Institutional Reforms in European Labor Market

Tito Boeri

Università Bocconi and Fondazione Rodolfo Debenedetti

November 6, 2009
Motivations

- Huge literature on European type labor market institutions
- Reviewed up to 2000 in previous HLE volumes
- No survey to date on the very many Institutional Reforms taking place especially in Europe
- Reforms are widely used to identify the effects of LM institutions as natural experiments
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This rich empirical literature needs stronger guidance from economic theory.

- Because reforms rarely increase or reduce a one-dimensional institution for everybody as envisaged by models with institutions but create longlasting asymmetries
- Properties of these multi-tier regimes have yet to be fully understood
- Theory useful also in highlighting the relevant institutional interactions and the general equilibrium effects (multi-tier reforms as a device to implement larger reforms)
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Outline

1. Introduction
2. Institutions and Reforms
3. A Simple Model of Labor Reallocation and Reforms
4. Learning from the Reforms
5. Final Remarks
Institutional Activism

Level of Labor Market Institutions in mid 1980s and at the most recent observation available:

OECD Index of Strictness of EPL

OECD Summary Generosity measure of UB
Institutional Activism

ALMP Expenditure to GDP Ratio (OECD)

Taxes and Benefits low wages (OECD)
## Mostly in Europe

<table>
<thead>
<tr>
<th>EPL Index</th>
<th>UB Generosity measure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>European</td>
</tr>
<tr>
<td>Mean</td>
<td>2.46</td>
</tr>
<tr>
<td>St. Dev</td>
<td>1.04</td>
</tr>
<tr>
<td>Average% variation</td>
<td>23.59%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>ALMP/GDP</th>
<th>Low Wages Tax (% points)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>European</td>
</tr>
<tr>
<td>Mean</td>
<td>0.64</td>
</tr>
<tr>
<td>St. Dev</td>
<td>0.53</td>
</tr>
<tr>
<td>Average% variation</td>
<td>79.36%</td>
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### Evolution of Labor Market Institutions in OECD countries
Some Key Definitions

- Labor market **institution**: a system of laws, norms or conventions resulting from a *collective* choice, and providing constraints or incentives which alter individual choices over labor and pay.
- Institutional **reform**: change in the design of an institution.
  - Two-tier (vs. complete) reform: the reform is confined to a subset of the potentially eligible population (alternatively its complete phasing in involves a very long transitional period). Focus on the scope/coverage.
  - Incremental (vs. discrete) reform: the reform involves a small change in the overall institutional level-indicator. Focus on the size.
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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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# The Taxonomy

<table>
<thead>
<tr>
<th>Size</th>
<th>Scope</th>
</tr>
</thead>
<tbody>
<tr>
<td>Discrete Two-tier</td>
<td>Structural</td>
</tr>
<tr>
<td>Incremental Two-tier</td>
<td>Incremental Complete</td>
</tr>
</tbody>
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T. Boeri (Università Bocconi)
Orientation of Reforms

Every institution creates a wedge between labor’s marginal productivity and opportunity cost.

Reforms increase or reduce the wedge.
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Reforms increase or reduce the wedge.
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The FRDB Social Policy Reform Inventory

- EPL, Employment Protection Legislation
- UB, Unemployment Benefits
- AP, Activation Programmes
- ECI, Employment Conditional Incentives
- ER, Early Retirement plans
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Tracking Reforms in Europe

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## Tracking Reforms in Europe

A snapshot from Fondazione Debenedetti database (1):

**Spain - EPL database**

<table>
<thead>
<tr>
<th>Year</th>
<th>Month</th>
<th>id</th>
<th>Number</th>
<th>Law</th>
<th>Description</th>
<th>Topic</th>
<th>Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>3</td>
<td>ES077</td>
<td>1</td>
<td>Ley 51/1980, Basic Employment Law (Ley Básica de Empleo)</td>
<td>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.</td>
<td>Trade union rights</td>
<td>employees</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>2</td>
<td>Regulation on termination of employment contracts.</td>
<td>Individual dismissals</td>
<td>Procedural obligations</td>
<td>employees</td>
</tr>
<tr>
<td>1981</td>
<td></td>
<td>ES078</td>
<td>1</td>
<td>Real Decreto 1362/1981</td>
<td>Regulation of fixed-term contracts</td>
<td>Fixed-term contracts</td>
<td>Fixed-term contracts</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>1</td>
<td>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 &quot;Contrato temporal de fomento del empleo&quot; (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.</td>
<td>Fixed-term contracts</td>
<td>Fixed-term workers</td>
<td></td>
</tr>
</tbody>
</table>
# Tracking Reforms in Europe

