

The Elusive Quest for Flexicurity

Perverse Effects of Dual Track Reforms

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- 1 Desperately looking for Flexicurity
- 2 Why Flexicurity?
- 3 Are we Going to Denmark?
- 4 Aggregate Effects of Dual-track Reforms: some Theory
- 5 Empirical Evidence on Dualism
- 6 How to Reform Employment Protection for Everybody

"We consider the following measures as essential:

[...]

*A thorough review of the rules regulating the **hiring and dismissal of employees** should be adopted in conjunction with the establishment of an **unemployment insurance system** and a set of **active labour market policies** capable of easing the reallocation of resources towards the more competitive firms and sectors."*

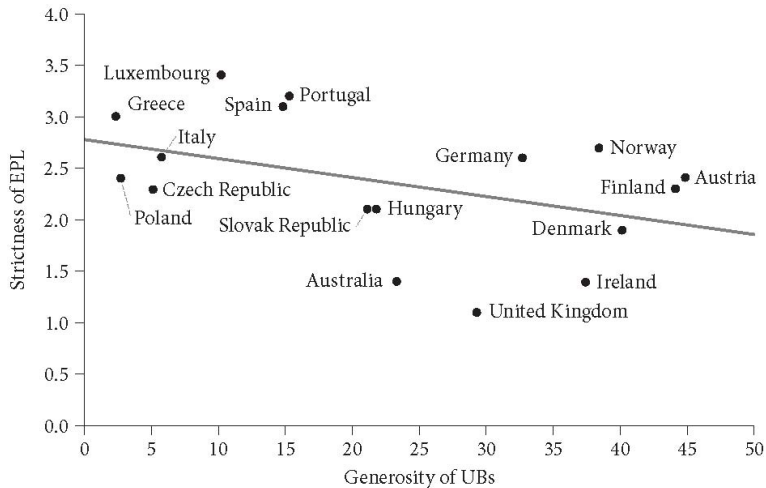
M. Draghi and J.C. Trichet, August 8th, 2011

- ▶ Lisbon (2000) final statement: We need to improve the **adaptability** of workers and enterprises.
- ▶ Integrated Guidelines (IG 21): Member States are asked to promote **flexibility** combined with employment **security** and reduce labour market segmentation, having due regard to the role of the social partners.
- ▶ 2006 Spring European Council: need to develop more systematically in the National Reform Programmes comprehensive policy strategies to improve the adaptability of workers and enterprises. reforming labour market and social policies under an integrated **flexicurity** approach, adequately adapted to specific institutional environments and taking into account the need to combat labour market segmentation.

- ▶ **Review of Hiring and Dismissals:** less EPL
- ▶ **Unemployment Insurance:** more (coverage) UBs
- ▶ **Active Labor Market Policies:** stricter entitlement rules

UB vs. EPL: the trade-off

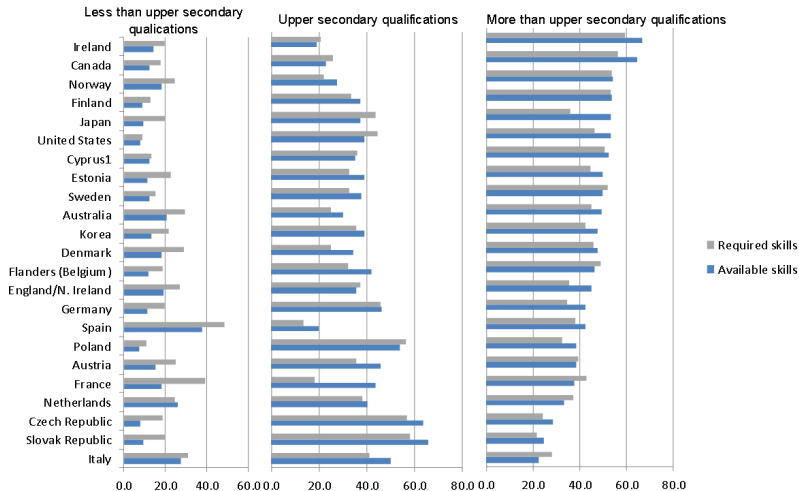
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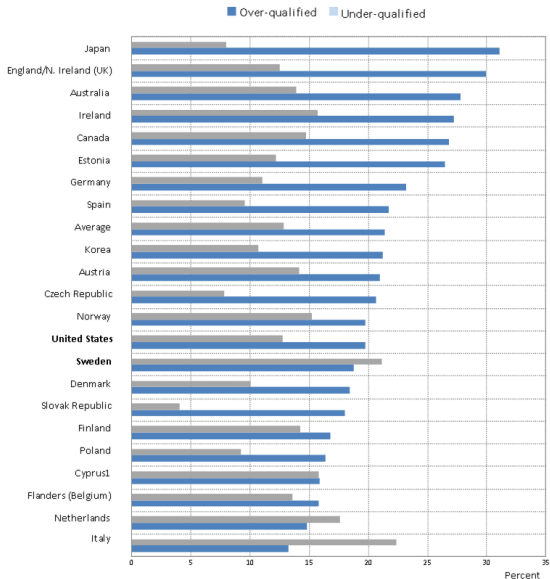
Skills are available...

