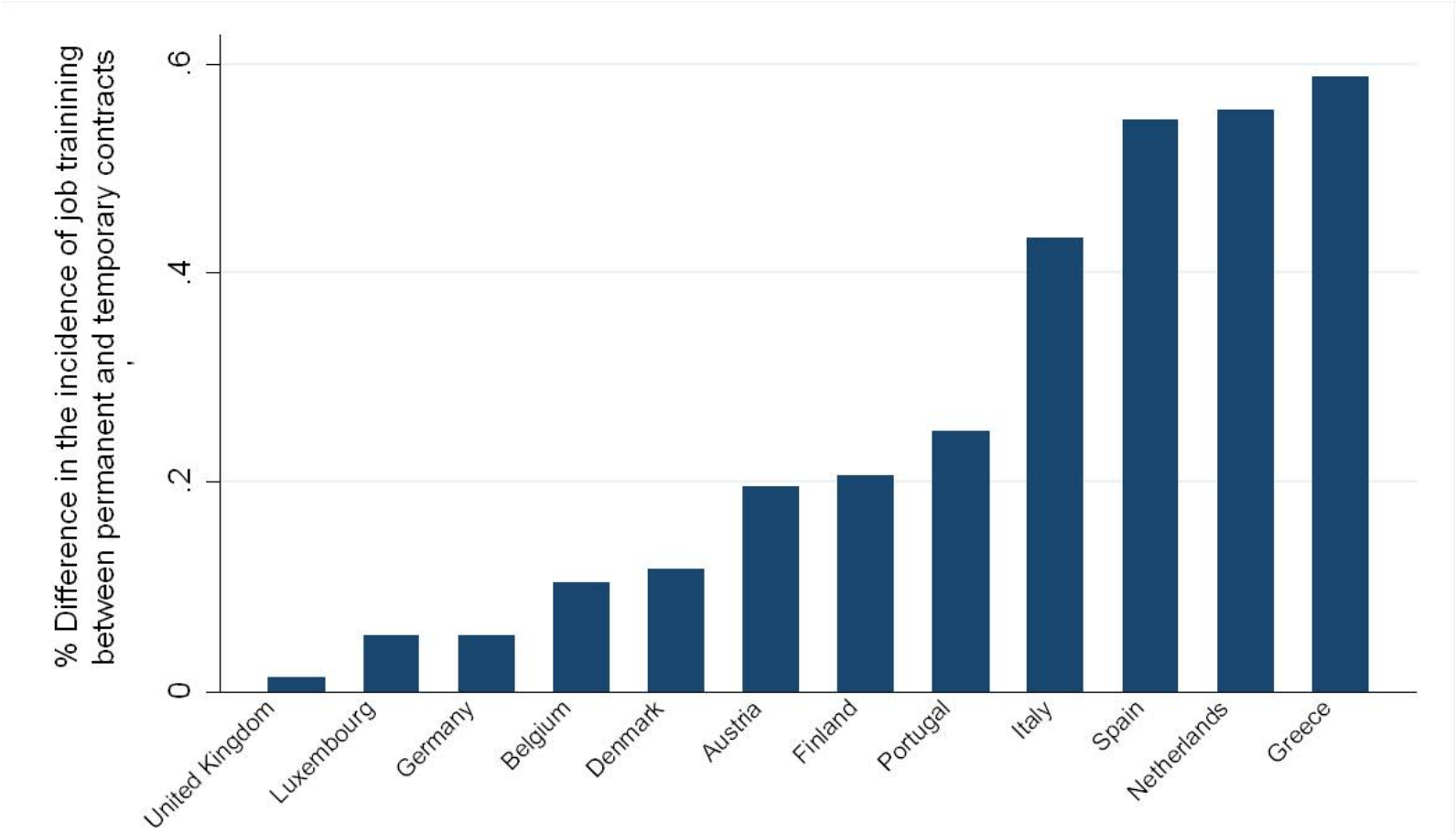
Including country and sector fixed effects. Source: IMF data

