

# Labour Market Reforms, Segmentation and the Great Recession

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- 1 Policy Induced Segmentation: Labour Market Reforms
- 2 Aggregate Effects of Dual-track Reforms
- 3 Dualism at Work
  - Dualism Over the Cycle
  - Longer Term Effects of Dualism
- 4 Exit Strategy

# Outline

- 1 Policy Induced Segmentation: Labour Market Reforms
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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
- Way to engineer politically feasible reforms
- Trade-off between size and scope

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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 (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
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# The Taxonomy

<b>Size</b>	Discrete Two-tier	Structural
	Incremental Two-tier	Incremental Complete
<b>Scope</b>		

# Two-Tier Reforms

- Two-tier reforms which involve less than 50% of potentially eligible population

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%

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# Employment Protection Legislation

- Incremental reforms involve change of less than 10% of the average period cross-country standard deviation in the level of the institution (OECD indicator)
- Two-tier reforms involve less than 50% of potentially eligible population

EPL reforms by size and scope as a percentage of the total

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

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## Setup: qualitative description

Equilibrium job search model. Endogenous job creation and destruction. Four types of Institutions:

- an exogenous firing tax  $T$  (not transfer) levied on termination of job-worker matches
- 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 ( $\rho$  measures the generosity of unemployment benefits)
- an employment subsidy (or tax credit),  $e < b$  also provided on a flow basis at continuing jobs.
- 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.

Government budget constraint not considered.

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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 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. Continuing jobs have lower average productivity but higher average wages than entry jobs. Partial equilibrium of **two-tier reforms: increase wage differentials between entry jobs and continuing jobs.**

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## A two-tier Reform

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

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# Empirical Predictions

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
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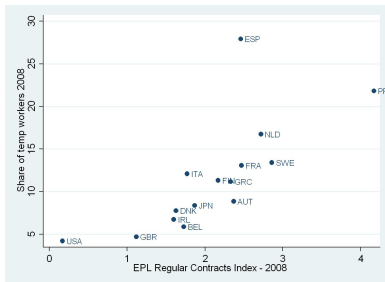
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# How relevant is dualism?

$$\rho = 0.81$$



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

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

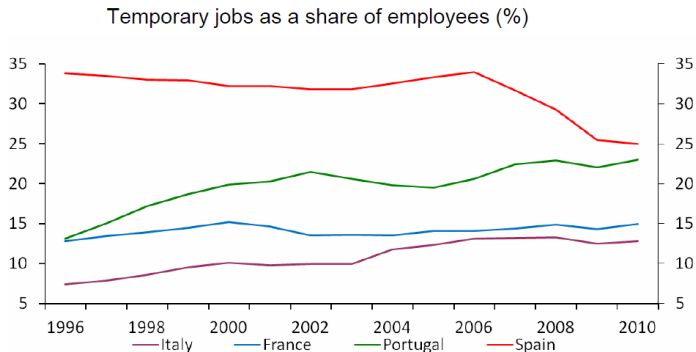
	Premium temporary-permanent $\mu$	St. Err.	Obs.
Austria	20.1***	0.023	9867
Belgium	13.9***	0.017	7948
Denmark	17.7***	0.015	8009
Finland	19.0***	0.011	8940
France	28.9***	0.016	15260
Germany	26.6***	0.010	25448
Greece	20.2***	0.013	6978
Ireland	17.8**	0.069	1583
Italy	24.1***	0.008	30177
Luxembourg	27.6***	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

# Pre-Reform EPL Strictness and Post-Reform Temporary Employment

Country	Time Period	EPL strictness (Regular Index)	EPL Strictness (Temporary Empl.)	Temporary Emp. Growth $\Delta ET_t$ (000)	Contribution of Temporary Jobs $\Delta ET_t / E_0$
Belgium	1987-1996	1.68	4.63	22.7	0.66
	1997-2005	1.71	2.63	135.3	3.54
	$\Delta$	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
	$\Delta$	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
	$\Delta$	-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
	$\Delta$	-0.27	-0.40	600.6	14.19
Spain <sup>1</sup>	1981-1984	3.83	-	0	0
	1985-1995	3.67	3.66	3377.1	28.5
	$\Delta$	-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
	$\Delta$	-0.02	-1.65	328.1	8.04