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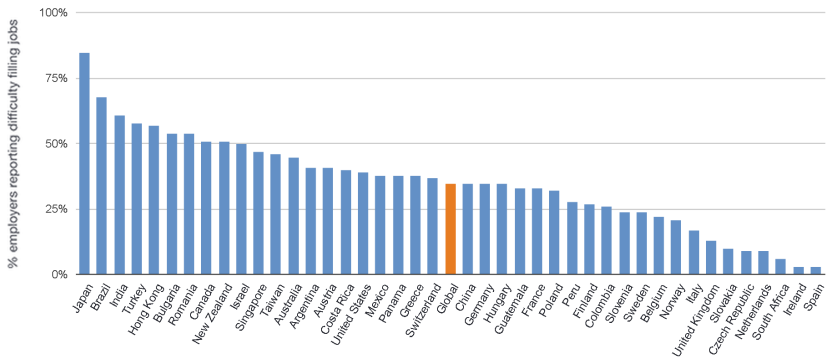
... but they are mismatched

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High costs in filling vacancies

Percentage of employers reporting difficulties in filling jobs.



- ▶ Huge differences in productivity across regions and sectors
- ▶ The reallocation of jobs and of workers is associated with productivity gains (up to 50% of productivity gains associated with reallocation)
- ▶ Employment growth is higher in firms with higher productivity growth.
- ▶ Process of creative destruction described by Joseph Schumpeter *Capitalism, Socialism and Democracy*, 1942. Faster during recessions Problem: workers face important risks

How to reconcile reallocation with social security? Flexicurity.

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"We all know what to do, we just don't know how to get re-elected after we have done it."

Jean-Claude Junker, Mr. Euro

Are we Going towards Flexicurity?

Level of Labor Market Institutions in mid 1980s and in latest available data:

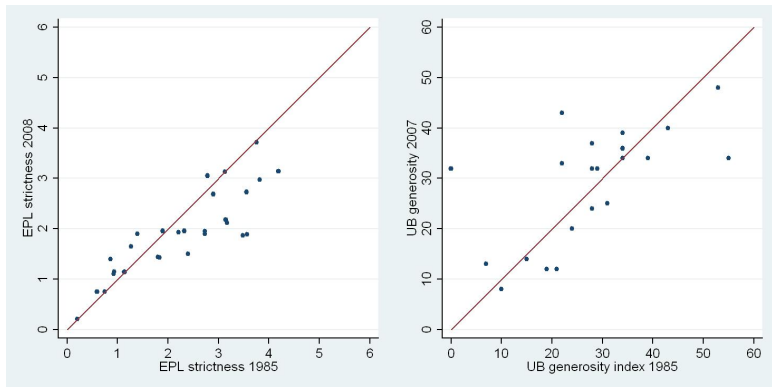
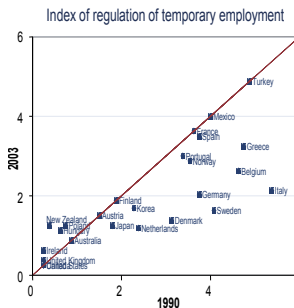
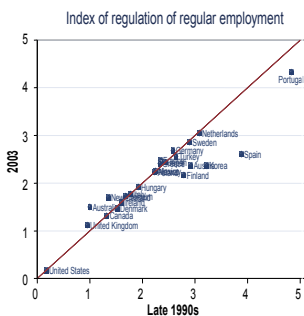


Figure: OECD Index of Strictness of EPL and generosity measure of UB

EPL Strictness: Temporary Vs. Regular Contracts

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Reforms involving less than 50 per cent of potentially eligible population Discrete vs. incremental refers to size of change in indicator

EPL	Two-tier	Complete	Total	Of which two-tier
Discrete	17	7	24	71%
Incremental	86	89	175	49%
Total	103	96	199	52%
of which discrete	17%	7%	12%	

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Setup: qualitative description

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HLE,2011. Equilibrium MP job search model. Free entry of firms, but match frictions. Rents split according to Nash bargaining wage rule. Shocks to match productivity, x . Endogenous job creation and destruction. 4 types of Institutions:

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- 1 an exogenous firing tax T
- 2 an unemployment benefit $b = \rho \bar{w}$
- 3 an employment subsidy (or tax credit), $e < b$
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Job creation and destruction affected by institutions either directly and indirectly (via wages).