A snapshot from Fondazione Debenedetti database (2):

## Spain - EPL database

<table>
<thead>
<tr>
<th>Topic</th>
<th>Target</th>
<th>Sign</th>
<th>Overall sign</th>
<th>Two-Tier vs. Complete</th>
<th>Two-Tier vs. Complete - Overall</th>
<th>incremental vs. discrete</th>
<th>Source</th>
<th>Other policy area?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trade union rights</td>
<td>employees</td>
<td>increasing</td>
<td>increasing</td>
<td>complete</td>
<td>complete</td>
<td>incr</td>
<td>EMIRE</td>
<td></td>
</tr>
<tr>
<td>Individual dismissals - Procedural obligations</td>
<td>employees</td>
<td>increasing</td>
<td>complete</td>
<td></td>
<td></td>
<td></td>
<td>/</td>
<td></td>
</tr>
<tr>
<td>Fixed-term contracts</td>
<td>Fixed-term contracts</td>
<td>decreasing</td>
<td>decreasing</td>
<td>two-tier</td>
<td>two-tier</td>
<td>incr</td>
<td>NATLEX</td>
<td></td>
</tr>
</tbody>
</table>
Reforms and the Wedge

Reforms by Institution and Direction in 7 European Countries (France, Germany, UK, Spain, Italy, Netherlands, Denmark) in the 1980-2007 period.

<table>
<thead>
<tr>
<th>Reform area</th>
<th>Decreasing the Wedge</th>
<th>Increasing the Wedge</th>
<th>Total per row</th>
<th>Of which decreasing</th>
</tr>
</thead>
<tbody>
<tr>
<td>EPL</td>
<td>68</td>
<td>44</td>
<td>112</td>
<td>61%</td>
</tr>
<tr>
<td>UB</td>
<td>78</td>
<td>61</td>
<td>139</td>
<td>56%</td>
</tr>
<tr>
<td>AP</td>
<td>97</td>
<td>7</td>
<td>104</td>
<td>93%</td>
</tr>
<tr>
<td>ECI</td>
<td>60</td>
<td>6</td>
<td>66</td>
<td>91%</td>
</tr>
<tr>
<td>ER</td>
<td>21</td>
<td>22</td>
<td>43</td>
<td>49%</td>
</tr>
</tbody>
</table>
Reforms Decreasing the Wedge

Share of Reforms Decreasing the Wedge

Note: 5-year moving average
## Packaging of Reforms

Distribution of reforms by number of policy areas involved

<table>
<thead>
<tr>
<th>Number of Reform Areas involved by Reform</th>
<th>Number of Reforms</th>
<th>Percentage on total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 area</td>
<td>361</td>
<td>81.86%</td>
</tr>
<tr>
<td>2 areas</td>
<td>59</td>
<td>13.38%</td>
</tr>
<tr>
<td>3 areas</td>
<td>19</td>
<td>4.31%</td>
</tr>
<tr>
<td>4 areas or more</td>
<td>2</td>
<td>0.45%</td>
</tr>
<tr>
<td>Total</td>
<td>441</td>
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Two-Tier Reforms

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

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Incremental Reforms

Incremental reforms involve change in relevant institutional indicator of less than 10% of the average period cross-country standard deviation in the indicator.