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

# The Rise (and Fall) of Temporary Employment



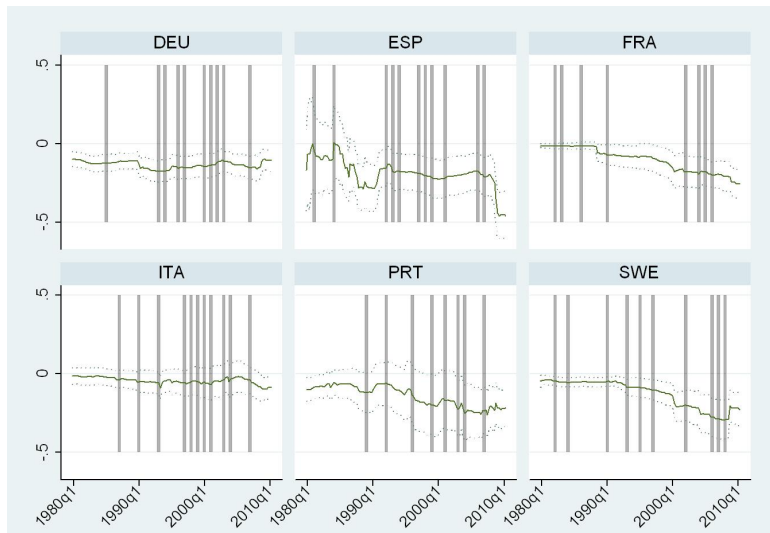
# Dualism Over the Cycle: The Honeymoon Effect

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



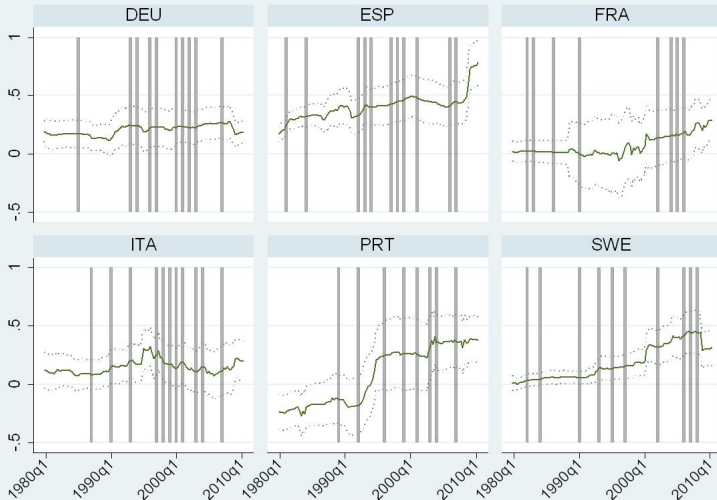
# Honeymoon effect and unemployment volatility

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



# Honeymoon effect and employment volatility

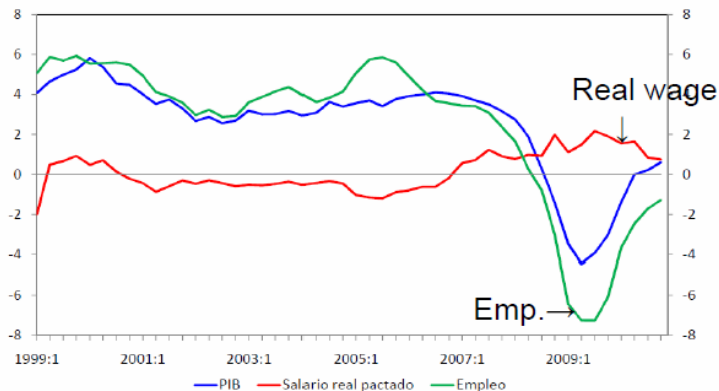
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# Labor Market adjustment to recession: Spain

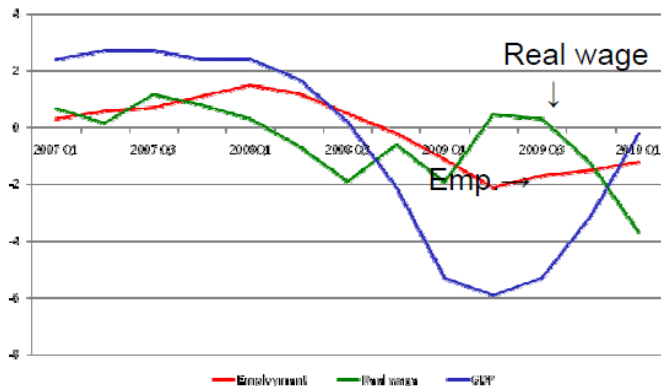
## Spain (employment)

Tasa de variación del PIB, el empleo y el salario real pactado (%)



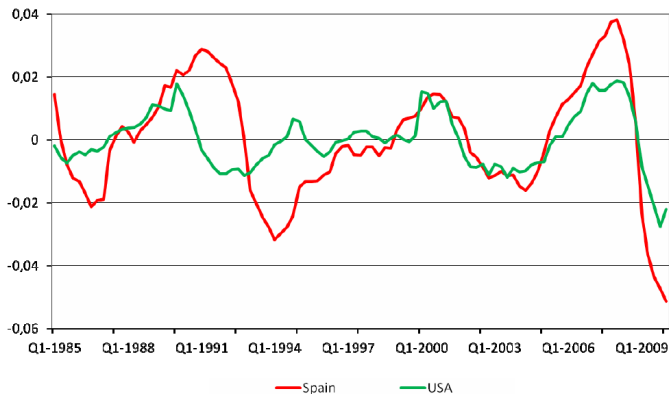
# Labor Market adjustment to recession: UK