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.

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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

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.

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

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.**

COMPARATIVE STATICS RESULTS OF TWO-TIER REFORMS.

<i>Effect of an increase in \Rightarrow</i>	ρ	T	e_0
<i>on \Downarrow</i>			
R_o^*	0	+	+
R^*	+	-	0
θ^*	0	+	+
u^*	+	-?	-?
Job loss rate (from entry jobs)	0	+	+
Job loss rate (from continuing jobs)	+	-	0
Job finding rate	0	+	+
Premium on permanent contracts	+	+	+
Conversion temporary-permanent	0	-	-
Entry jobs as % of total employment	+	+	+

Key differences with respect to complete reforms:

- ▶ $\rho \uparrow$ increases the premium of permanent over temporary contracts
- ▶ $T \uparrow$, that is, more contractual dualism, **increases turnover** via less transformation of entry into continuing jobs
- ▶ $e \uparrow$ reduces conversion of temporary into permanent contracts

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Effect of higher T on dualism?

$$\rho = 0.81$$

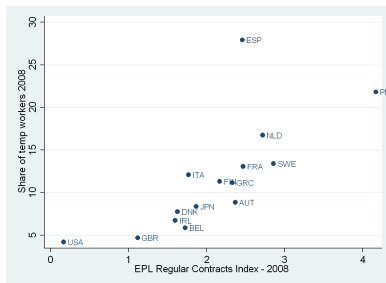


Figure: Strictness of EPL for Permanent Contracts and Share of Temporary Contracts in Total (Dependent) Employment

Effect of higher T on conversion of TEMPs?

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$$\rho = -0.72$$



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

Two-tier wage structures:

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Premium of Permanent Contracts

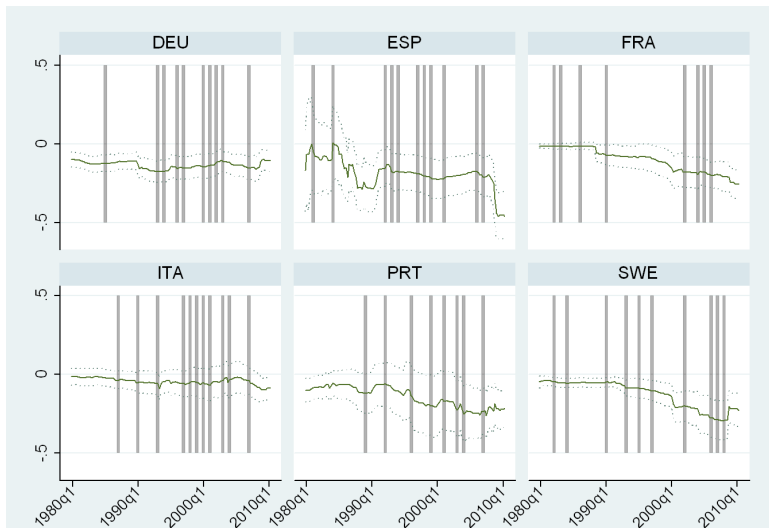
$$\log w_i = \alpha + \beta_1 EDU_i + \beta_2 EDU_i^2 + \gamma_1 TEN_i + \gamma_2 TEN_i^2 + \mu PERM_i + \varepsilon_i$$

	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

Do these reforms allow automatic stabilizers to operate?

