

Contents

List of Boxes xv

Preface and Acknowledgments xix

Symbols and Acronyms xxxi

1 Overview 1

1.1 Why Study Labor Economics? 1

1.2 The Two Key Decisions 7

1.2.1 The Labor Supply Decision 8

1.2.2 The Labor Demand Decision 16

1.3 Labor Market Equilibrium 19

1.3.1 A Perfect Labor Market 19

1.3.2 An Imperfect Labor Market 21

1.4 Labor Market Institutions 24

1.4.1 Why Do Labor Market Institutions Exist? 25

1.4.2 Institutions Matter 29

1.5 Measures of Labor Market Outcomes 32

1.5.1 Stock Measures 32

1.5.2 Flow Measures 33

1.5.3 Problems with Standard Measures of Labor
Market Status 34

1.6 Documenting Reforms in Labor Market Institutions 36

1.7 Review Questions and Exercises 47

1.8 Technical Annex: Competitive Pressures and Institutions 49

1.8.1 A Competitive Labor Market 49

1.8.2 Labor Market Institutions 50

1.8.3 The Wedge 51

1.8.4 Product Market Competition and the Employment Bias
of Institutions 53

2 Minimum Wages 55

2.1 Cross-Country Comparisons 57

2.2 Theory 61

2.2.1 A Perfect Labor Market 61

2.2.2 An Imperfect Labor Market 63

2.3	Empirical Evidence	71
2.3.1	Studies Based on Firm-Level or Household Survey Data	72
2.3.2	Studies Based on Natural Experiments	73
2.3.3	Studies Based on Matched Employer-Employee Data	78
2.4	Policy Issues	83
2.4.1	Are Minimum Wages Effective in Reducing Poverty?	83
2.4.2	Should There Be a Youth Minimum Wage?	85
2.5	Interactions with Other Institutions	91
2.6	The Future of the Minimum Wage	92
2.7	Suggestions for Further Reading	94
2.8	Review Questions and Exercises	94
2.9	Technical Annex: Minimum Wage Revisited	96
2.9.1	Minimum Wage and Monopsony	96
2.9.2	Bargaining or Government Setting?	97
2.9.3	Efficiency Wages and the Solow Condition	98
3	Unions and Collective Bargaining	100
3.1	Measures and Cross-Country Comparisons	101
3.1.1	Union Density	101
3.1.2	Coverage and Excess Coverage	105
3.1.3	Centralization and Coordination	106
3.1.4	The Extension of Collective Bargaining	109
3.1.5	Strike Activity	112
3.2	Theory	113
3.2.1	A Perfect Labor Market	113
3.2.2	An Imperfect Labor Market	114
3.3	Empirical Evidence	125
3.3.1	Bargaining Coordination, Union Density, and Unemployment	126
3.3.2	Effects of Unions on Wages	127
3.3.3	Characteristics of the Collective Bargaining System	130
3.4	Policy Issues	134
3.4.1	Do Unions Increase Efficiency?	134
3.4.2	Should Occupational Licensing Be Restricted?	136
3.5	Interactions with Other Institutions	138
3.6	The Future of Unions	139
3.7	Suggestions for Further Reading	140
3.8	Review Questions and Exercises	141
3.9	Technical Annex: Unions Revisited	143
3.9.1	How Strong Must Unions Be to Be Efficient?	143
3.9.2	Deriving the Contract Curve	146
4	Anti-Discrimination Legislation	149
4.1	Measures and Cross-Country Comparisons	150
4.2	Theory	153
4.2.1	A Perfect Labor Market	153
4.2.2	An Imperfect Labor Market	158

4.3	Empirical Evidence	164
4.3.1	Cross-Country Differences	165
4.3.2	Discrimination in the Labor Market	169
4.4	Policy Issues	177
4.4.1	Should Applications Be Anonymized?	179
4.4.2	Should Minority Quotas Be Introduced?	180
4.5	Interactions with Other Institutions	183
4.6	The Future of Anti-Discrimination Legislation	184
4.7	Suggestions for Further Reading	185
4.8	Review Questions and Exercises	185
4.9	Technical Annex: Issues on Discrimination	188
4.9.1	Prejudice in a Competitive Labor Market	188
4.9.2	Monopsony and Gender Discrimination	189
4.9.3	Unobserved Heterogeneity and Correspondence Studies	190
5	Regulation of Working Hours	192
5.1	Measures and Cross-Country Comparisons	193
5.1.1	Legal Restrictions on Working Hours	194
5.1.2	Regulations of Part-Time Employment	194
5.1.3	Subsidized Short-Time Work	196
5.2	Theory	200
5.2.1	A Perfect Labor Market	200
5.2.2	An Imperfect Labor Market	207
5.3	Empirical Evidence	214
5.3.1	Macro Facts about Working Hours	214
5.3.2	Microeconomic Evidence on the Effects of Reductions in Working Hours	220
5.4	Policy Issues	225
5.4.1	Should Governments Regulate Working Hours?	225
5.4.2	Should Governments Subsidize Short-Time Work?	226
5.5	Interactions with Other Institutions	229
5.6	The Future of Working Hours Regulations	231
5.7	Suggestions for Further Reading	232
5.8	Review Questions and Exercises	233
5.9	Technical Annex: Intensive and Extensive Margins	234
6	Early Retirement Plans	237
6.1	Measures and Cross-Country Comparisons	238
6.2	Theory	241
6.2.1	A Perfect Labor Market	241
6.2.2	An Imperfect Labor Market	245
6.3	Empirical Evidence	248
6.3.1	Macro Facts about Retirement	248
6.3.2	Microeconomic Evidence on Push Factors	252
6.3.3	Microeconomic Evidence on Pull Factors	258

6.4	Policy Issues	264
6.4.1	How Much Flexibility in Early Retirement?	264
6.4.2	Should We Have Mandatory Retirement?	266
6.5	Interactions with Other Institutions	271
6.6	The Future of Early Retirement	273
6.7	Suggestions for Further Reading	275
6.8	Review Questions and Exercises	275
6.9	Technical Annex: Optimal Retirement Age	277
6.9.1	The Optimal Retirement Age	277
6.9.2	Young and Older Workers: Crowding In or Out?	278
7	Family Policies	282
7.1	Measures and Cross-Country Comparisons	285
7.1.1	Childcare	285
7.1.2	Parental Leave	286
7.2	Theory	290
7.2.1	A Perfect Labor Market	291
7.2.2	An Imperfect Labor Market	299
7.3	Empirical Evidence	301
7.3.1	Cross-Country Variation	301
7.3.2	Microeconometric Evidence	306
7.4	Policy Issues	316
7.4.1	Should Paternity Leave Be Encouraged?	316
7.4.2	How to Encourage Mothers with Young Children to Work?	317
7.5	Interactions with Other Institutions	318
7.6	The Future of Family Policies	319
7.7	Suggestions for Further Reading	320
7.8	Review Questions and Exercises	321
7.9	Technical Annex: Family Policies and the Household	323
7.9.1	Childcare Facilities	323
7.9.2	The Surplus from Home Production	324
7.9.3	The Unitary and Collective Models of the Household	324
8	Education and Training	326
8.1	Measures and Cross-Country Comparisons	329
8.2	Theory	334
8.2.1	A Perfect Labor Market	334
8.2.2	An Imperfect Labor Market	337
8.3	Empirical Evidence	340
8.3.1	Cross-Country Comparison	340
8.3.2	Estimating the Returns to Schooling	343
8.3.3	On-the-Job Training	351
8.4	Policy Issues	354
8.4.1	Should Governments Subsidize In-Company Training?	354
8.4.2	Should There Be Early School Tracking?	354

8.5	Interactions with Other Institutions	355
8.6	The Future of Education and Training	357
8.7	Suggestions for Further Reading	358
8.8	Review Questions and Exercises	359
8.9	Technical Annex: Schooling and Training	361
8.9.1	Optimal Years of Schooling	361
8.9.2	Signaling	363
8.9.3	Derivation of the Mincer Equation	364
8.9.4	Who Pays for General Training?	366
9	Migration Policies	367
9.1	Measures and Cross-Country Comparisons	370
9.2	Theory	375
9.2.1	A Perfect Labor Market	376
9.2.2	Skilled and Unskilled Migration	378
9.2.3	Relocation of Native Workers, Firms, and Migrants	380
9.3	An Imperfect Labor Market	382
9.3.1	An Economy with Wage Rigidities	382
9.3.2	Labor Market Externalities	384
9.3.3	What Drives Migration Decisions?	384
9.4	Empirical Evidence	387
9.4.1	Macro Facts about Migration	387
9.4.2	Microeconomic Evidence	389
9.5	Policy Issues	402
9.5.1	How to Compensate the Losers?	402
9.5.2	How to Handle the Labor Market of Refugees?	411
9.6	Interactions with Other Institutions	413
9.7	The Future of Migration Policies	413
9.8	Suggestions for Further Reading	415
9.9	Review Questions and Exercises	415
9.10	Technical Annex: Cost and Benefits of Migration	417
9.10.1	The Net Gains from Migration	417
9.10.2	Heterogeneous Labor and Wage Rigidities	419
10	Employment Protection Legislation	421
10.1	Measures and Cross-Country Comparisons	423
10.2	Theory	428
10.2.1	A Perfect Labor Market	428
10.2.2	An Imperfect Labor Market	431
10.3	Empirical Evidence	447
10.3.1	Macro Facts	447
10.3.2	Microeconomic Evidence	450
10.4	Policy Issues	460
10.4.1	What Is the Optimal Level of EPL?	460
10.4.2	Should There Be a Graded Security Contract?	462
10.5	Interactions with Other Institutions	464

10.6	The Future of EPL	465
10.7	Suggestions for Further Reading	466
10.8	Review Questions and Exercises	467
10.9	Technical Annex: The Political Economy of Two-Tier Reforms	469
10.9.1	The Quest for Flexibility	469
11	Regulations on Self-Employment	476
11.1	Measures and Cross-Country Comparisons	477
11.2	Theory	484
11.2.1	A Perfect Labor Market	484
11.2.2	An Imperfect Labor Market	488
11.3	Empirical Evidence	493
11.3.1	Macro Facts	493
11.3.2	Micro Evidence on the Two Faces of Self-Employment	499
11.4	Policy Issues	503
11.4.1	Should Self-Employment Be Promoted?	503
11.4.2	Should Social Insurance Be Mandatory for the Self-Employed?	507
11.5	Interactions with Other Institutions	509
11.6	The Future of Self-Employment Regulations	509
11.7	Suggestions for Further Reading	510
11.8	Review Questions and Exercises	510
11.9	Technical Annex: The Choice between Self-Employment and Dependent Employment and Finance	511
11.9.1	Self-Selection into Self-Employment	511
11.9.2	Complementarity between Labor and Financial Frictions	512
12	Unemployment Benefits and Active Labor Market Policies	515
12.1	Measures and Cross-Country Comparisons	517
12.2	Theory	523
12.2.1	A Perfect Labor Market	523
12.2.2	An Imperfect Labor Market	526
12.3	Empirical Evidence	535
12.3.1	Cross-Country Differences	535
12.3.2	Effects of UB on Unemployment Duration	537
12.3.3	Effect of UB on Post-Unemployment Outcomes	546
12.3.4	ALMP Studies	547
12.4	Policy Issues	552
12.4.1	Do We Need Activation Policies?	552
12.4.2	Should the Generosity of Unemployment Benefits Vary over the Cycle?	553
12.5	Interactions with Other Institutions	554
12.6	The Future of UB and ALMP	556
12.7	Suggestions for Further Reading	557
12.8	Review Questions and Exercises	558