## UK (wages)

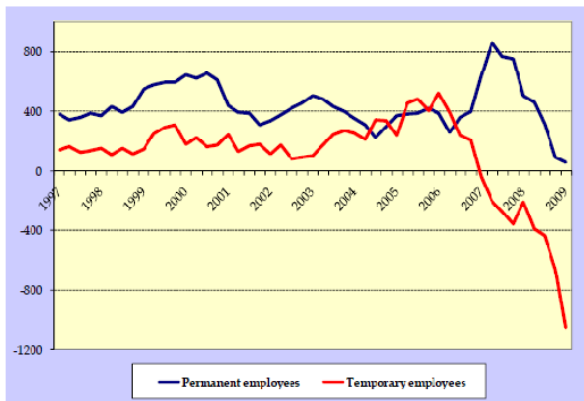


# Labor market flexibility or rigidity?

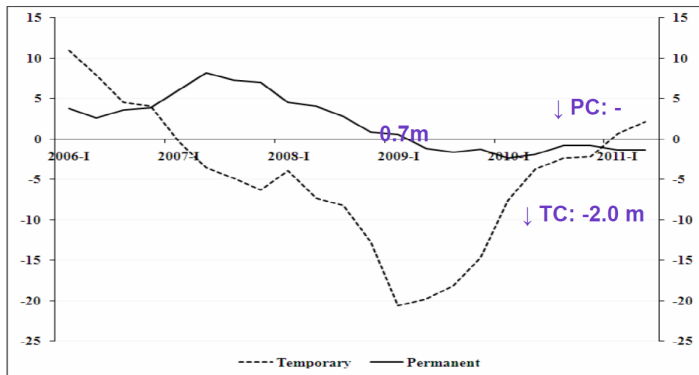
Bulimic LM: (HP) Cyclical component of employment



# JD concentrated on Dual Workers

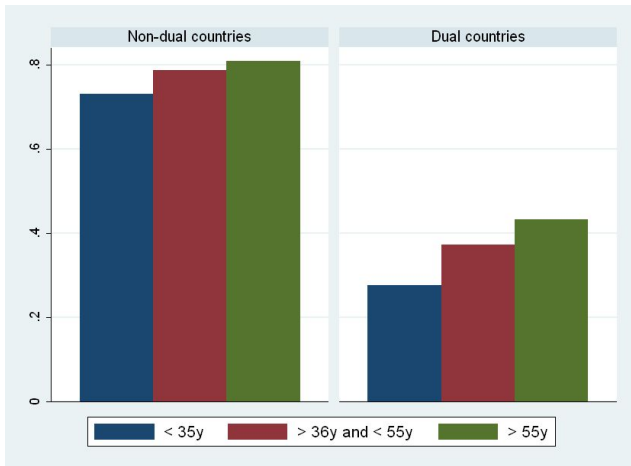


# Job destruction by type of contract



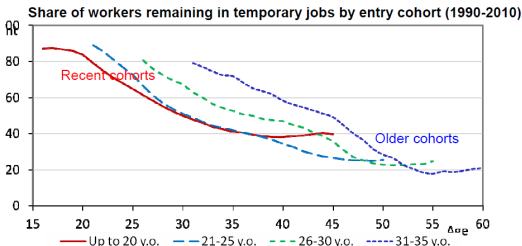
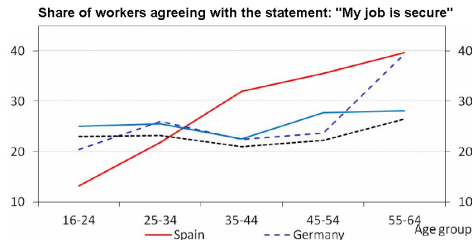
# Lower Coverage of Unemployment Benefits with Dualism

