



## Evaluating labor market reforms: A normative analysis



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### ABSTRACT

This paper shows that a reform aimed at improving labor market flexibility is not necessarily welfare-enhancing. We adopt a New-Keynesian model enriched with search and matching frictions. We investigate the effects of institutional labor market reforms, described by a permanent change in firing costs and unemployment benefits. Improving labor market flexibility by cutting unemployment benefits is welfare-enhancing for households. On the contrary, cutting firing costs reduces welfare. We argue that real wage dynamics play a crucial role in the results. Furthermore, welfare effects tend to zero when the reform is pre-announced.

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## 1. Introduction

In many developed countries, the recent financial crisis has led to a strong deterioration of the labor market. Consequently, several European countries have made large reforms in labor regulation aimed at dealing with historical high unemployment rates. The Structural Issues Report by the ECB (2012) argues that “A comprehensive reform strategy to increase labour market flexibility is a key ingredient for a solid economic recovery”. In April 2013, the UK government implemented the ‘Benefit Cap’ policy, putting a limit on the total amount of benefits that people can receive. The objective of this cap, among others, is to give clear incentives to unemployed to accept a job. The labor market flexibilisation has started before the crisis in some countries. For instance, Germany implemented from 2003 a set of reforms (‘Hartz Reforms’) which mostly seek to relax some rules protecting workers, notably by drastically cutting unemployment benefits.<sup>2</sup>

The aim of this paper is to evaluate the normative implications of reforms aimed at increasing the degree of labor market flexibility. In the presence of strict employment protection regulation, employers tend to fill vacancies only with well-matched employees, as firing might be costly. Therefore, a cut in firing costs increases flexibility insofar as employment is more likely to adjust to cyclical and structural changes. Similarly, labor market deregulation can be achieved by cutting unemployment benefits, which is viewed as an increase in the disutility from unemployment.

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<sup>2</sup> Some papers have investigated the impact of the Hartz Reforms on the German labor market. For instance, Krause and Uhlig (2012) show that the reduction of the duration of unemployment benefits has helped to reduce the unemployment rate. The Hartz Reform has also helped to improve the matching efficiency, as shown by Fahr and Sunde (2009) and Klinger and Rothe (2012). Hertweck and Sigris (2012) provide a formal estimation of the matching function and they show that the matching efficiency coefficient increased by 23% in late 2003.

We resort to a New Keynesian model enriched with search and matching frictions on the labor market. The search and matching model is widely accepted for analyzing the role of labor market institutions on (un)employment (Mortensen and Pissarides, 2003).<sup>3</sup> Thomas and Zanetti (2009) emphasize the negligible role of employment protection legislation in European inflation dynamics. Campolmi and Faia (2011) show that differences in terms of unemployment protection systems among countries lead to inflation volatility differential and welfare losses. Abbritti and Mueller (2013) disentangle the role of labor market institutions and real wage rigidities on the unemployment and inflation volatility differential among countries. The closest paper to ours is the one by Zanetti (2011), who shows that firing costs and unemployment benefits substantially affect macroeconomic fluctuations. These papers mainly focus on how labor market institutions influence the business cycle.

This paper contributes to the literature by assessing the effects of labor market reforms on welfare.<sup>4</sup> We focus on two types of instruments designed to undertake labor market reforms, namely firing costs and unemployment benefits. These instruments are known to have different effects on wages and the labor share in the surplus (Mortensen and Pissarides, 2000; Pissarides, 2000). In this paper, we stray from the positive approach to propose a normative analysis of labor market reforms. Consequently, the contribution of the paper is twofold. First, by building a model incorporating a set of instruments, we can evaluate which labor market policy is preferable in terms of welfare. Second, we investigate how welfare is affected by unanticipated and pre-announced labor market reforms. In a first step, we build a medium-scaled deterministic Dynamic General Equilibrium (DGE) New-Keynesian-type model with endogenous separations and matching frictions. The labor market specification is based on the economics of search along the lines of Mortensen and Pissarides (1994) and den Haan et al. (2000). In a second step, we parameterize the model for the Euro Area, based on stylized facts and literature evidence. In a third step, welfare implications of structural labor market reforms are investigated. We follow Lucas (1987): the net welfare effect of the reform is measured as the constant percentage increase in one of these instruments that leaves households indifferent between the lifetime utility obtained by remaining in the pre-reform equilibrium, and the lifetime utility obtained by undertaking the reform, inclusive of the transitional dynamics. Then, we investigate which reform is preferable in terms of welfare. We consider two types of timing regarding the labor market reform. Either it is announced and undertaken at time 0 or it is pre-announced a few quarters in advance. This allows us to compare the normative implications of implementation delays.