12.9	Technical Annex: Job Search Theory	560
12.9.1	Unemployment Benefits in a One-Sided Search Model	560
12.9.2	Two-Sided Job Search and Matching	566
12.9.3	Statistical Foundations of the Matching Function	568
12.9.4	Activating Unemployed Workers	569
13	Health-Related Labor Policies	571
13.1	Cross-Country Comparisons	573
13.1.1	Workplace Safety	573
13.1.2	Disability and Absenteeism	575
13.2	Theory	580
13.2.1	A Perfect Labor Market	580
13.2.2	An Imperfect Labor Market	585
13.3	Empirical Evidence	590
13.3.1	Workplace Accidents and Safety Policies	590
13.3.2	Sickness and Disability	595
13.4	Policy Issues	599
13.4.1	Do Workplace Safety Regulations Benefit Firms?	600
13.4.2	Should Absenteeism Be Monitored More Strictly?	601
13.5	The Future of Health-Related Labor Policies	602
13.6	Interactions with Other Institutions	604
13.7	Suggestions for Further Reading	604
13.8	Review Questions and Exercises	605
13.9	Technical Annex: Reporting Workplace Accidents	606
14	Payroll Taxes	609
14.1	Measures and Cross-Country Comparisons	610
14.2	Theory	613
14.2.1	A Perfect Labor Market	614
14.2.2	An Imperfect Labor Market	620
14.3	Empirical Evidence	622
14.4	Policy Issues	627
14.4.1	How to Make Work Pay?	627
14.4.2	How to Pay and Target Beneficiaries?	633
14.5	Interactions with Other Institutions	634
14.6	The Future of Payroll Taxes	636
14.7	Suggestions for Further Reading	636
14.8	Review Questions and Exercises	637
14.9	Technical Annex: Payroll Taxes	639
14.9.1	A Perfect Labor Market	639
14.9.2	An Imperfect Labor Market	642
	<i>References</i>	649
	<i>Name Index</i>	677
	<i>Subject Index</i>	683

CHAPTER ONE **Overview**

1.1 Why Study Labor Economics?

The labor market is a core concern of billions of people every day. Finding a job (possibly a good one), getting the best out of it, obtaining a pay rise, keeping your post in bad times, being reinstated after a maternity leave, and being insured against unemployment and its consequences on retirement savings and health coverage are just some of the preoccupations of persons of working age. Even during the years of compulsory schooling, it is the parents of the students, if not the students themselves, who are worried about their future in the labor market.

Throughout the Great Recession of 2008–2009, brought on by the global financial crisis, internet users googled the term “jobs” more than “housing,” “credit,” and “terrorism.” Figure 1.1 plots the number of searches as a percentage of the peak value reached in October 2011, when unemployment had skyrocketed to its highest levels in the United States. Notice also the marked seasonality of job searches: They increase at the beginning of the budget year in January, when firms do most hirings, and in June, at the end of the school year, when students look for short-term jobs.

According to the October 2019 Eurobarometer survey, European citizens ranked migration and youth unemployment as the two priority issues for the new European Parliament that was elected in the following weeks. Terrorism, environmental protection, and human rights were listed as lesser priorities.

The labor market is so relevant for individuals’ well-being that people form opinions, often strong ones, about the way it works. Actually

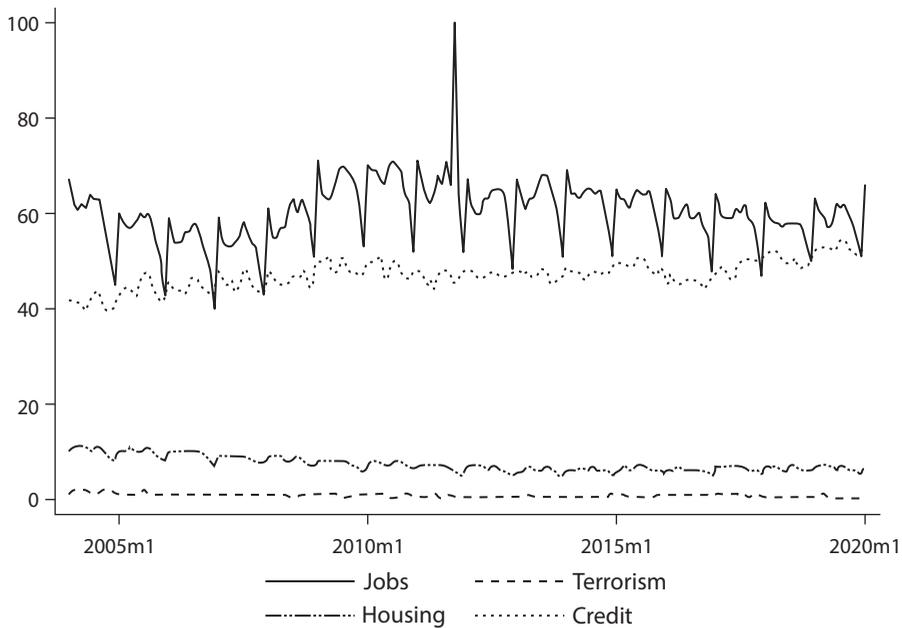


FIGURE 1.1. Google trends

they typically hold beliefs, in several cases rather misleading ones, as to how labor markets operate. To give a few examples, the layperson often believes that

1. there is a fixed number of jobs so that early retirement or a reduction in working hours generates new employment opportunities for the unemployed,
2. wages can be arbitrarily set by policymakers independently of the law of demand and supply, and
3. stronger job protection increases employment.

It is sufficient to look at some aggregate statistics to grasp how these perceptions can be misleading.

Is the Number of Jobs Fixed?

According to common wisdom, labor markets are like a bus in rush hour: Someone must get out first to let someone else get in. However, there is no reason the number of jobs should be fixed over time. This is clear from figure 1.2, which displays employment rates (i.e., the number of persons working as a percentage of the working-age population) in the European Union, Japan, and the United States in the last 20 years. Employment rates have been on an upward trend everywhere. When they have not

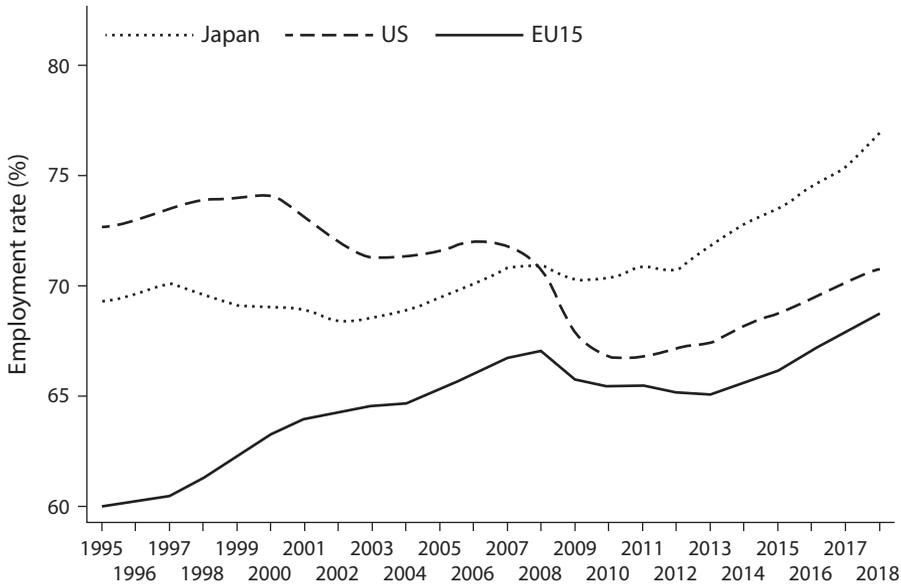


FIGURE 1.2. Employment rates: EU, Japan, and the US

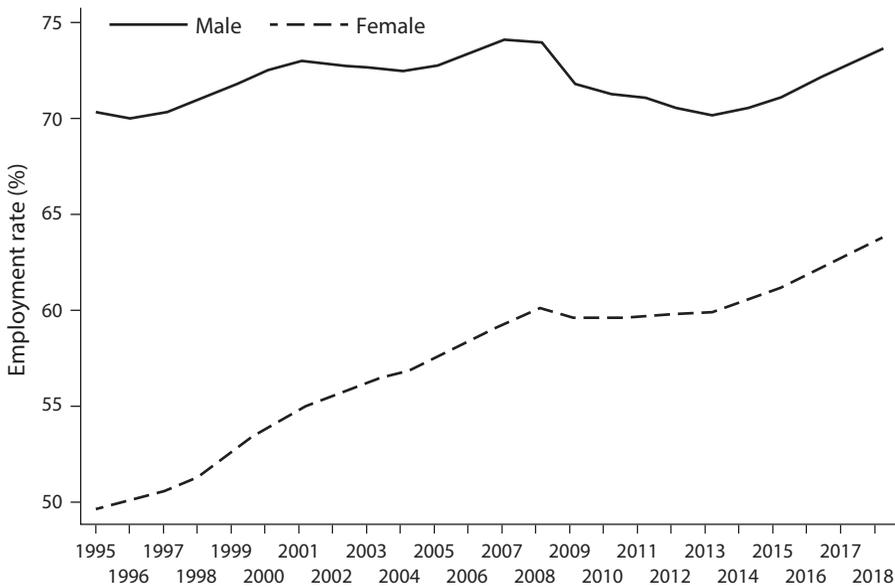


FIGURE 1.3. Employment rates by gender: EU15

been growing, they have been declining, as during the Great Recession. There is no evidence of a constant number of jobs over time.