Unemployment benefits coverage by age in 2008

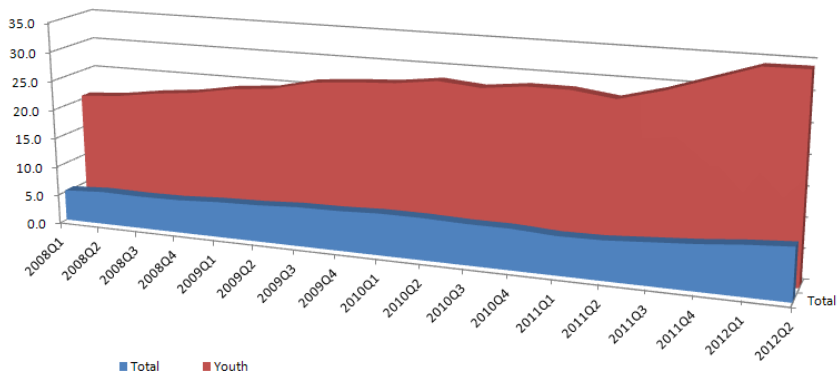




# Perceptions of insecurity by age (ESS)



# Longer Term Effects of Dualism: Youth unemployment in Italy



**Labour Market Prospects**

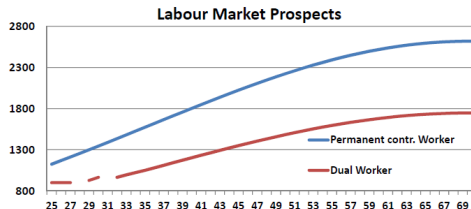
Age	Dual Worker (Millions of Lire)	Permanent Contr. Job (Millions of Lire)
25	80	100
27	80	110
29	80	120
31	85	130
33	90	140
35	95	150
37	100	160
39	105	170
41	110	180
43	115	190
45	120	195
47	125	200
49	128	202
51	130	204
53	132	205
55	133	205
57	134	205
59	135	205
61	135	205
63	135	205
65	135	205

**Dual worker career:**

- 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

			Dual Worker		Permanent Contr. Worker	
Growth Rate (g)	Retirement Age	Transformation Coefficients (2010)	Monthly Pension	Replacement Rate	Monthly Pension	Replacement Rate
1.5%	67	0.0562	1052	79%	1677	84%
	65	0.0562	996	75%	1591	79%
	60	0.04798	690	53%	1112	57%
1.2%	67	0.0562	1015	76%	1576	79%
	65	0.0562	943	71%	1502	75%
	60	0.04798	658	50%	1058	54%
1.0%	67	0.0562	953	71%	1513	75%
	65	0.0562	910	68%	1446	72%
	60	0.04798	638	49%	1023	52%

# Pension simulations for youngs: SWEDEN



## Dual worker career:

**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

			Dual Worker		Permanent Contr. Worker	
Growth Rate (g)	Retirement Age	Transformation Coefficients (2009)	Monthly Pension	Replacement Rate	Monthly Pension	Replacement Rate
2.0%	65	0.0621	957	46%	1508	48%
	67	0.0678	1147	55%	1804	56%
	70	0.0784	1506	71%	2365	72%
1.5%	65	0.0621	811	47%	1256	48%
	67	0.0678	964	55%	1490	57%
	70	0.0784	1249	72%	1927	74%

# Summarizing Pension Effect

The dualism is likely to deeply affect future pension entitlements of the youngsters by three main channels:

- Workers with temporary contract earn, *ceteris paribus*, less than workers with open-ended contracts
- They experience more frequent career breaks
- They are generally not covered by unemployment insurance
- The problem of adequacy is related to the dualism of labour markets, not to pension rules by themselves.

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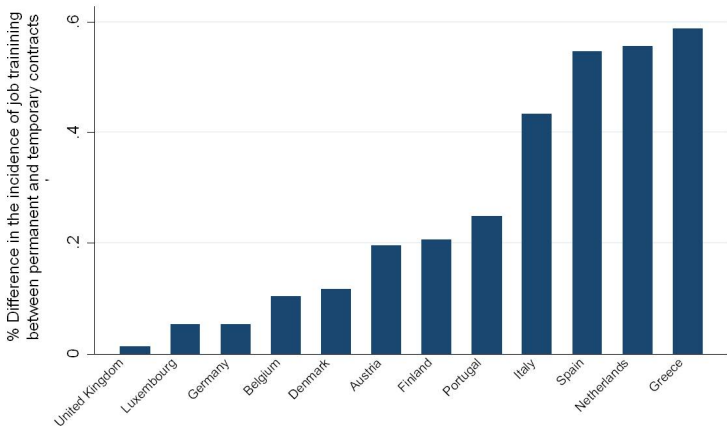
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# A lost Generation?

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



Source: ECHP

# How many cohorts affected? For how long?

The fact that they are young not mean that the costs are temporary.  
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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# Summarizing Undesirable Effects of Dualism

- 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: like the cohorts entering the labor markets in Japan and Sweden after the financial crises of the 1990s

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# Outline

- 1 Policy Induced Segmentation: Labour Market Reforms
- 2 Aggregate Effects of Dual-track Reforms
- 3 Dualism at Work
- 4 Exit Strategy**

# 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

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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 high salaries and higher contributions to unemployment benefits

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