We show that reforms aimed at improving labor market flexibility are not necessarily welfare-enhancing. In particular, reducing firing costs generates a drop in welfare by 0.23% of steady-state consumption. This result can be explained by a “wage channel”.<sup>5</sup> Precisely, we stress that a reform which increases the real wage (as for instance a firing costs reduction) can be costly in terms of welfare since it generates inflationary pressures and a monetary tightening, which in turn depresses consumption and reduces welfare. Although monetary policy is neutral in the long-run, we argue that it plays a role during the transition period. We also find that increasing labor market flexibility by reducing permanently unemployment benefits increases welfare. A reduction by one percent increases welfare by 0.55% of steady-state consumption. Here again, this result is explained by the presence of the wage channel in this monetary model: lower unemployment benefits reduce real wages, which makes the monetary policy more accommodative and stimulates consumption during the transition. We emphasize the importance of price stickiness and the Taylor rule in our results. Finally, we show that the welfare effects are reduced by implementation delays in a non-linear way. In case of a reduction in unemployment benefits, firms lay-off immediately some workers since they anticipate a rise in wages, which slightly reduces the welfare gains of the reform.

Some papers have already analyzed firing costs from a normative perspective. By using a search model with asymmetric information during the bargaining process, Matouschek et al. (2009) show that a small reduction in the firing tax reduces welfare when labor market frictions are severe. Hopenhayn and Rogerson (1993) use an industry general equilibrium model which abstracts from unemployment and focuses on employment-nonemployment decisions. Unlike the previous authors, they find that a lower tax on firing costs distorts the job creation and destruction process which in turn increases productivity and welfare.<sup>6</sup> On the contrary to previous studies, we use a DGE model with search and matching frictions and nominal rigidities. We argue that the nominal dimension does play a role in understanding the normative implication of a firing cost cut.<sup>7</sup>

The remainder is as follows. Section 2 presents the theoretical model. Section 3 discusses model's parameterization. Section 4 discusses the results from using different instruments to increase labor market flexibility, with different timing set-ups. The last section briefly concludes.

<sup>3</sup> The matching process between workers and firms represents a convenient hypothetical concept to analyze individual decisions on the labor market. Alternative designs are also used in the literature to analyze labor market institutions (Alonso-Borrego et al., 2005; Brown et al., 2009).

<sup>4</sup> The literature focusing on the welfare implications of labor market reforms in a dynamic general equilibrium model is somewhat sparse. Brown et al. (2011) look at the effects of employment subsidies on welfare. Mendoza and Tesar (1998) show that welfare gains of eliminating labor income tax are higher when the financial markets across countries are integrated. Gomes et al. (2013) use large-scaled models to analyze a labor market deregulation. They show that the normative implications are sizeable, especially when it generates favorable terms of trade movements (due to a cross-country coordination of reforms). Poilly and Sahuc (2013) assess how welfare is sensitive to a change in the labor market structure. By incorporating an endogenous separation rate, we depart from these two authors since we can evaluate the effect of structural labor market policy reforms.

<sup>5</sup> Christoffel and Kuester (2008) emphasize the role of the wage channel for price dynamics in a New-Keynesian model with job-related fixed costs, right-to-manage bargaining, and wage stickiness. However, they focus on the implications of the wage channel for business cycle dynamics.

<sup>6</sup> Alvarez and Veracierto (1998) extend the previous model by introducing reallocation and search frictions. They find similar results. Later on, Alvarez and Veracierto (2000) use an island search model to analyze a wider range of labor market reforms.

<sup>7</sup> Some papers look at the interaction between nominal rigidities and labor market frictions (see for instance, Walsh, 2004; Krause and Lubik, 2007; Barnichon, 2010; Thomas, 2011, among many others). However, they perform a business cycle analysis.

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