If the number of jobs were fixed, then we should expect employment rates of men and women to move in opposite directions over time. Once more, there is no indication that this is happening (figure 1.3). Female

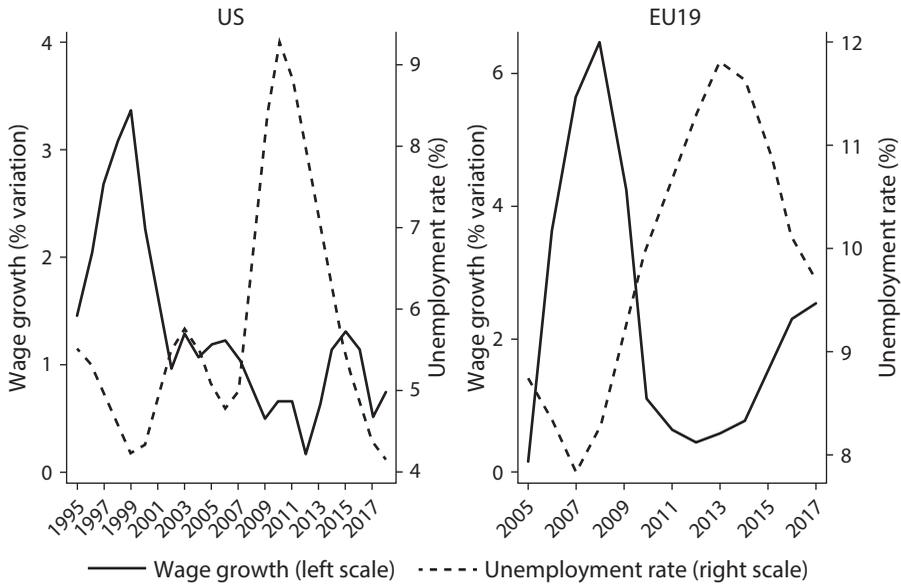


FIGURE 1.4. Unemployment rate and wage growth

employment rates have been increasing at a faster pace than employment rates of men in the European Union, but there is no evidence that women have taken away jobs from men: In the years in which the employment rate of women was increasing, so did the employment rate of men.

Can Governments Set Wages?

Union leaders often argue that wages in the private sector are “an independent variable”—that is, something that can be altered at will by governments. This view is functional to union platforms and captures a rather common belief: the idea that the labor market operates as if there were a unique employer whom laborers (or the government representing all citizens) could ask for a pay rise, just like a worker can do with her boss. However, there is not such a thing like a single employer in the private sector and wages result from market interactions of thousands (if not millions) of employers and workers. Wages are the outcome of these interactions; they react to the demand for labor of employers and to the labor supply of workers. Figure 1.4 shows wage growth and unemployment in the European Union and the United States. Unemployment and wage growth move in opposite directions: When unemployment goes down, wages increase, and the opposite happens during recessions, when

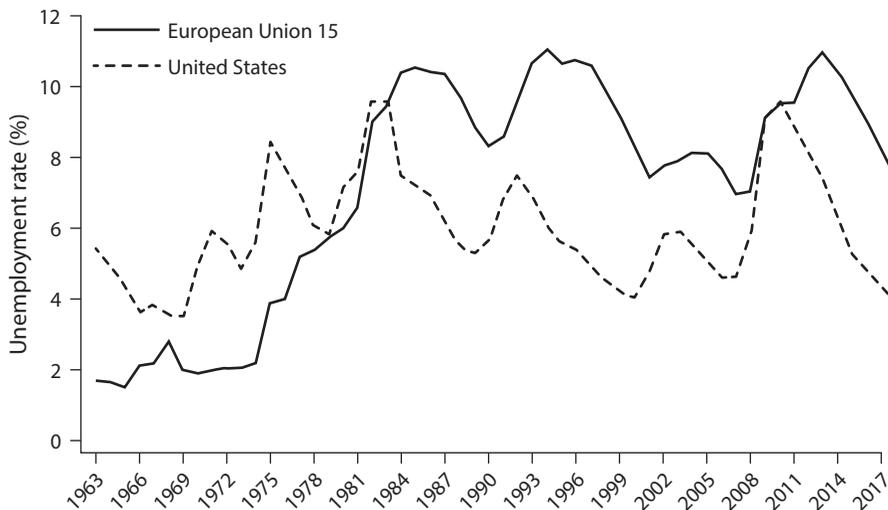


FIGURE 1.5. Unemployment rates on two sides of the Atlantic

unemployment goes up. The dynamics of wages do not look exogenous at all.¹

True, governments can introduce and adjust the minimum wage, as discussed in chapter 2, but this is only a wage floor, preventing hourly pay from falling below a certain level. The wage distribution is not an independent variable.

Does Job Protection Increase Employment?

Another popular view is that making it more costly for employers to fire workers increases employment. The reasoning behind this belief is deeper and captures a real feature of labor markets. It is indeed true that higher costs of dismissals discourage layoffs. However, higher firing costs may also discourage hiring by employers who realize that it will be very costly for them to reduce the workforce in case things go wrong. Thus, it is not clear a priori which one of the two effects (less dismissals hence more employment or less hiring hence less employment) will dominate. Historically we have seen both effects or no effects at the aggregate.

Consider figure 1.5 depicting unemployment rates on the two sides of the Atlantic. When unemployment was lower in Europe than in the United States, influential US policymaker Robert Myers wrote in a 1964

1. Notice that wages appear to respond less to unemployment in the most recent period. This may have to do with monopsony power, as further discussed in chapter 2.

report² that the United States should be “looking enviously at our European friends to see how they do it” and invited everybody to take a look at institutions on the other side of the Atlantic: “It would be short-sighted indeed to ignore Europe’s recent success in holding down unemployment.” In the mid-1990s, when unemployment was higher in Europe than in the United States, the G7 (the intergovernmental group of—at the time—the seven largest economies in the world: Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) commissioned a report to the Organization for Economic Cooperation and Development (OECD 1994) explaining the dismal employment/unemployment performance of Europe vis-à-vis the US “jobs miracle.” The key message provided by the OECD Jobs Study report was that there are institutional “rigidities” imposed by too strict employment protection in Europe that prevent the labor market from creating as many jobs in the private sector as it does in the United States. It took another 15 years and the Great Recession, which brought US unemployment above the EU level, to have a new celebration in the United States about Europe’s rigid labor market institutions. This time it was Nobel Prize winner Paul Krugman writing in the widely read *New York Times* on November 12, 2009: “Germany’s jobs miracle hasn’t received much attention in this country—but it’s real, it’s striking. Germany came into the Great Recession with strong employment protection legislation. This has been supplemented with a ‘short-time work scheme,’ which provides subsidies to employers who reduce workers’ hours rather than laying them off. These measures didn’t prevent a nasty recession, but Germany got through the recession with remarkably few job losses.”

Thus, the very same institutions that bore the brunt of blame for the poor employment performance of the United States versus Europe in the 1960s were, some 30 years later, considered responsible for the dismal unemployment performance of Europe with respect to the United States in the 1990s and were again celebrated during the Great Recession for holding down unemployment in Europe compared to the United States. How is this possible? The issue is that dismissal costs act on both job destruction and job creation, and depending on which one of the two effects dominate, they can increase, reduce, or even leave employment unaltered.

As labor issues are so important for everyday life, individuals with no background in economics tend quite naturally to find their own

2. See Myers (1964) for a complete reference.

representation of how labor markets operate. The problem is that these representations can be rather misleading because labor markets are extremely complex, and what labor economists have discovered both theoretically and empirically about the effects of labor market institutions is quite often not intuitive and can be hardly grasped without proper training. Better knowledge of how labor markets operate is needed to achieve better policy outcomes. Gross mistakes in the design of some programs can be avoided and measures potentially improving the welfare of millions of people can be devised.

Another reason to study labor economics is that a wealth of data is nowadays available on labor markets. In addition to the surveys used so far by most studies, administrative data collected by public administrations as part of their institutional activities (e.g., data on unemployment benefit recipients or on job seekers registered at labor offices) are becoming increasingly available to researchers. Such high-frequency data can be a very useful complement to surveys and cover the universe not constrained by sample size in representing relatively small areas and groups of individuals. Such data can be very informative if there is some theoretical guidance. One should have some framework to put those restrictions on the potential interactions between different variables which make it possible to draw causal inferences. One should also know statistical and econometric methods in order to test the robustness of the results.

In addition to benefiting from more data, scholars of labor markets have access to a very rich history of reforms of labor market institutions. As discussed in section 1.6, the institutions described in this book have undergone regular changes. These reforms offer very valuable material to understand the effects of labor market institutions as they provide the best environment for a social scientist interested in knowing their effects on labor markets. Indeed, reforms represent quasi-experiments making it possible to compare the behavior of labor markets before and after the policy change as well as with and without the reform. The techniques exploiting these reforms are also discussed in the final section of this chapter.

1.2 The Two Key Decisions

By *labor market* we mean a market where a quantity of labor services L , corresponding to tasks specified in an *unfilled* assignment or job description (*vacant job*), is offered in exchange for a price or remuneration,

called *wage* w . Not all labor services offered by an individual are paid. For instance, the time we devote to cleaning our own apartment is not paid. It becomes market work only if we hire a house cleaner. To be in the labor market, there must be an exchange of a labor service for a wage.

There are two key decisions individuals of working age make with respect to the labor market:

1. Should I work (for someone else)?
2. Should I hire someone?

Many individuals are at the same time workers and employers—that is, they have a job and hire someone to take care of their children. However, for the sake of simplicity we will assume that these two decisions—the labor supply and the labor demand decisions—are made by two different types of individuals. They can be either potential employers-entrepreneurs, in which case they decide whether or not to buy labor services, or they are potential employees, in which case they decide whether or not to supply labor. Later on (in chapter 11 on self-employment) we will allow individuals to choose among being a salaried worker or a self-employed worker.

1.2.1 The Labor Supply Decision

Consider an individual who has to decide whether or not to participate in the labor market and supply labor services. She will do so if she can improve her condition with respect to her nonworking status. Working absorbs time that could otherwise be devoted to leisure activities. At the same time, supplying labor earns a wage that conveys purchasing power to the individual. Thus, there will be a trade-off between what labor can buy and what labor can take away in terms of less time available for leisure. We assume that both leisure and consumption are *normal goods*—that is, higher incomes do not reduce an individual's demand for leisure time and for the consumption of goods.

As usual in microeconomics, we can represent this trade-off as a set of *indifference curves* mapping all combinations of purchasing power and leisure that provide the same net benefits to the individual. Each indifference curve provides the same net benefit or utility to the individual. The individual is indifferent to movements along the same indifference curve, while movements across indifference curves increase or decrease the utility to the individual. Higher indifference curves

represent combinations of leisure and income providing higher net benefits to the individual. Clearly, not all these indifference curves can be attained. It will depend on the wages offered in the market and on whether the individual has other (nonlabor) sources of income. In other words, it will depend on the constraints to the choice of the individual.

The decision rule is that the individual will work if, by doing so, she can reach a higher indifference curve than she reaches while not working. She will be indifferent between working or not working if she, by working, attains the same indifference curve reached if not working. The wage that makes the individual indifferent between working or not working is the *reservation wage*. In other words, the reservation wage is the lowest wage at which the individual will decide to work.

We can express these concepts in an analytical fashion. Consider an individual whose utility function is defined over consumption c and leisure l , which are both normal goods: $U(c, l)$, whose partial derivatives are $U_c, U_l > 0$. The individual allocates the endowment of time, l_0 , alternatively to work h hours earning at the hourly wage w or to leisure (clearly, $h = l_0 - l$). Define nonlabor income (the income when working zero hours) as m and take the price of the consumption good as the numeraire (the price of c is 1 euro).