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<tr>
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<tr>
<td>Incremental</td>
<td>40.18%</td>
<td>48.21%</td>
<td></td>
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## Labor market vs. Financial and Product Market Reforms

### Reforms of Product, Financial and Labor Markets

<table>
<thead>
<tr>
<th>Product Mkt Reforms</th>
<th>Decreasing the Wedge</th>
<th>Increasing the Wedge</th>
<th>Total</th>
<th>Of which Increasing</th>
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<tbody>
<tr>
<td>Discrete</td>
<td>31</td>
<td>0</td>
<td>31</td>
<td>100%</td>
</tr>
<tr>
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<td>14</td>
<td>22</td>
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</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>14</td>
<td>53</td>
<td>74%</td>
</tr>
<tr>
<td>Of which discrete</td>
<td>79%</td>
<td>0%</td>
<td>58%</td>
<td></td>
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<table>
<thead>
<tr>
<th>Financial Mkts Reforms</th>
<th>Decreasing Wedge</th>
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<th>Total</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Discrete</td>
<td>52</td>
<td>0</td>
<td>52</td>
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<tr>
<td>Incremental</td>
<td>42</td>
<td>0</td>
<td>42</td>
<td>100%</td>
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<tr>
<td>Total</td>
<td>94</td>
<td>0</td>
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<tr>
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<tr>
<td>Discrete</td>
<td>52</td>
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<td>52</td>
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<tr>
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</tr>
<tr>
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<table>
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<th>Labor Mkt Reforms</th>
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<tr>
<td>Incremental</td>
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<td>41</td>
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</tr>
<tr>
<td>Total</td>
<td>39</td>
<td>30</td>
<td>69</td>
<td>57%</td>
</tr>
<tr>
<td>Of which discrete</td>
<td>41%</td>
<td>43%</td>
<td>41%</td>
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</tr>
</tbody>
</table>
Labor market vs. Financial and Product Market Reforms

Reforms of Product, Financial and Labor Markets

<table>
<thead>
<tr>
<th>Product Mkt Reforms</th>
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<td>58%</td>
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<tr>
<th>Financial Mkts Reforms</th>
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</tr>
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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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Trade-off between size and scope
Outline

1. Introduction
2. Institutions and Reforms
3. A Simple Model of Labor Reallocation and Reforms
4. Learning from the Reforms
5. Final Remarks
Equilibrium job search. Labor market tightness, \( \theta \equiv v/u \). Aggregate matching function is \( m = m(u, v) \), unconditional probability of a vacancy to match with an unemployed worker is \( q = \frac{m(u, v)}{v} = m(\theta, 1) \), with \( q'(\theta) < 0 \), \( q''(\theta) > 0 \), and \( \lim_{\theta \to 0} q(\theta) = \infty \), the probability of an unemployed worker meeting a vacancy is \( \frac{m(u, v)}{u} = \frac{\theta m(u, v)}{v} = \theta q(\theta) \).
Unemployment

- **Endogenous job destruction.**
- Match productivity hit by shocks at frequency $\lambda$ (Random draw from $F()$)
- If it falls below an (endogenously determined) reservation productivity level $R$, the job is destroyed.
- The evolution of unemployment is governed by

$$\Delta u = \lambda F(R)(1 - u) - \theta q(\theta)u$$

(1)

where the constant labor force is normalized to one, so that $(1 - u)$ denotes employment.

Equating (1) to zero and solving for $u$ obtains the steady state $u$:

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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 ($\rho$ 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-wedges. Govt budget constraint not considered.
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Institutions in Partial Equilibrium

Wages set according to a bilateral bargaining process between each worker and each employer. The institution-free and match-specific wage obeys the Nash bargaining rule:

\[ w(x) = \beta(x + c\theta) \]

where \( 0 \leq \beta < 1 \) measures the relative bargaining strength of workers vis-a-vis employers. Size of the wedge related to match frictions. Sharing of rents to bargaining power.
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Institutions and the Wedge

Introducing now the three sets of institutions described above and solving again the Nash bargaining problem we obtain the institution-weighted wage equation:

\[ w(x) = (1 - \beta)(\rho w - e) + \beta [x + (c - h)\theta + rT] \]

Showing how institutions affect the size of the wedge and the way in which rents are split between workers and firms:

- When \( \beta = 0 \), wages equal the reservation wage of the unemployed net of employment subsidy.
- When instead \( \beta = 1 \), the workers will appropriate the entire match surplus. (Labor market shuts down; we need to impose \( \beta < 1 \)).

