

# Spanish Labor Market Reforms

What does economic theory teach us?

Thijs van Rens

CREI, Universitat Pompeu Fabra, and Barcelona GSE

8th Trobada of the Barcelona GSE

October 22, 2010

# The labor market reform, simplified

- The Spanish labor market: high **employment protection** (EP)
  - ① High severance pay,

## OECD indicators on Employment Protection

### Employment protection in OECD and selected non-OECD countries, 2008\*

Scale from 0 (least restrictions) to 6 (most restrictions)

	Protection of permanent workers against (individual) dismissal	OECD employment protection index	Severance pay (weeks of salary), World Bank Doing Business Survey	
United States	0.56	0.86	0	
Canada	1.17	1.02	28	
United Kingdom	1.17	1.09	22	
Ireland	1.67	1.39	24	
Switzerland	1.19	1.77		
Denmark	1.53	1.91	0	
Sweden	2.72	2.08	26	
Hungary	1.82	2.11		
Slovak Republic	2.45	2.13		
Netherlands	2.73	2.23	17	
Finland	2.38	2.29	26	
Czech Republic	3.00	2.32		
Austria	2.19	2.41		
Poland	2.01	2.41		
Italy	1.69	2.68	11	
Belgium	1.94	2.81	16	
Germany	2.85	2.63	69	
India	3.65	2.63		
Norway	2.20	2.66		
Slovenia	2.98	2.78		
Portugal	3.51	2.84	95	
Greece	2.28	2.97		
France	2.60	3.00	32	
Spain	2.38	3.11	56	
Luxembourg	2.68	3.39		

# The Spanish labor market, simplified

- The Spanish labor market: high **employment protection** (EP)
  - 1 High severance pay,
  - 2 which increases in job tenure,  
(45 days of salary per year worked)
  - 3 in a discontinuous manner.  
(dual labor market)
- The reforms: mitigate 1, 2 and 3

# A (Nobel-prize winning) model of the labor market

- Mortensen-Pissarides (REStud 1994)
  - Unemployed workers receive benefits and search for jobs
  - Firms post vacancies (costly) and search for workers
  - Wages are set by Nash bargaining
  - Matches are subject to idiosyncratic productivity shocks
- Job Creation
  - Posting more vacancies decreases probability to find worker
  - Create vacancies until ENPV costs = ENPV profits
- Job Destruction
  - Marginal job has productivity  $y_R$  such that ENPV profits = 0
  - Destroy job if idiosyncratic productivity  $y < y_R$

# EP in the model: Severance pay

	Steady state			Volatility			Welfare
	JD	JC	u	JD	JC	u	
Severance pay	0	0	0	0	0	0	0

- Severance pay
  - Transfer from firm to worker
  - Offset in ex-ante wage bargaining
- How realistic is this?
  - Wages are pretty low in Spain
  - Wages are low *before* firms commit to severance pay
- Crucial question: How flexible are wages?

# EP in the model: Firing costs

	Steady state			Volatility			Welfare
	JD	JC	u	JD	JC	u	
Firing costs	-	+	?/0				

- Firing costs
  - Increase labor hoarding  $\Rightarrow$  reduce JD
  - Reduce the ex-ante value of a vacancy  $\Rightarrow$  reduce JC
- Net effect is ambiguous

$$\frac{du}{u(1-u)} = \frac{ds}{s} - \frac{df}{f} = \frac{y_R F'(y_R)}{F(y_R)} \frac{dy_R}{y_R} - \frac{\theta p'(\theta)}{p(\theta)} \frac{d\theta}{\theta}$$

- Ambiguous across different models (Ljunqvist 2002)
- For reasonable calibrations, net effect is small

# EP in the model: Firing costs

	Steady state			Volatility			Welfare
	JD	JC	u	JD	JC	u	
Firing costs	-	+	?/0	-	+	?/-	?/0

- Firing costs  $\Rightarrow$  Volatility
  - Increase labor hoarding  $\Rightarrow$  reduce volatility JD
  - Reduce match surplus  $\Rightarrow$  increase volatility JC
- Net effect is again ambiguous
  - For reasonable calibrations, net effect is reduced volatility (Veracierto 2008, Thomas 2006)
  - We should be able to do better than this!! (using observed elasticities of  $s$  and  $f$ , cf Costain and Reiter 2008)
- Empirical evidence is mixed (Güell 2010)

## EP in the model: EP increasing with tenure

	Steady state			Volatility			Welfare
	JD	JC	u	JD	JC	u	
EP incr w/ tenure	?	?	?	?	?	?	?

- In the model, it is irrelevant whether EP depends on tenure (or on skill, occupation, gender, ...)
- Why may be optimal to increase EP with tenure?
  - “the psychological costs associated with job loss, which are typically increasing with time in the job” (Bentolilla, Boeri and Cahuc, VoxEU 2010)
  - Risk aversion + retirement decision
  - Match-specific human capital

# EP in the model: Dual labor markets

	Steady state			Volatility			Welfare
	JD	JC	u	JD	JC	u	
Dual labor market						+	-

- Dual labor markets increase volatility
  - Sala, Silva and Toledo (2009), Bentolila, Cahuc, Dolado and LeBarbanchon (2010), Costain, Jimeno and Thomas (2010)
  - Important insight: firing costs low at the firing margin, high on average (worst of both worlds!)

# EP in the model: Dual labor markets

	Steady state			Volatility			Welfare
	JD	JC	u	JD	JC	u	
Dual labor market	?	?	?	?	?	?	?

- Dual labor markets increase volatility
  - Sala, Silva and Toledo (2009), Bentolilla, Cahuc, Dolado and LeBarbanchon (2010), Costain, Jimeno and Thomas (2010)
  - Important insight: firing costs low at the firing margin, high on average (worst of both worlds!)
- However, this is only part of the story
  - No reason for why EP should vary at all with tenure
  - Distortions hard to understand without heterogeneity: inefficient labor turnover (Bentolilla, Boeri and Cahuc 2010; Bentolilla 2008; Blanchard 2005)
- My intuition: The *discontinuity* must be distortionary

# EP in the model: Summary

	Steady state			Volatility			Welfare
	JD	JC	u	JD	JC	u	
Severance pay	0	0	0	0	0	0	0
Firing costs	-	+	?/0	-	+	?/0	?/0
EP incr w/ tenure	?	?	?	?	?	?	?
Dual labor market	?	?	?	?	?	?	?

# What does economic theory teach us?

- What have we learned so far?
  - Not much!
  - High employment protection not necessarily bad,
  - but dual labor market seems a bad idea
- Missing elements
  - 1 Heterogeneity
    - Heterogeneity in firing costs  $\Rightarrow$  mismatch & inefficient turnover
    - Segmentation  $\Rightarrow$  'structural' unemployment
  - 2 Optimal EP with heterogeneity (match-specific human capital)
  - 3 How are wages set? (centralized bargaining)

# Finally, there is no free lunch ...

- Focus on labor market reform driven by lack of options
  - (Keynesian) fiscal stimulus is infeasible because of fear of debt crisis
  - Structural changes take time
  - Politics ...
- But: How effective will reform be?
  - 20% unemployment in Spain has happened before, including in 1984, before introduction temporary contracts
  - If unemployment is cyclical, removing firing costs may make things worse! (Krugman, Rodrik)