Constraints to choice are imposed by the *budget constraint* given by

$$c \leq m + wh.$$

In the consumption/leisure space this constraint has a kink that corresponds to the level of nonlabor income, as depicted in figure 1.6. To the left of the kink at point E , income grows at rate w , because each additional hour of work yields an extra hourly wage. Point E is sometimes referred to as the *endowment point*—that is, the situation that one can obtain without working. When $m = 0$, the budget constraint is a straight line crossing the horizontal axis at l_0 , where no hours of work are supplied and hence income to buy consumption goods is zero.

By fixing any arbitrary level of utility, we can solve the utility function for the combinations of consumption and leisure that yield the same level of utility to the worker. These level curves are the analytical counterpart of the indifference curves. Because utility is increasing in both arguments, the indifference or level curves are negatively sloped: more consumption is needed to compensate the worker for the loss of an hour of leisure, and vice versa. The degree of convexity of these curves is decreasing with the degree of substitutability between consumption and

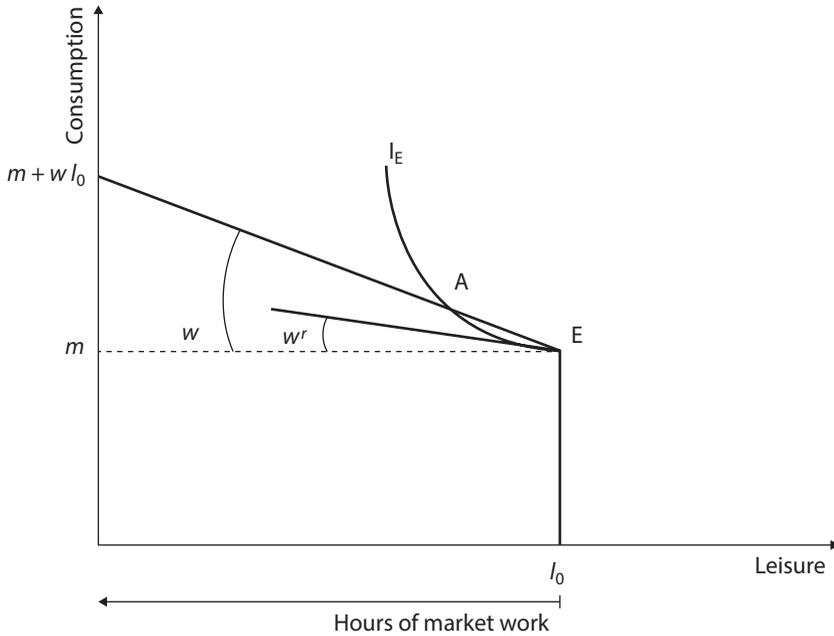


FIGURE 1.6. Reservation wage

leisure. Because of our assumptions, indifference curves do not intersect and utility is increasing farther away from the origin.

The reservation wage w^r is given by the slope of the indifference curve crossing the endowment point (the kink of the budget constraint) at E , evaluated precisely at the point where the individual allocates m euros to the purchase of consumption goods and works zero hours.³ Any wage w lower than the reservation wage will not be accepted by the individual because the marginal value of leisure (the reservation wage) exceeds its opportunity cost (the market wage). Conversely, when $w > w^r$, as in figure 1.6, the individual who is maximizing utility will work some hours and devote the remaining time to leisure.⁴ At point A the budget constraint crosses the indifference curve I_E through the endowment point E . Clearly, if the individual chooses any point on the budget constraint between A and E , the utility is higher than along the indifference curve through E .

3. This is not necessarily the case for more complex budget constraints.

4. This definition of the reservation wage separates employment from nonemployment. When the reservation wage is higher than the market wage, the individual is simply not working. In the dynamic search model setting of chapters 10–13, the reservation wage separates employment from unemployment: Individuals having a reservation wage higher than the wage offered to them will not accept the job offer and will search for alternative employment. In other words, they will be unemployed.

This definition of the reservation wage applies to conditions in which the individual can choose freely how many hours to work and how many hours to devote to leisure. In real life individuals rarely have an unconstrained choice of h . They have, at best, some leverage in deciding among a subset of possible hours of work—for example, between working full-time or part-time. This is because there is an institution (mandatory working-time legislation or collective-bargaining agreements regulating working hours) that imposes, via a collective choice mechanism, constraints on individual decisions.⁵

The reservation wage with restrictions on hours no longer coincides with the slope of the indifference curve at the endowment point (see box 1.1). The reservation wage with restrictions on hours can be graphically represented as the slope of the segment going from the kink of the budget constraint (point A) to the locus where the indifference curve through the (m, l_0) pair crosses the vertical hours constraint, as depicted by point B in figure 1.7. This hours-constrained choice yields a lower level of utility than the unconstrained choice, provided that the latter, at the market wage, involves some positive number of hours of work; otherwise the hours constraint is not binding.

The Reservation Wage with and without Constraints on Hours

BOX 1.1

When there are no constraints on the choice of hours, the reservation wage is given by the condition

$$\left(\frac{U_l}{U_c}\right)_A = w^r,$$

where U_l and U_c denote the marginal utility of leisure and consumption, respectively, and their ratio is the marginal rate of substitution between consumption and leisure. The rate is evaluated at the locus of zero hours of work (A in figure 1.7), where the individual is buying consumption goods by drawing only on nonlabor income.

An individual free to choose how many hours to work equates the marginal rate of substitution to the market wage. Hence, when $w^r = w$, the individual is indifferent between working and not working. When $w^r \leq w$, the optimal choice of hours h^* is greater than zero. When $w^r \geq w$, $h^* = 0$.

5. The reasons hours are regulated, although such institutions apparently reduce the well-being of an individual, are discussed in chapter 5.

Consider now a constrained choice. Suppose for simplicity that individuals actually have no choice over working hours and can only work h_{ft} hours, corresponding to a full-time job. The reservation wage will now be implicitly defined as the wage that would make the individual indifferent between not working at all and working exactly h_{ft} hours, that is,

$$U[m + w_{ft}^r h_{ft}, l_0 - h_{ft}] = U(m, l_0).$$

The interpretation of this condition is that when $w = w_{ft}^r$, the constrained choice is on the same indifference curve that intersects the zero-hours locus. In other words, the individual is indifferent between working h_{ft} hours and not working at all.

More important, the reservation wage of an individual who is constrained in terms of hours of work (w_{ft}^r) is higher than that of an individual free to choose hours of work (w^r). Because of the concavity of the utility function, the slope of the indifference curve increases as we move to the northwest along the same indifference curve. The labor supply decision of the individual will now obey a simple rule: supply h_{ft} hours if $w \geq w_{ft}^r$, otherwise do not offer labor services (supply zero hours).

If the wage increases, more individuals will be tempted to enter the labor market. Hence, in terms of the number of individuals, a wage increase will always lead to an increase in labor supply. Once an individual has entered the labor market, the effect of a wage increase is ambiguous, as there are two mutually offsetting effects at work:

1. *Income effect*: If the wage goes up with the same hours of work, income goes up. If leisure is a normal good, individuals will buy more leisure, thereby reducing their hours of work.
2. *Substitution effect*: If the wage goes up, the price (opportunity cost) of leisure goes up, causing consumption of leisure to go down and working hours to increase.

With leisure as a normal good, the income effect negatively affects labor supply. The substitution effect is always positive on the hours worked. The overall effect depends on the relative magnitudes of income and substitution effects. Generally, the substitution effect dominates for low-wage earners while the income effect is most important for

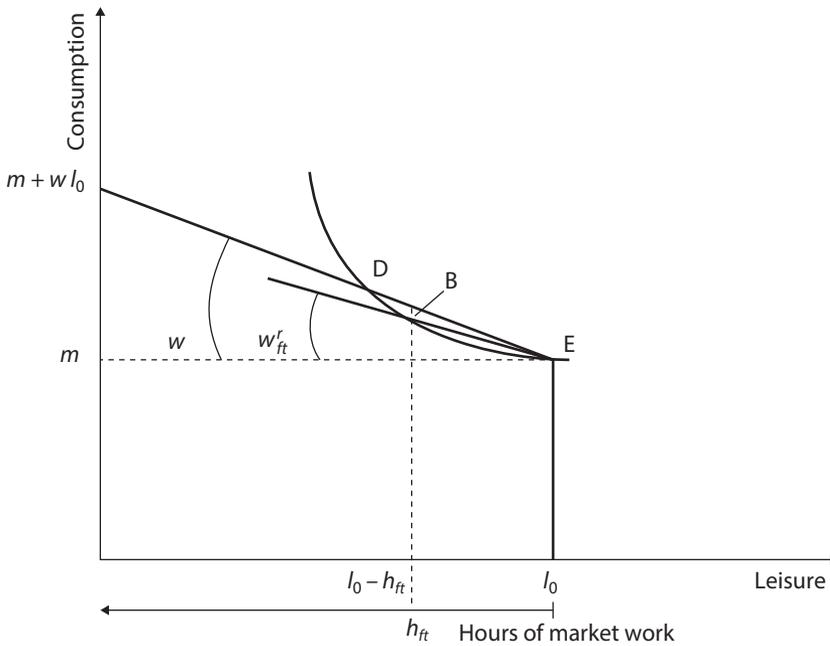


FIGURE 1.7. Reservation wage with a constraint on hours

high-wage earners. Only if leisure is an inferior good will the income and substitution effects reinforce each other. Then a wage increase always leads to an increase in working hours. At the participation margin, the income effect is irrelevant. Since the substitution effect is positive, an increase in the wage will always lead to an increase in the probability that an individual enters the labor market.

Figure 1.8 displays income and substitution effects of a wage rise. In the left-hand diagram, the wage-rise effect on the labor income to leisure trade-off is displayed. Initially the worker is very close to the participation margin, the point where he devotes a large fraction of his time to leisure. As the wage increases from w_0 to w_1 , the worker decides to supply more hours of work moving from A to C. This change in labor supply is also displayed in the right-hand diagram, showing hours supplied per different hourly wages, and is the by-product of a positive substitution (from A to B along the initial indifference curve) and a negative income effect (from B to C). Thus the initial wage rise induces an increase in labor supply of the individual. A further wage rise, however, may have the opposite effect on labor supply. At longer hours and higher incomes, the income effect becomes more important and eventually dominates the substitution effect. This happens in our case where labor supply declines as hourly wages increase from w_1 to w_2 . This geometric analysis

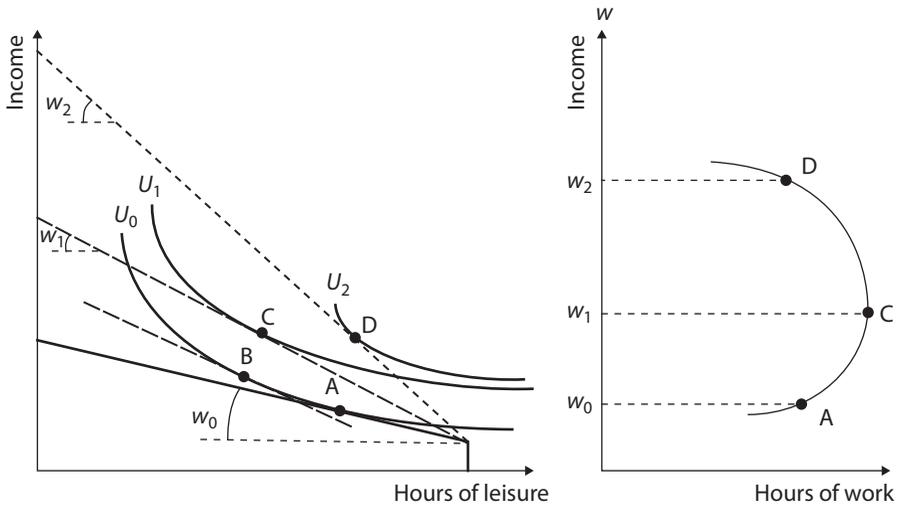


FIGURE 1.8. Income and substitution effects of wage rises

indicates that it is of paramount importance to obtain good estimates of the income effect in order to make predictions about the effects on labor supply of policies altering take-home wages.