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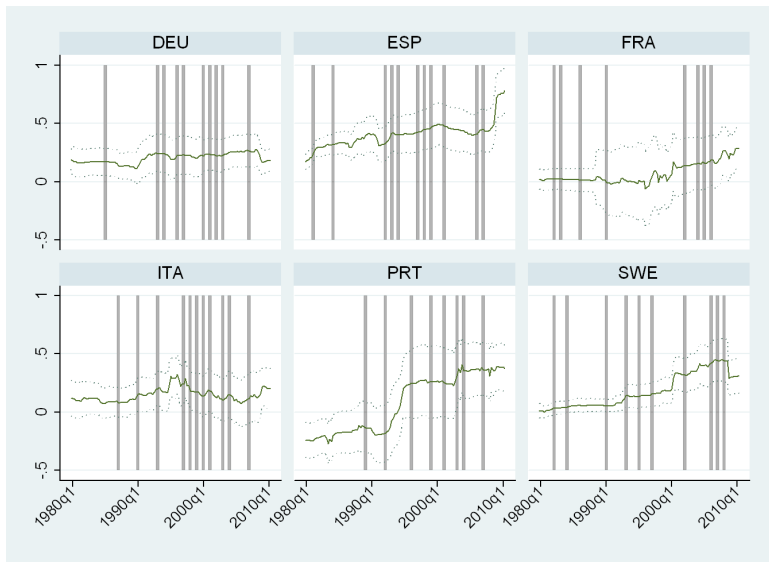
Estimating Okun's Law Betas: $\Delta u_t = \alpha + \beta \Delta y_t + \varepsilon_t$



Two-tier Reforms and Employment Volatility

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



Two-tier is only flexi or also security?

Figure: Unemployment benefits coverage by age in 2008

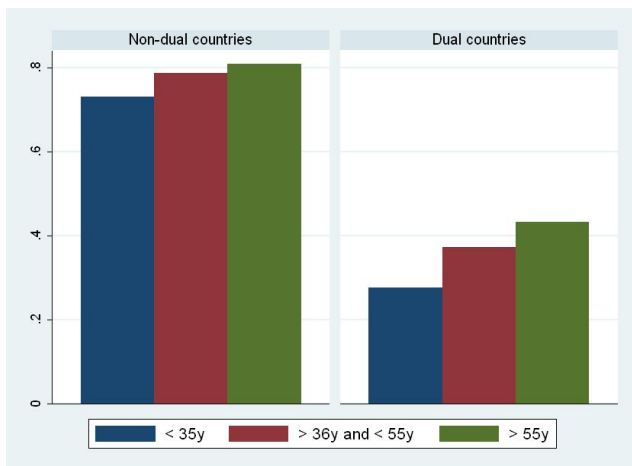


Figure: Source: EU-SILC 2008

Do they really know what to do?

- ▶ They know how to be re-elected
- ▶ Two-tier reforms create excess turnover and do not allow automatic stabilizers to operate properly
- ▶ reducing the coverage of UBs rather than increasing it
- ▶ We get flexidualism rather than flexicurity

Effects on human capital investment

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In France, Italy, and Spain up to 90 per cent of new hirings is fixed-term. No training is offered.

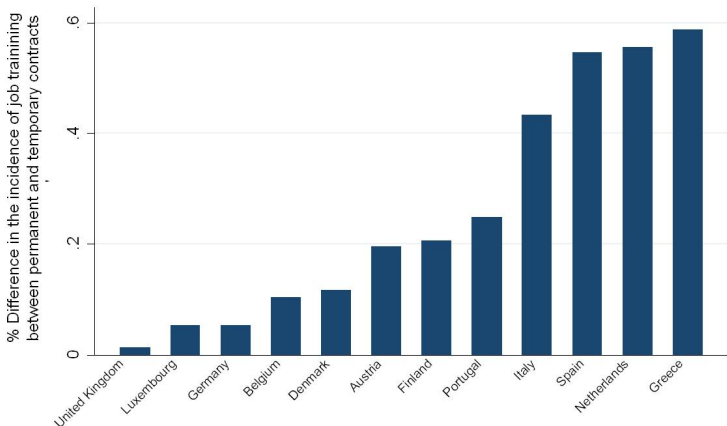
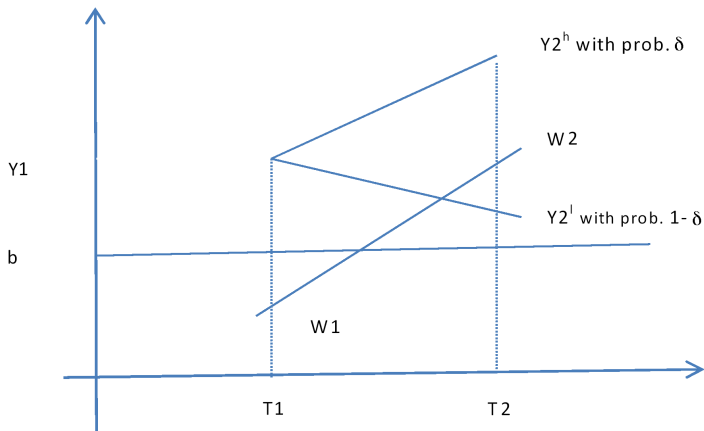