Wages increasing in UB generosity and EPL strictness. Decreasing in ECI and AP. Notice that the effects of \( \theta \) on \( w \) interact with institution hiring subsidy.
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General Equilibrium Effects of Complete Reforms

Allowing macrovariables to vary (totally differentiate the two equilibrium gross job creation and gross job destruction conditions, implicitly providing the equilibrium values $\theta^*$ and $R^*$).

### Comparative Statics Results of Complete Reforms

<table>
<thead>
<tr>
<th>Effect of an increase in $\rho$ on $R^*$</th>
<th>$\rho$</th>
<th>$T$</th>
<th>$e$</th>
<th>$h$</th>
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<tbody>
<tr>
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<td>?</td>
<td>?</td>
</tr>
<tr>
<td>$\theta^*$</td>
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<td>+</td>
<td>+</td>
</tr>
<tr>
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</table>
Economics behind these results

An increase in the replacement rate offered by unemployment benefits moves up the reservation productivity at which matches are dissolved by increasing the outside option of workers. The new equilibrium features a higher job destruction rate $\lambda F(R^*)$. The higher outside option of workers also positively affects $\delta$ the average wage in continuing jobs (second round effect on UB).

As gross job destruction increases, the equilibrium unemployment rate unambiguously increases, bringing down the equilibrium level of market tightness, $\theta^*$.

The new equilibrium features a higher probability of job loss and a lower job finding rate $\theta^* q(\theta^*)$. 
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An increase in firing taxes reduces the gross job destruction rate. Also job creation declines. Ambiguous effect on unemployment.

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A two-tier reform of EPL 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, occurring, as for the other types of jobs, at Poisson frequency \(\lambda\). 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 costlessly converted into permanent contracts, covered by the standard firing taxes, \(T\).
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The expected duration of a fixed-term job is \( \frac{1}{\lambda} \) whilst the rate at which these jobs are converted into permanent jobs is \( \lambda [1 - F(R_0)] \) where \( R_0 \) is endogenously determined at the equilibrium.

Insofar as firing taxes are higher for long-tenured than for entry jobs (a standard feature of employment protection in all countries), the reservation productivity at entry jobs will be higher than the reservation productivity at continuing jobs, that is, \( R_0 > R \).

Entry jobs also receive employment subsidies. Unemployed from entry jobs are entitled to lower UB (\( \rho_0 < \rho \)).
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We now have two job destruction conditions implicitly defining the two thresholds ($R$ and $R_0$), and two wage equations. The first wage equation determines workers pay in entry jobs or the wage of outsiders, denoted by the subscript 0.

$$w_0 = (1 - \beta) (\rho_0 \bar{w} - e_0) + \beta (1 + (c - h)\theta - \lambda T)$$

The second applies to continuing jobs and provides insider wages at all productivity levels above the reservation productivity level, $R$

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Even for lower \( x \), \( w(x) > w_0 \) in this setting. Continuing jobs have lower average productivity, but higher average wages than entry jobs.
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Job flows and two-tier reforms

The job creation and job destruction condition for the two-tier regimes can be derived by imposing that $V = 0$, $J(R_0) = 0$ and $J(R) = -T$ and using the Nash bargaining rule. This yields the job creation condition

$$\frac{(1 - \beta) (e_0 - R_0)}{r + \lambda} - \frac{\beta}{r + \lambda} (1 - \lambda T) = \frac{c - h}{q(\theta)}$$

The job destruction condition for temporary jobs

$$R_0 + \frac{\lambda}{r + \lambda} \int_{R_0}^1 (z - R_0) dF(z) + e_0 - \lambda T = \rho_0 w + \frac{\beta (c - h) \theta}{1 - \beta}$$

and the job destruction for continuing jobs

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Job flows and two-tier reforms

Comparative Statics of Two-Tier Reforms

<table>
<thead>
<tr>
<th>Effect of an increase in $\rightarrow$</th>
<th>$\rho$</th>
<th>$T$</th>
<th>$e_0$</th>
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</thead>
<tbody>
<tr>
<td>$R^*_o$</td>
<td>0</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>$R^*$</td>
<td>+</td>
<td>-</td>
<td>0</td>
</tr>
<tr>
<td>$\theta^*$</td>
<td>0</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>$u^*$</td>
<td>+</td>
<td>-?</td>
<td>-?</td>
</tr>
</tbody>
</table>