From Individual to Aggregate Labor Supply

Consider now a plurality of individuals who may well have different preferences about consumption and leisure and varying endowments of nonlabor income. The reservation wage will then vary across individuals, depending on their nonlabor income as well as on their preferences about leisure and work. As discussed in chapter 7, time spent outside work can also be devoted to (unpaid) activities, such as household tasks generating goods and services that increase the welfare of the household. For instance, some workers may have childcare responsibilities, which increase their reservation wage.

Denote by $G(w)$ the fraction of individuals of working age with a reservation wage equal to or lower than w . By multiplying this fraction by the number of persons of working age, we obtain the *aggregate labor supply* schedule. Insofar as work involves some effort, the percentage of individuals willing to work will be increasing with the wage offered to them. Thus, we expect $G(w)$ to be monotonically increasing with w . By construction, $G(w)$ also takes values only in the interval bounded from below by 0 (nobody is willing to take the job at a wage lower than the lowest reservation wage) and above by 1 (when nobody of working age has a higher reservation wage). It is certainly possible that more than one

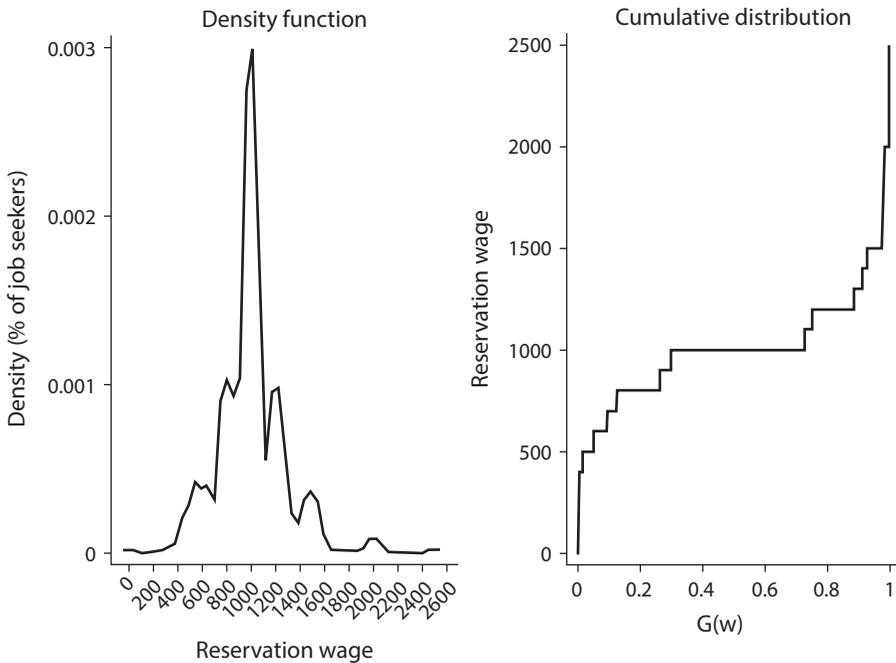


FIGURE 1.9. Labor supply in Italy
 Source: Italian Statistical Office (ISTAT), Labor Force Survey (LFS).

individual has the same reservation wage, in which case aggregate labor supply will involve some flat segments. It is also plausible that some individuals, for example, a rich heiress, would not work whatever the wage offered to them.

Many surveys, such as labor force surveys, in several OECD countries ask respondents about the lowest wage at which they would be willing to take a full-time job offer. This self-reported reservation wage is a subjective measure of w^r . Longitudinal data (observations of the same individuals at different times) suggest that respondents take this question quite seriously. For instance, individuals observed to be unemployed at a given date and employed at the time of the next interview generally work at a wage that is not lower than the reservation wage stated in the first place. Thus, individuals appear to follow consistently the decision rule described at the beginning of this section—that is, a reservation wage policy in their labor supply decisions (they accept only jobs offering $w \geq w^r$). Figure 1.9 displays, in the left-hand panel, the distribution of unemployed job seekers by stated monthly reservation wage as elicited from the 2012 Italian Labor Force Survey. The spike at 1,000 euros (as well as the peaks at 500, 800, and 1,200 euros) is the result of rounding. The right-hand diagram displays, on the horizontal axis, the cumulative

of this distribution function $G(w^r)$ —that is, the fraction of job seekers having a reservation wage lower than or equal to the wage levels displayed on the vertical axis. This is the aggregate labor supply. There are some flat segments denoting workers having the same reservation wage.

1.2.2 The Labor Demand Decision

Consider now the labor demand decision of potential employers. Their income is of the residual claimant type—that is, they earn total revenues minus the wage bill and the rental costs of capital. They would hire as many workers, if any, as required to maximize these net revenues (or profits) of the activity or firm that they are carrying out. Production takes place by combining labor (L) with capital (K) according to best technologies available, summarized by the production function $f(L, K)$. Income of the employers is therefore given by $pf(K, L) - wL - rK$, where p is the price at which goods or services generated are sold and r denotes the rental cost of capital.

BOX 1.2

Labor Demand of a Monopolist

If firms have some monopoly power in product markets, the value of the marginal product of labor will include an additional term that captures the change in price associated with the extra output produced by the additional job, multiplied by total output. Formally, for a competitive firm (superscript c), the value of the marginal product of labor, y is

$$y^c = pf_L,$$

where p , the (given) price at which output can be sold, is independent of the production level (of the number of workers hired) and f_L is the marginal product of labor. For a firm operating in a noncompetitive product market, we have instead

$$y = pf_L + p_L f(L, K),$$

where p_L is the marginal effect on prices of the increase in the quantity produced by the firm associated with the use of an additional unit of labor. From the above it follows that $y = y^c$ when $p_L = 0$; that is, the firm is a price-taker also in product markets. Because p_L is negative, labor

demand of a monopolist will always be to the left of the demand curve of a competitive firm: For any given wage, fewer workers are hired by an employer with monopolistic power. Notice further that the difference between y^c and the value of a marginal product for a monopolist is increasing in $f(L, K)$, hence in the amount of labor being used. This indicates the labor demand of a monopolist is steeper, less responsive to wage changes than that of a competitive firm.

Intuitively, when a firm faces a downward-sloping product demand curve, increasing production lowers prices of all units being sold. The less competitive the product market is, the stronger will be the decline in prices associated with an increase in the quantity of jobs and output. By the same token, more competition in product markets involves a flatter labor demand curve.

To summarize, independent of the product market structure, labor demand L^d will be declining with wages, or the inverse labor demand, $y(L)$, will be declining with L . When product markets are noncompetitive, labor demand will be less responsive to wage changes (steeper labor demand). This relationship between product markets and labor demand explains why the latter is often called *derived labor/demand*.

The Short Run

In the short run, capital is fixed, so there is no possibility to substitute labor with capital. Suppose for simplicity that there is only one type of worker from the standpoint of a firm; that is, labor is homogeneous.⁶ A profit-maximizing employer will hire workers up to the point where y , the value of the marginal job, equals the marginal cost of labor, which is the wage. This *value of a job* is the value of the labor product obtained when a firm and a worker engage in production. One can think of it as the revenues from the job—that is, the product of the quantity of output produced by that job and the price of this output. Both the value of a job and the price of the good produced by this job may not be fixed but may vary with the quantity of jobs and output. Thus we typically refer to the value of the *marginal* product of labor—that is, the price of the good multiplied by the increase in output made possible by hiring an additional worker.

6. Notice that we could as well assume that workers differ in terms of productivity but that these differences are fully offset by wage differentials, so that each employer is indifferent between hiring a high-productivity or a low-productivity worker.

In a competitive market all employers will take the wage as given. Hence all firms will also have the same y at the equilibrium and the *aggregate labor demand* will simply add up the number of jobs in each firm, yielding the same y . Put another way, y provides the employers' *marginal willingness to pay* for labor services or their *inverse labor demand* schedule $y(L)$. To obtain labor demand, we simply have to substitute y with w and solve for L . Formally, we set $y(L) = w$ and solve for L , obtaining $L^d(w)$.

Can we say anything about the slope of this labor demand function? By the law of diminishing marginal returns, the marginal product of labor is declining with the number of jobs for each individual firm. If not only the labor market but also the product market is competitive, then each firm will sell the product of labor at a given price, independent of the level of output. In this case the labor demand function will have the same slope as the (declining) marginal productivity of labor; that is, it will be decreasing with L , the quantity of labor being used.

The Long Run

In the long run, the employer can also vary the amount of capital used in production. The responsiveness of labor demand to wage changes will then also embody the degree of substitutability between labor and capital allowed by production technologies. Intuitively, the higher the substitutability, the more responsive labor demand to wage changes.

In particular, there are two effects at work in the long run:

1. a *substitution effect*, capturing the substitutability between labor and capital, and
2. a *scale effect*, capturing the effects of wage changes on the amount produced.

These two effects are akin to the substitution and income effects involved by labor supply decisions. However, in this case they operate in the same direction: a higher wage involves a negative substitution effect as well as a negative scale effect, as depicted in figure 1.10. The substitutability between labor and capital can be geometrically represented by the convexity toward the origin of the isoquants (the level curve for production, denoting all combinations of labor and capital generating the same level of output).