Figure: Source: ECHP

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Why we need some EPL

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Boeri-Garibaldi-Moen, The Economics of Severance Pay

- ▶ Partial equilibrium: One worker and one firm (risk neutral) with a two periods job. No discounting
- ▶ At the beginning of period 1, the firm proposes a wage contract (w_1, w_2) , and the worker accepts or rejects
- ▶ In period 1 the worker faces a specific investment opportunity $s = \{0, 1\}$ at costs C .
- ▶ Conditional on $s = 1$, productivity in the second period will take a stochastic value $y_2 \in (y_0, y^{max})$
- ▶ If the worker does not invest, output is y_0 , which is less than the worker's outside option b
- ▶ Only the firm observes y_2 , and only the worker observes s

- ▶ **Disciplinary Dismissal.** Dismissal of a shirking worker that did not invest. Must be proved in court
 - ▶ With probability $1 - q$ the court observes shirking, no severance payment is due
 - ▶ With probability q a shirking worker "gets away with it" and receives T .
- ▶ **Economic Dismissal.** The worker did invest, but is fired due to low productivity (bad luck). Receives severance T with probability 1
- ▶ The severance T is set by the government and is a pure transfer. The firm can not commit to a severance payment.

- ▶ Without severance pay, $w_2 > y_2$, and we have too much firing
- ▶ Optimal separation requires that $T = w_2 - b$, which inserted into the icc gives

$$T^* = \frac{C}{1 - q} \quad q < 1$$

- ▶ The easier it is to get away with shirking, the higher is severance pay
- ▶ May rationalize lower severance pay in small firms and in countries with a reliable legislative system

Measure of unpredictability of dismissal costs, Σ . obtained by multiplying the weighted standard deviation of dismissal costs by an overall measure of unpredictability, notably appeal rates before the second instance as a percentage of population (α). The weighted standard deviation uses rules concerning the burden of proof as proxy for the probability that a dismissal is considered unfair.

$$\Sigma = \sqrt{\alpha(E[T^2] - E[T]^2)} = \sqrt{\alpha((1-p)T_U^2 + p^2T_F^D{}^2 + p(1-p)T_F^E{}^2)}$$

Level and unpredictability of dismissal costs

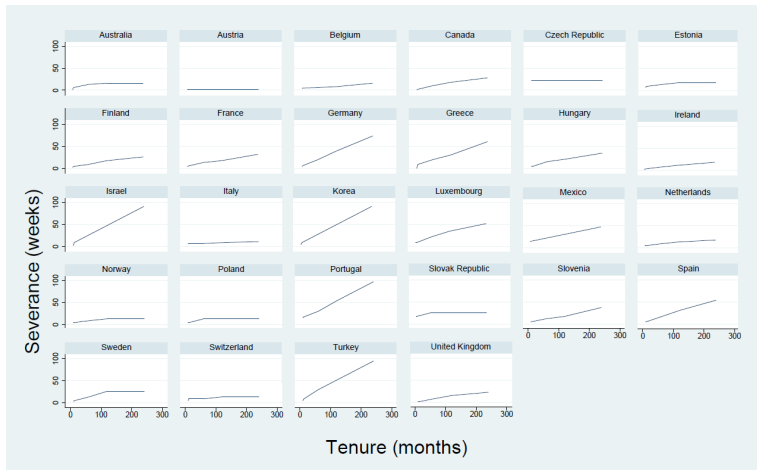
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Country	T_U	T_F^E	T_F^D	$T_U - T_F^E$	$T_F^E - T_F^D$	st.dev	Σ
Denmark	19.97	9.00	6.00	10.97	3.00	5.83	2.00
Germany	43.58	17.00	7.00	26.58	10.00	12.77	2.49
Italy	40.14	6.00	6.00	34.14	0.00	14.78	8.00
Spain	36.50	12.50	0.50	24.00	12.00	11.98	6.71
Sweden	38.00	6.00	6.00	32.00	0.00	13.86	2.42
United Kingdom	17.67	7.60	3.00	10.07	4.60	4.96	1.16

- ▶ The severance pay is increasing with tenure
- ▶ even more so if judges are lenient wrt senior workers
- ▶ Wages are also increasing in tenure
- ▶ The tenure structure depends on the time profile of effort costs, q , and the outside option b .

Severance Tenure Profile

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- ▶ Reduce the discretion of judges
- ▶ Make the judicial system more effective
- ▶ Let severance be increasing with tenure without discontinuities
- ▶ Put wage floors on temporary contracts?

Contrato Unico, Contratto Unico di Inserimento, Contrat Unique

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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. ciao