Labor market regulation

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Key definitions

- **Insiders**: incumbent workers (with/without given seniority) who benefit of favorable work conditions
- **Outsiders**: unemployed or workers employed in the secondary market (i.e., shadow, low-pay, temporary).
- At some point, we'll refer to broader classification:
    1. Skilled workers
    2. Unskilled workers
    3. Short-term unemployed
    4. Long-term unemployed
    5. Firms or capitalists

Political economy models

- **Key idea**: employed are more numerous and/or better organized than the unemployed. As a result, institutions respond to the interests of the former
- **Conflict of interests**: policies helping long-term unemployed put downward pressure on wages (by increasing the competition from outsiders)
- *But* policies favoring short-term unemployed increase the outside option of insiders, allowing them to bid up their wages

The political roots of labor market rigidities

- **Basic assumption**: decisive voter (e.g., median) is employed. This could also be due to the fact the employed easily self-organize (Olson 1965)
- Assume that his/her welfare can be expressed as: $V=Pw_e(1-t)+(1-P)w_u$ where
  - P = probability of remaining employed
  - w_e = income when employed
  - w_u = income when unemployed
  - t = tax paid by the employed
- Hence, labor market institutions can influence the employed welfare through a number of **channels**

Labor market institutions and the decisive voter

1. **Wage formation (w_e)**: institutions affect the outside option, rent, and productivity of insiders (w_e = outside option + rent = MPL – firm's rent)
2. **Exposure (w_u)**: As long as P<1, also the employed are exposed to unemployment
3. **Turnover (P)**: This interacts with the exposure effect in shaping how the employed are "sympathetic" with the unemployed
4. **Tax (t)**: Institutions also affect taxation (through both direct and indirect effects)

Labor market institutions and the decisive voter (cont.)

- *Examples*:
  - **Firing costs** directly affect both insiders' rent and the turnover rate (P)
  - **Minimum wage** (assuming that median voter earns more) indirectly affects wage and taxes
  - **Unemployment benefits** directly affect insiders' outside option, taxes, and exposure to unemployment (w_u)

Institutions, politics, and the economic environment

- We have seen how institutions determine economic variables
- But the economic environment usually strikes back by making some institutions more politically viable than others. *Examples*:
  - **Unemployment level**
  - **Turnover rate**
  - **Recessions and political hysteresis**
  - **Elasticity of labor demand**

Reform design

- Many of the reforms that would reduce unemployment are unpopular because they would remove benefits for insiders
- That's why most reforms are designed to act **at the margin** (by leaving existing employees unaffected). This may lead to a *two-tier system*:
  - **Primary sector** of protected and high-pay workers
  - **Secondary sector** of (long-term) temporary workers

Economic crises and reforms

- For the same reason, it may be easier to implement reforms when economic crisis is looming:
  - Because winners and losers are unknown ex ante
  - Expected turnover rate increases

- But when the crisis is over, insiders have again incentive to introduce labor market rigidities