Starting from any initial combination of capital and labor—say, L_0 and K_0 in figure 1.10—a wage increase will involve a shift along the initial

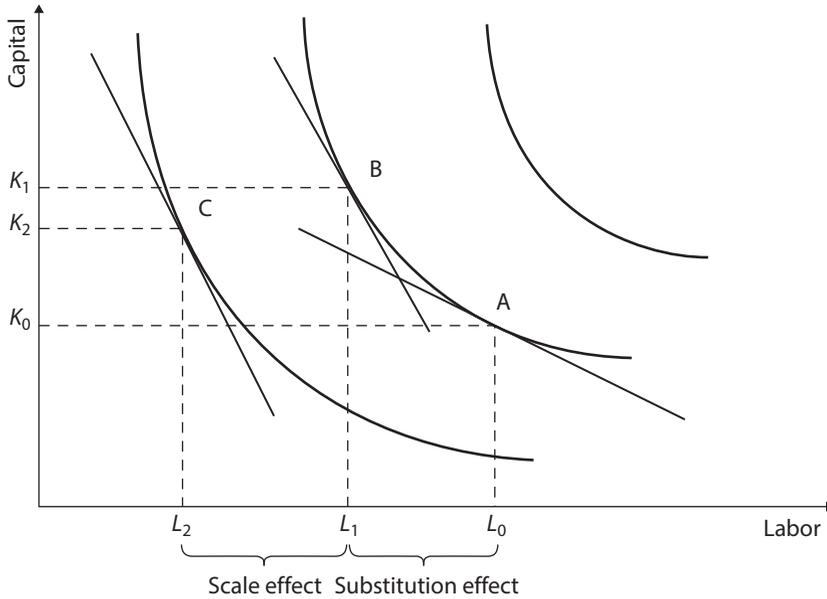


FIGURE 1.10. Long-run scale and substitution effects

isoquant changing the capital-labor mix to preserve the initial level of output. This is the substitution effect, involving a reduction of labor demand from L_0 to L_1 . In addition to this effect, the wage rise will also involve a reduction of the quantity produced, a shift toward an isoquant closer to the origin. This is the scale effect, represented in figure 1.10 by a reduction of labor demand from L_1 to L_2 .

1.3 Labor Market Equilibrium

1.3.1 A Perfect Labor Market

The study of the decision rules of workers and employers indicates that, under general circumstances, the aggregate labor supply will be increasing in wages while labor demand will be decreasing in wages. Figure 1.11 depicts a downward-sloping labor demand together with an upward-sloping aggregate labor supply. In a *perfect labor market* the equilibrium wage level w^* will lie at the intersection of the two curves. If any of the two curves shifts up or down, wages adjust to clear the market. All workers supply labor at the same wage and all employers pay labor at this very same wage.

It is important to notice that there is only one wage level being determined at the equilibrium in this context. Thus, workers with a reservation wage strictly lower than w^* will obtain net benefits from

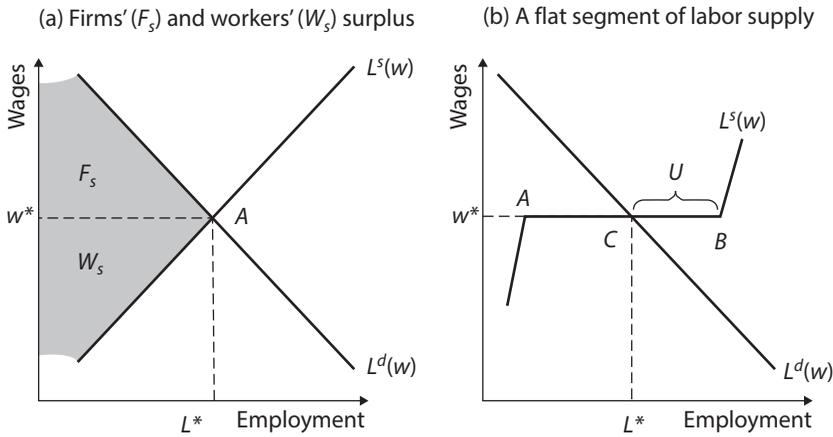


FIGURE 1.11. Equilibrium in a competitive labor market

participating in the labor market. This *worker's surplus* is given by the difference between the wage actually earned by the worker and that worker's *reservation wage* w^r —that is, the lowest wage at which the worker is willing to accept a job offer or the wage that makes the worker indifferent between working and not working. Any wage earned above this level represents a net gain over the option of not working, or a *surplus* from the standpoint of the worker. Formally, the worker's surplus is given by $(w - w^r)$.

The total worker's surplus is the sum of all these individual surpluses and is graphically depicted in figure 1.11 as the shaded area (W_s) below the equilibrium and above the labor supply curve.

Employers may also realize some surplus or profits. The *surplus of the employer* is the difference between the value of a job (the revenues from the job) and its costs, notably the wage paid to the worker engaged in that job—that is, $(y - w)$. All this surplus can be added up among all employers and, in figure 1.11, is given by the shaded area (F_s) above the wage rate and below the labor demand.

The *total surplus* of workers and employers from a job is the sum of the employer's and the worker's surplus: $(y - w) + (w - w^r) = y - w^r$. Notice that the wage, the value of a job, and the reservation wage can all be expressed in monetary terms—for instance, in euros. Hence, given y , w , and w^r , one can readily obtain the worker's surplus, the firm's surplus, and the total surplus. Notice further that the wage cancels out in the total surplus.

Workers with a reservation wage larger than w^* will decide not to work. In other words, $L^* = G(w^*)$ will be the *employment rate* (the

fraction of the working-age population holding a job), while $1 - G(w^*)$ will be the equilibrium *nonemployment rate* (defined in section 1.5).

Notice that the equilibrium wage level may well be in a flat segment of the labor supply curve. In this case there will be individuals with $w^r = w^*$ who are not working, even if they are willing to work at the equilibrium wage. These individuals are, strictly speaking, *unemployed*, as denoted by the segment U in the right-hand panel of figure 1.11, although they do not suffer any welfare loss from not working ($w^r = w^*$ as they are just indifferent between working and not working). All other nonemployed individuals are *inactive*, according to the internationally accepted definitions of labor market status reviewed in section 1.5.

In a perfect labor market there is no total surplus associated with the marginal job. Neither the worker nor the employer enjoys any rent with respect to their outside options. In other words, it is a market where $y = w$ and $w = w^r$, so that also $y = w^r$; that is, wages are ultimately immaterial at the equilibrium: They simply align the value of the job to the employer to the reservation wage of the worker. Put another way, employers and workers are indifferent between continuing or terminating any job relationship. Losing a worker for an employer or losing a job for an employee is not a big deal. Another worker or job can be found instantaneously without suffering any loss in profits or reduction in well-being. The market is transparent, workers and firms are perfectly informed about wages and labor services offered by other workers-firms, and there are no *frictions* or costs (e.g., no time related to job search and no transportation costs when going to job interviews) involved in the matching of workers and vacancies—that is, of labor supply and demand.

1.3.2 An Imperfect Labor Market

An *imperfect labor market* is one where there are rents associated with any given job so that the total surplus of the marginal job is positive. Rents may arise, for instance, because of frictions in the labor market, preventing workers from costlessly changing jobs. Wages are, in this context, a rent-splitting device. They decide which fraction, if any, of the surplus goes to the employer and which fraction, if any, goes to the worker. In an imperfect labor market wage setting is therefore of paramount importance. Depending on the market power of employers or workers, wages can bring either one of the two surpluses to zero while allowing the other party to enjoy a rent. The above implies that at

least for one of the parties involved in the employment relationship, job destruction is a big deal—it involves a loss.

Imperfect labor markets are associated with frictions, informational asymmetries, or market power at least on one of the two sides of the market. These imperfections are often interrelated. For instance, as discussed in chapter 2, it is mainly labor market frictions that convey monopsony power to employers, allowing them to pay wages lower than the value of the marginal productivity of labor, as these frictions prevent workers from costlessly changing jobs. Informational asymmetries also prevent the attainment of labor market equilibria in which the total surplus is maximized. Informational asymmetries are frequent within a firm, in the actual work relationship between the employer and the employer's workers, as the effort put in production by the employees can only be imperfectly monitored. Under these circumstances, incentive schemes need to be devised by the employer—that is, a system of rewards and punishments aimed at aligning the objectives of workers to those of the firm.

Not only will there be a welfare loss associated to losing a job in such imperfect labor markets, but this loss can also be used as a disciplining device. Take once more the case where employers cannot perfectly monitor the effort of their workers. This is the situation considered by *efficiency wage models*. Workers can either put effort in production or shirk, in which case there is some positive probability (but strictly smaller than one) that they can be detected and laid off for disciplinary reasons (see the technical annex; that is, section 1.8). If wages equal the reservation wage of workers and there is no unemployment, this probability of being laid off is not a deterrent for shirkers. In order to deter workers from shirking, employers must pay workers above their reservation wage so that firing involves a punishment, a welfare loss for the shirkers. In the labor market, equilibrium wages are therefore above the market clearing level because rational employers maximize profits by setting wages above the market clearing level. Hence, there will be unemployment at the equilibrium and this unemployment acts as a disciplining device (see box 1.3).

BOX 1.3

Welfare Loss from Unemployment and Work Incentives

An employer, especially in large organizations, has to choose not only production technologies but also monitoring technologies to observe the actual effort of employees in production. Suppose that perfect

monitoring is unboundedly expensive, so the employer has to rely on imperfect monitoring technology to detect shirkers with a probability $0 < d < 1$. If a worker is found shirking, then he is laid off and does not earn the wage. Is there a way for the employer to align goals of the workers with profit maximization goals without using the prohibitively expensive monitoring technologies? This is the case investigated by Carl Shapiro and Joseph Stiglitz (1984) in their shirking model.

Suppose that workers' utility is given by

$$U(e) = c + (1 - e)\Gamma, \quad (1.1)$$

where e is effort that can take only two values: 1 if the worker puts in effort and 0 otherwise. Γ is the utility of shirkers if they can “get away with it”—that is, if they are not detected in their opportunistic behavior by the imperfect monitoring technology—and c is consumption constrained by the purchasing power of the wage (the only source of income of the worker). A nonshirker would therefore enjoy $U(1) = w$ while the expected utility of a shirker will be $U(0) = (1 - d)(w + \Gamma) + dw^r$. All workers are alike. To discourage the workers from shirking, the employer should offer them a wage sufficiently high as to make them better off by working rather than not working. That is, using

$$w \geq (1 - d)(w + \Gamma) + dw^r \quad (1.2)$$

solving for the wage rate, one obtains

$$w \geq \frac{1 - d}{d}\Gamma + w^r. \quad (1.3)$$

Notice that this efficiency wage is higher than the reservation utility of the worker. Thus, there is a welfare loss associated with being detected as shirking and losing a job. As the wage is higher than at the market clearing level, there is unemployment. This unemployment is the punishment by which the loss of the job acts as a disciplining device.

Wages eliciting effort are also discussed in technical annex 2.9.3 and boxes 10.3 and 12.3.

Source: Shapiro and Stiglitz (1984).

The case of efficiency wages provides a good description of the key difference between perfect and imperfect labor markets. In a perfect

labor market there is no unemployment except of the type not hurting individuals (the equilibrium is in a flat segment of the labor supply). In an imperfect labor market, there can well be *involuntary unemployment* with people in this condition suffering a welfare loss because their reservation wage is lower than the market wage. In the efficiency wage case discussed above, a jobless person cannot convince an employer that she works at a wage lower than the equilibrium wage because the employer worries that shirking occurs after the person is hired.

As shown by figure 1.11 (and formally proved in section 1.8, the technical annex), a perfect labor market maximizes the total surplus of workers and employers. There is no way to increase the total surplus from a perfect labor market equilibrium. It is possible to redistribute (e.g., allow the workers to increase their surplus at the expense of the employers or vice versa), but in this redistribution a part of the total surplus is lost. From an imperfect labor market equilibrium it is instead possible in principle to increase the total surplus, making the equilibrium more efficient in generating net benefits for the individuals supplying or demanding labor services.