- Job loss rate (from entry jobs) 0 + +
- Job loss rate (from continuing jobs) + - 0
- Job finding rate 0 + +
- Tenure (wage premium) + + +
- Conversion temporary-permanent 0 - -
- Entry jobs as % of total employment + + +
Comparing Two-tier and Complete Reforms

<table>
<thead>
<tr>
<th>Comparative Statics of Reforms</th>
<th>Two-tier</th>
<th>Complete</th>
</tr>
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<tbody>
<tr>
<td>Effect of an increase in $\rho$ on $T$</td>
<td>$e_0$</td>
<td>$\rho$</td>
</tr>
<tr>
<td>$R^*_0$</td>
<td>0</td>
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</tr>
<tr>
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<td>+</td>
<td>-</td>
</tr>
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Key differences with respect to complete reforms:

- $\rho \uparrow$ accompanied by reduction of $\rho_0$ does not necessarily increase $u$ (important in pathways to flexicurity)
- $T \uparrow$ increases turnover
- $\rho \uparrow$ may increase job destruction (for entry jobs)
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Example of two-tier reforms of Epl (Boeri and Garibaldi, 2007)

Flexi-land

$L^d (bad\ times)$

$L^d (good\ times)$

Employment

A

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

<table>
<thead>
<tr>
<th>Country</th>
<th>Time Period</th>
<th>EPL strictness (Overall Index)</th>
<th>EPL Strictness (Temporary Employment)</th>
<th>Temporary Emp. Growth $\Delta ET_t$ (000)</th>
<th>Contribution of Temporary Jobs $\Delta ET_t/E_0$</th>
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<tbody>
<tr>
<td>Belgium</td>
<td>1987-1996</td>
<td>3.15</td>
<td>4.63</td>
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<tr>
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<td>1997-2005</td>
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<td>135.3</td>
<td>3.54</td>
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<td></td>
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<td>112.6</td>
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<tr>
<td>Italy</td>
<td>1987-1997</td>
<td>3.54</td>
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<td>402.9</td>
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<td>1998-2005</td>
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<td></td>
<td>823.2</td>
<td>4.11</td>
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<td>$\Delta$</td>
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<td>420.3</td>
<td>4.09</td>
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<tr>
<td>The Netherlands</td>
<td>1987-1995</td>
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<td>2.38</td>
<td>340.1</td>
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<td>1996-2005</td>
<td></td>
<td></td>
<td>288.8</td>
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<td>$\Delta$</td>
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<td>-51.3</td>
<td>-2</td>
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<tr>
<td>Portugal</td>
<td>1987-1996</td>
<td>3.95</td>
<td>3.34</td>
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<tr>
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<td>1997-2005</td>
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<td>431.8</td>
<td>10.09</td>
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<td>600.6</td>
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<tr>
<td>Spain</td>
<td>1981-1984</td>
<td>3.9</td>
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<td>0</td>
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<tr>
<td></td>
<td>1985-1995</td>
<td></td>
<td></td>
<td>3377.1</td>
<td>28.5</td>
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<td>28.5</td>
</tr>
<tr>
<td></td>
<td>1997-2005</td>
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<td></td>
<td>189.2</td>
<td>4.82</td>
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<tr>
<td></td>
<td></td>
<td>$\Delta$</td>
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<td>328.1</td>
<td>8.04</td>
</tr>
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- What are the relevant institutional interactions involved by the reform?
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Review

Literature based on cross-country variation in the OECD EPL strictness indicator: why there is not less employment turnover with strict EPL?