JD concentrated on Dual Workers



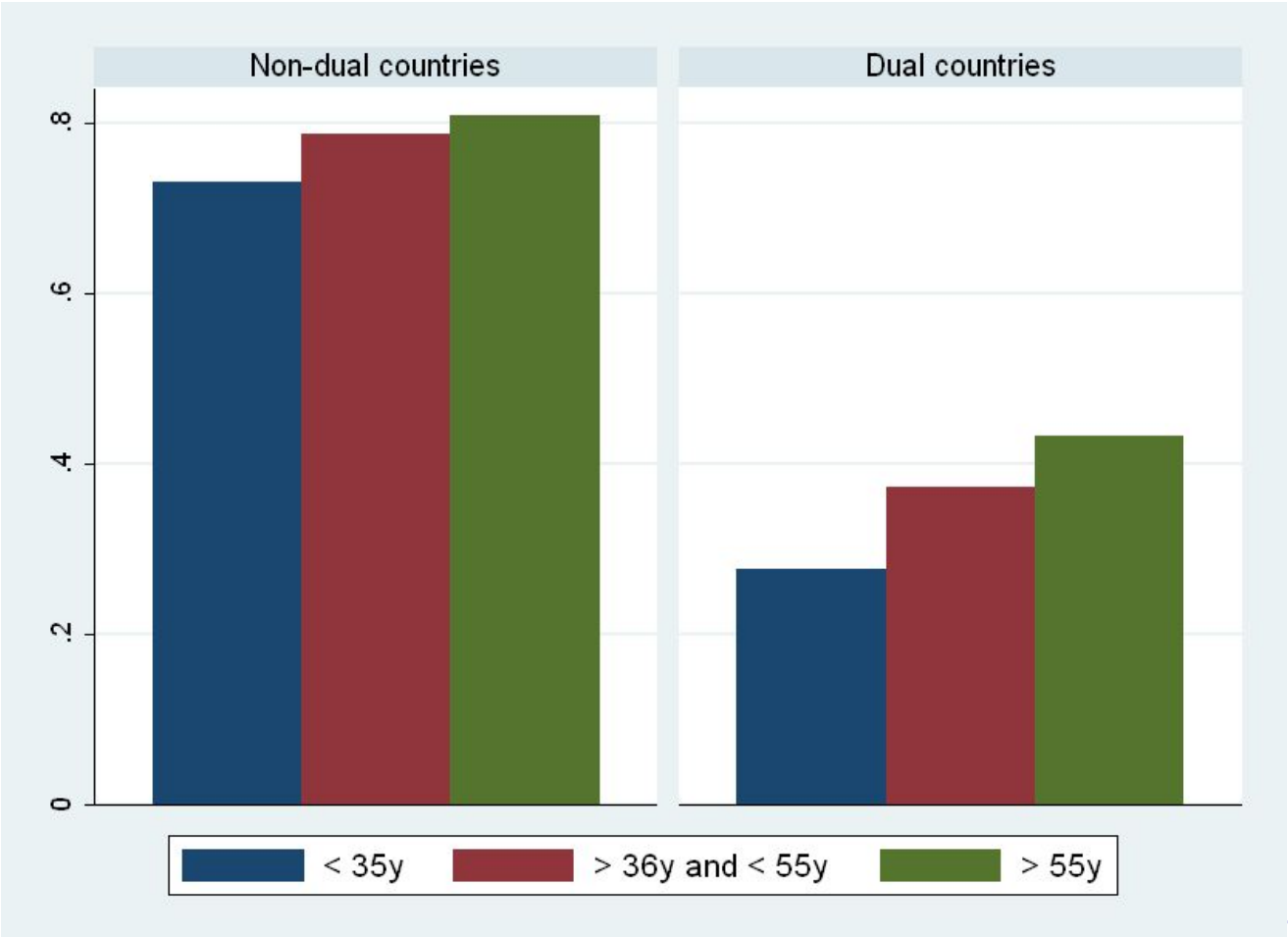
All new Hires are Temporary with Less Training

In France, Italy, and Spain up to 90 per cent of new hirings is fixed-term. Also in the US increasing role of TWA. No training is offered.



Lower Coverage of Unemployment Benefits with Dualism

Unemployment benefits coverage by age in 2008



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
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- Financial Crisis hit particularly hard Leveraged Firms
- Huge Job Losses when High Leverage is accompanied with low EPL or large share of Dual Workers
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Dualism during and after FC

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- Automatic stabilizers do not operate efficiently
- Higher social costs of recessions
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We do not want an Exit from Finance!

- Access to finance reduced unneccessary layoffs in the US (secular fall of temporary layoffs)
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- Strenghtening of contributory nature of social security is a key condition for sustainability under Ageing Populations and Migration to Welfare
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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
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Contrato Unico, Contratto Unico di Inserimento, Contrat Unique

Proposals developed in Spain (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 clause 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 clause: 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 contracs) and higher contributions to unemployment benefits

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- *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 clause 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 clause: 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 contracs) and higher contributions to unemployment benefits