1.4 Labor Market Institutions

As discussed when presenting the labor supply decision, workers have limited choice over the number of hours of work because collective choices such as regulation on working time and collective agreements limit their possibility to decide freely how many hours to work. Real-world labor markets are crowded by these and other *labor market institutions*—that is, systems of laws, norms, or conventions resulting from a collective choice and providing constraints or incentives that alter individual choices over labor and pay. Single individuals and firms consider the institutions as given when making their own individual decisions. Going back to the working hours example, regulations of working hours (chapter 5) are an institution aimed, *inter alia*, at coordinating the allocation of time or for work, leisure, or home activities across and within households.

Because of their foundations in collective choices, institutions are the by-product of a political process. Often, institutions are established by laws, but this does not need to be the case. For instance, collective bargaining institutions (chapter 3) are most frequently regulated by social

norms and conventions rather than by formal legislation. What matters is that they constrain individual choice of workers and employers. Labor market institutions operate by introducing a *wedge* between the value of the job for the employer and the reservation wage of the individual. In other words, they can create rents even in perfect labor markets. At the same time, in imperfect labor markets, they can also be a rent-reducing device. As rents are already there, they can be diminished by a proper set of institutions. Clearly, jobs can be created only if both workers and employers obtain from them some non-negative surplus. Institutions can therefore destroy or create jobs, depending on whether they raise the reservation wage of workers above the value of a job for the employer. If $y < w^r$ in all jobs, then a labor market cannot operate.

Summarizing, labor market institutions are outcomes of collective choice mechanisms that interfere with the exchange of labor services for pay. They do so by introducing a wedge between the reservation wage of workers and the value of a job—that is, between the labor supply and labor demand schedules. This wedge creates rents or redistributes rents between workers and employers.

1.4.1 Why Do Labor Market Institutions Exist?

Because all labor market institutions introduce a wedge between labor demand and supply, they reduce the size of labor markets. If the labor market is competitive, there will be an efficiency loss because in principle, by increasing the size of the labor market and redistributing the surplus, it should be possible to make everybody better off. The obvious question is then why these institutions are so developed in modern labor markets. They are certainly not imposed by heaven. They are introduced by democratically elected governments. If voters did not like these institutions, they would sooner or later be removed. If these institutions reduce the size of the economic pie, then it should be possible to make everybody happier (or at least as happy) without them.

We offer three arguments for the existence of labor market institutions:

1. *Efficiency*. Perfect labor markets do not exist. Because a (first-best) competitive labor market outcome maximizing the total surplus is unattainable, there are (second-best) arguments justifying the presence of these institutions.

2. *Equity*. In the absence of nondistortionary taxes and transfers that could change the way the total surplus is shared between workers and employers without reducing the total surplus, these institutions are best suited to achieve some redistribution that reduces the total surplus but is supported by voters.
3. *Policy failures*. There are failures in the political process that make it possible for minority interest groups to succeed in imposing their preferred institutions on majorities who would be better off without them.

Often these three reasons coexist, but we discuss them separately for the sake of simplicity. We confine ourselves here to a few illustrations of how these mechanisms operate. Later chapters contain a thorough discussion of the rationale for each institution.

Efficiency

Labor market institutions exist because there are *market imperfections* that prevent the institution-free equilibrium from attaining the competitive equilibrium outcome. In practice, a perfect labor market does not exist. Labor markets are far from competitive because there are important informational asymmetries between employers and employees as well as externalities (i.e., goods produced and consumed that are not subject to market interactions). In both cases—*asymmetric information* and *externalities*—labor markets violate the transparency and complete market properties of a perfect labor market. Well-designed labor market institutions, in this context, may remedy these failures of markets and increase the size of the pie compared with the *laissez-faire* outcome.

Equity

Even when institutions reduce the size of the economic pie, they may make one side of the market (those supplying labor services or those purchasing them) strictly better off than it would be without the institutions. In principle, redistribution could also be achieved by taking the *laissez-faire* outcome and then taxing employers or employees and transferring the proceeds to the other side of the market. In practice, however, redistribution through *lump-sum taxes and transfers* is not possible because redistributive policies can only rely on information—on signals, which can be altered at will by individuals. Thus, any type of

redistribution is unavoidably distortionary, and labor market institutions, such as distortionary labor taxes and transfers, can be the most efficient way to redistribute.

Policy Failures

Because of these redistributive properties of institutions, there are also instances in which some powerful minorities succeed in imposing a set of institutions on a majority of citizens. This happens particularly when the benefits of an institution are concentrated in a small segment of the population while the costs are spread over a very large crowd of individuals. Under these conditions, groups organized as a lobby may succeed in influencing political decisions disproportionately.

A Few Examples

In practice, labor market institutions perform several functions at once: They remedy market failures but, at the same time, affect the income distribution or meet the requests of specific interest groups. For example, in the absence of perfect capital markets, the welfare of risk-averse individuals can be increased by offering insurance against the risk of income fluctuations. Job loss is one of the occurrences against which workers could be protected. However, no private insurer will ever want to provide insurance against unemployment because *moral hazard* and *adverse selection* stand in the way of these potential contractual arrangements. Workers would not try as hard to avoid unemployment and find new jobs if they were covered against the negative consequences of the event by purchasing insurance at a given market price (moral hazard), and workers who know that their unemployment risk is particularly high would make the scheme unprofitable for insurance providers and unattractive to workers with average risk (adverse selection). This explains why collective action (institutions) tries to remedy the inequitable or unfair labor market treatment of workers who, lacking insurance, become or remain unemployed despite their best efforts. Unemployment benefits (chapter 12) and employment protection legislation (chapter 10) are remedies for this failure of markets. By supplying insurance, however, they involve some trade-offs. For instance, provision of insurance in the presence of asymmetric information unavoidably decreases productive efficiency. Workers have no less incentive to decrease their job-seeking effort when they are covered by social rather than private insurance, and protection

from supposedly unfair developments unavoidably decreases the labor market's speed of adjustment.

While remedying a market failure, employment protection legislation and unemployment benefits transfer resources from employers to employees, creating a vertical redistribution of income. Most of the institutions analyzed in this book address distributional tensions by attributing a larger share of the economic pie to workers or to nonworking individuals and extracting surplus from employers. Minimum wages (chapter 2), restrictions on hours of work (chapter 5), and collective bargaining institutions and unions (chapter 3) respond to distributional concerns by assigning a larger share of the pie to workers even at the cost of generating overall a smaller pie. At the same time, these institutions remedy market imperfections, such as the presence of monopsonistic power of firms and externalities in the wage-setting process and in bargaining over hours. Migration restrictions (chapter 9) also have a well-defined distributional objective: They insulate native workers from competition from foreign workers. Their presence can also be explained in terms of market failures associated with interactions with other institutions. In the presence of minimum wages, migrants may crowd out native workers, or migrants who do not find a job may exert a negative fiscal externality on the native population by drawing nonemployment benefits without perhaps having contributed to their financing (just like native new entrants in the labor market displaced by a minimum wage). Taxes on labor (chapter 14) are often progressive, which suggests that they pursue vertical redistribution. At the same time, however, they can be rationalized by interactions with other institutions: Someone has to pay for early retirement (chapter 6), family policies (chapter 7), education (chapter 8), unemployment benefits and active labor market policies (chapter 12), and health-related labor policies (chapter 13).

Institutional interactions are quite complex, and there can be many of them, given that there are several possible combinations of institutions in place. At the end of each chapter, we discuss the interactions that appear most relevant to us. Unavoidably the list is not exhaustive. The important thing to remember at this stage is that one should never confine the analysis to the simple direct effect of one institution on the labor market. We live in labor markets in which institutions never operate in isolation.

In the technical annex in section 1.8, we provide a simple formalization of the redistributive role of labor market institutions. We model a competitive market with a government caring about income distribution or agents bargaining over wages, not always optimally sized, because

specific interests prevail. Strict employment protection, for instance, involves large implicit transfers from the unemployed to employees or to some categories of employees who are de facto insulated from competition from *outsiders*. More broadly, the combination of price and quantity institutions that is present in many labor markets is successful in protecting *insiders* from negative labor market developments: Not only are wages compressed and stable, but also tenure lengths of regular workers are clearly much longer in more rigid labor markets. Unsurprisingly, it is the insiders who oppose reforms of these institutions, even when they are a minority and when the optimal size of the wedge (operating the desired amount of vertical income distribution) would be lower. Often labor market institutions tend to privilege minority subsets of the market's labor force. Such policy failures can emerge over time as economies are hit by shocks (Blanchard and Wolfers 2000) or the economic environment is altered (Ljungqvist and Sargent 2004). The model in technical annex 1.8 suggests that the redistributive properties of institutions should be adjusted to the economic environment in which they operate. If product markets become more competitive, then redistribution involves higher costs in terms of forgone efficiency (Bertola and Boeri 2002). Under these conditions, it is better to pursue the same distributional objectives by imposing a smaller wedge between labor demand and labor supply. But policy failures may make this adjustment more difficult or altogether prevent it.

1.4.2 Institutions Matter

The above provides a number of reasons why labor market institutions are a salient feature of modern labor markets. Still, before spending more time in understanding how these institutions operate, one would like to be reassured that they are indeed very important in affecting labor market outcomes. In each chapter of this book we survey the empirical literature on the effects of any specific institution.

A major example of the relevance of labor market institutions in affecting labor market outcomes is provided by the Great Recession of 2008–2009. It was, no doubt, a crisis that developed outside the labor market, and yet it heavily impacted the markets where labor services are exchanged for pay. The job death toll was on the order of 30 million. Youth unemployment was still on the rise worldwide five years down the road. In the United States, unemployment almost doubled from peak to

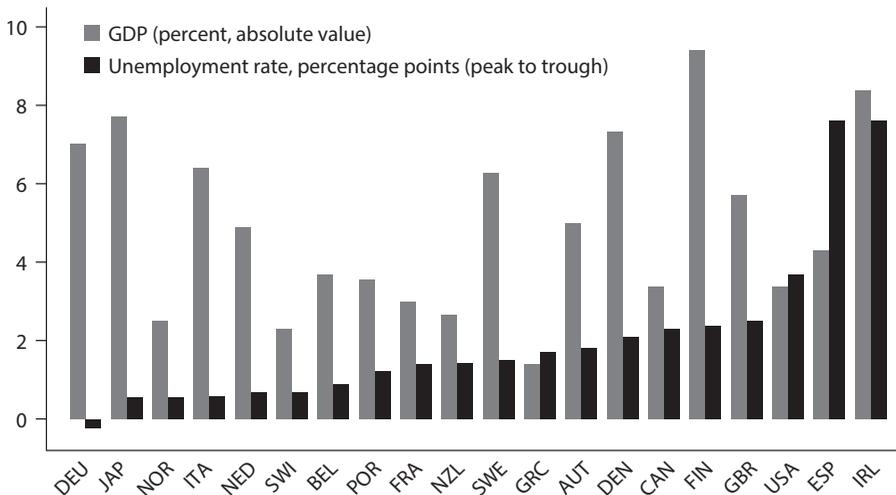


FIGURE 1.12. Changes in unemployment rates and GDP decline, 2008–2009 peak to trough

trough within one and a half years: Every quarter about one million jobs had disappeared. There were, at the same time, very important cross-country differences in the responsiveness of unemployment to output falls. In Germany, unemployment actually fell, in spite of a very severe recession, involving a cumulative 7 percent decline in gross domestic product (GDP), almost twice as bad as in the United States.