<table>
<thead>
<tr>
<th>Author(s)</th>
<th>STOCKS</th>
<th>FLOWS</th>
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<tbody>
<tr>
<td></td>
<td>Employment</td>
<td>Unemployment</td>
</tr>
<tr>
<td>Lazear (1990)</td>
<td>—</td>
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</tr>
<tr>
<td>Grubb &amp; Wells (1993)</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Di Tella &amp; McCulloch (1998)</td>
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<td>+</td>
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<tr>
<td>Kugler &amp; StPaul (2000)</td>
<td></td>
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</tr>
<tr>
<td>Belot &amp; Van Ours (2001)</td>
<td>—</td>
<td></td>
</tr>
<tr>
<td>Garibaldi &amp; Violante (2005)</td>
<td>+</td>
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</tbody>
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The Effects of Employment Protection on Labor Market: Empirical Results
It does not seem to be a measurement problem

Workers Reallocation and Epl strictness (2000-2005)
Revised series - OECD(2009)

Is it Two-tier Reforms?
Problems

Identification of causal effects in a differences-in-differences framework requires that the two segments of the labor force taken as the "treatment" (\(s = 1\)) the "control" (\(s = 0\)) groups would have had the same trends in the outcome variable, had the reform not occurred. Assuming for simplicity that EPL reform simply adds a constant \(\delta\) to the conditional mean of some outcome variable (e.g., employment, \(N\)), i.e.:\[
N_{it} = \beta_t + \gamma_i + \delta s_i + \varepsilon_i
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where \(i\) denotes the labor market segment (temporary vs permanent contracts), \(t\) is time, \(\beta\) is a common time trend, \(\gamma\) is a segment-specific fixed effect, \(s\) is a dummy variable taking value one after the reform limited to the treatment group.
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$$\{ E[N_{it} \mid s_i = 1, t = 1] - E[N_{it} \mid s_i = 1, t = 0] \} +$$

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(2)

If the reform of EPL also affects the "control" group, by adding $\delta_2$ to its conditional mean, the first difference in (2) identifies $\delta_1 + \beta + \gamma$ while the second difference $\delta_2 + \beta + \gamma$. And double diff obtains differential effect $\delta_1 - \delta_2$.
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Employment Protection

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T. Boeri (Università Bocconi)
Macro and micro literature consistent in finding that duration of UBs matters more than replacement rates.

Is it due to the endogeneity of the duration of UBs?
Review

- Macro and micro literature consistent in finding that duration of UBs matters more than replacement rates.

- Is it due to the endogeneity of the duration of UBs?
Problems: Policy endogeneity

Evidence that duration of UB reacts to levels of unemployment.

If reforms are dictated by stronger trend growth of unemployment being different in the two groups ($\beta_{10} > \beta_{00}$), a double differences identifies $(\beta_{11} - \beta_{10}) - (\beta_{01} - \beta_{00}) + \delta$ attributing to the reform effects which are instead related to differential dynamics of unemployment in the absence of the reform.

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Problems: Neglected Interactions with other institutions

Example of Social Assistance

\[ b \]

\[ \text{Duration of Unemployment} \]

\[ \text{Reservation Wage} \]

\[ \text{Duration of Unemployment} \]
Employment Conditional Incentives

- Narrow targets. Goals: not only employment, but also poverty reduction.
- Literature mostly on US and UK.
- A few randomized experiments (mainly in Us and Canada)
- Partial equilibrium analysis.
- Focus on efficiency
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A few randomized experiments (mainly in US and Canada)

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Focus on efficiency
Problems

- Sorting into treatment and control groups

- Empirical research on employment conditional incentives has mainly evaluated the effects on labor supply.

- The model suggests that labor demand effects could also be important.
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Activation programs

- Compulsory involvement on PES placement and counselling services. Device to enforce of work-tests.

- Sanctions are effective.

- Public Employment Services, by themselves, not much.
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Problems

- Activation relies on self-selection on the most needy.
- Thus serious endogenous sorting issue.
- Wage effects generally overlooked. Important also in partial equilibrium.
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Outline

1. Introduction
2. Institutions and Reforms
3. A Simple Model of Labor Reallocation and Reforms
4. Learning from the Reforms
5. Final Remarks
Theoretical literature on labor market institutions evaluates complete reforms, but the bulk of reforms involves the introduction of two-tier regimes. Empirical research draws mainly on these two-tier reforms, but has received little theoretical guidance. Extensions of a general equilibrium model of the LM suggest that two-tier reforms are different than complete reforms, have important reallocate effects and interactions with other institutions. Rarely these effects and interactions are taken into account in micro evaluation studies. More theoretical work on two-tier reforms is warranted. Better descriptions of reforms in applied work (see the checklist) would help the development of a theory of labor market reforms.