Since the recession was global, it gave us the opportunity to evaluate differences in how labor markets respond to shocks originating elsewhere. There was a lot to learn: The differences are indeed quite striking, even when accounting for cross-country variation in how much output fell, as shown in figure 1.12. A GDP fall of the same magnitude was accompanied in some countries by a huge rise in unemployment, while in others unemployment hardly changed from peak to trough.

There are two further indications that institutions were important in affecting such different labor market outcomes, at least the component that is not explained by the different size of the output fall in the various countries.

The first indication is that during the Great Recession the cross-country dispersion of unemployment rates increased because of differences in the way entire countries reacted to the shock. In normal times, the cross-country dispersion in unemployment rates is largely driven by within-country differences in the incidence of unemployment. Italy has a high unemployment rate because of its Mezzogiorno. The large number of job seekers in Spain are highly concentrated in its southwest

regions, and in Germany unemployment is significantly higher in eastern than in western states. During the Great Recession, the increased cross-country divergence in unemployment rates was instead driven by national as opposed to regional factors (Boeri and Jimeno 2016). Unemployment increased more in *all* Italian regions than in *all* German regions. As labor market institutions typically vary across countries rather than within countries, this evidence supports the view that labor market institutions deeply affected the different responsiveness of unemployment to declines in output across the OECD countries.

The second indication is more direct. There are several facts pointing to the role of institutions in affecting different national adjustment trajectories to the output shock. Some countries used the intensive margin of labor market adjustment more, allowing employers to reduce hours of work rather than laying off workers, while other countries concentrated their response on the extensive margin of outright dismissals (as recalled in the initial quote of Paul Krugman). Some countries had bargaining structures that allowed for nominal wage cuts preventing mass layoffs, while others could not use wage reductions as an alternative to dismissals. Some countries used early retirement as a shock absorber, increasing inactivity more than unemployment, while in others employment losses translated to unemployment increases (almost one to one). Another important factor in determining the different responsiveness of unemployment to output changes was labor market segmentation between temporary and permanent contracts, concentrating the adjustment on the former.

Thus, there are several indications that the labor market response to the global shock was affected by the country-specific design of labor market institutions. The Great Recession told us that labor market institutions matter. Something similar happened in the aftermath of the lockdown measures taken to prevent the spread of the Covid-19 epidemic. In the US, during the lockdown the number of unemployment benefit claimants skyrocketed to more than 30 million in 6 weeks, while in Germany and Italy the shock was initially almost entirely absorbed by short-time work schemes, such as the *Kurzarbeit* and the *Cassa Integrazione*. In the US no restrictions were imposed on layoffs, which were to a large extent permanent layoffs. In several European countries layoffs were banned throughout the crisis. Institutions are so important that they should be handled with care. It is of fundamental importance to understand how they operate. We need to know the institutional details and identify which of them are most important from an economic

perspective to be able to shed light on their impact on labor market performance. It is also of paramount importance to understand how these institutions operate when the economy is under strain. Do institutions operate symmetrically over the business cycle? How do they interact with shocks coming from the product or the financial market? Who is most affected by them, and who is protected or penalized by these institutions? What type of redistribution do they involve? Answering such questions is largely an empirical matter. In the following chapters we will survey the literature that has addressed these issues, taking as reference each specific labor market institution.

In order to better understand this literature, we need to clarify what are the key measures of labor market outcomes in applied labor economics and the most important econometric methods used to identify the effects of institutions on these outcomes. This is the task set out for the next section of this chapter.

1.5 Measures of Labor Market Outcomes

1.5.1 Stock Measures

According to internationally accepted OECD–International Labour Organization (ILO) definitions, the entire population of working age (15–64 years) can be classified into three main labor market states: employed, unemployed, or inactive:

1. An *employed individual* is someone who has worked for pay (in cash or in kind) for at least one hour during the reference period (a week or a day) or has a formal attachment to a job but is temporarily not at work (e.g., because of an illness, a holiday, or maternity leave).
2. A person of working age is classified as an *unemployed individual* if that individual is willing to work at the going wage. To be classified as unemployed the following four conditions need to be fulfilled:
 - (a) The person is currently *not* working.
 - (b) The person has looked for work in the four weeks before the survey.
 - (c) The person has looked for work actively (e.g., sending applications to employers or contacting a private placement agency or a public employment office).
 - (d) The person is immediately available for work, meaning that the person can start a job within two weeks following the interview.

3. *Inactive individuals* are persons who are neither employed nor unemployed according to these definitions. This residual group consists of a highly heterogeneous population, including people who are voluntarily inactive and individuals who are disabled.

Let U be the number of unemployed workers, L the number of employed workers, and O the measure of inactivity:

- The labor force LF is given by employment plus unemployment: $LF = L + U$.
- The working-age population adds up the three mutually exclusive categories of employed, unemployed, and inactive individuals: $N = LF + O$.

Clearly comparing these numbers across countries with different sizes of the working-age populations is meaningless. In this book we adopt several widely used (but not always well understood) *normalization rules*. Here are the most important:

- unemployment rate $u = \frac{U}{LF}$
- employment rate $e = \frac{L}{N}$
- participation rate $p = \frac{LF}{N}$

These indicators are clearly not independent of each other, as $e = p(1 - u)$.

1.5.2 Flow Measures

The above are stock measures, counting the number of persons in each status at a given point in time. The effects of labor market institutions are generally more visible if we look at labor market flows tracking the movements of individuals across the different labor market conditions.

Using the longitudinal structure of many labor force surveys and of administrative data (providing information on the same individual) or retrospective, subjective information provided by the interviewees on their previous labor market status, it is possible to generate *transition matrices*, tracking all flows across labor market states.

Each cell of a transition matrix counts the number of persons transitioning across labor market states (or remaining in a given status) over time.

TABLE 1.1 Transition matrix, 2015–2016

		2016			
		Inactive	Unemployed	Employed	Total
2015	Inactive	85.63	5.01	9.36	100.0
	Unemployed	14.28	58.35	27.36	100.0
	Employed	3.81	3.86	92.33	100.0

Source: Eurostat (2019), European Union Labor Force Survey.

For instance, the transition matrix in table 1.1 summarizes flows between inactivity, unemployment, and employment in eurozone countries in the period 2015–2016. Transitions are measured over a yearly interval and normalized by the population at origin. In other words, the first term on the left-hand side indicates that 85.63 percent of the persons inactive in 2015 were still inactive in 2016. Unsurprisingly, the fraction of those remaining in the same labor market status one year apart (the so-called stayer coefficients) is higher from employment and inactivity than from unemployment. The latter is a condition undesirable (a disequilibrium status) that individuals are trying to modify over time.

If the labor force is fixed, the unemployment rate will be constant over time if inflows into unemployment equal outflows from unemployment. Let δ be the rate at which workers lose their jobs and μ the rate by which unemployed workers find jobs. Thus, the *steady state* (dynamic) equilibrium unemployment implies that $\delta L = \mu U$. By solving for $u = \frac{U}{LF}$ we obtain the steady state unemployment rate $u = \frac{\delta}{\mu + \delta}$. In other words, the steady state unemployment rate is defined by the job separation rate and the job-finding rate.

1.5.3 Problems with Standard Measures of Labor Market Status

There are a number of problems with the standard OECD-ILO definitions of labor market status provided above. Although it is not always possible to find remedies to these shortcomings, it is important to be aware of them.

The key issue is that being inactive is a residual category and participation borders are rather porous, hence standard measures may exclude from the labor force persons who are in a condition very similar to that of unemployed persons. Among these:

1. Some *potential workers* search for jobs less intensely than required to be classified as unemployed and are therefore classified as

TABLE 1.2 Transition matrix Italy, 2013–2014

		2014				
		Employed	Unemployed	Inactive	Marginally attached	Discouraged
2013	Employed	93.8	2.7	1.4	1.3	0.8
	Unemployed	22.0	41.8	8.3	13.7	14.3
	Inactive	5.3	5.6	71.4	7.6	10.1
	Marginally attached	18.7	22.8	21.7	20.4	16.4
	Discouraged	7.9	18.9	29.5	12.6	31.1

Note: Italian Statistical Office (ISTAT), Labor Force Survey (LFS), longitudinal data. The sample of inactive, discouraged, and marginally attached workers does not include those in school, those who are retired, and disabled individuals.

inactive while they are indeed available to work and looking for jobs.

2. Some *discouraged workers* are without work and willing to work, but they are not searching because they believe there are no opportunities for them in the labor market. They are therefore classified as inactive when in fact they are not much different from the unemployed.

These two categories can be quite relevant. According to the European Labor Force Survey, in 2018 discouraged workers accounted for about 2 percent of the working-age population in EU28 countries. Comparable figures for the United States are on the order of 2.5 percent. A way to assess how different these categories of individuals are from unemployed people is to obtain “augmented” transition matrices displaying transitions also from this subcomponent of the “out of the labor force” status. One such transition matrix, concerning Italy in the period from 2013 to 2014, is displayed in table 1.2.

Interestingly enough, potential workers and discouraged workers display lower transition probabilities in the cells along the main diagonal than the other persons classified as inactive. These *stayer coefficients* offer an estimate of the probability of remaining in the same status from one year to the next. Thus, they offer a measure of persistence in any given status. For the reasons discussed above, we would expect inactive and employed individuals to display higher *stayer coefficients* than the unemployed. The augmented transition matrix suggests that potential and discouraged workers are more similar in this respect to the unemployed than to the remaining inactive individuals. It should be noted that in the presence of discouraged workers the cyclical fluctuations in employment and unemployment are not fully symmetrical.

If employment goes up, discouraged workers may find it attractive to enter the labor market and unemployment does not go down as much as employment goes up, and vice versa.

The borders between employment and unemployment are also rather poorly defined. If someone is working for more than an hour in the reference week, they would be considered employed, but as a matter of fact, their status may not be that different from that of an unemployed job seeker. Many individuals are forced to work less hours than desired because there are no full-time jobs for them. This (*underemployment*) is, like unemployment, an undesirable status for individuals in this condition, a status from which they would like to get out as soon as possible, unlike inactivity and employment.

In the last decades several OECD countries have witnessed the surge of (*temporary*) or dual employment, a sort of secondary labor market offering lower wages and lower security than standard jobs. Persons in this status are classified as employed but, as a matter of fact, they are also looking for better employment in the so-called primary labor market.

Overall, unemployment may not properly measure the extent of labor slack in the labor market. There is potential excess labor supply not captured by the statistical definitions. This problem was highlighted by the labor market response to the lockdown during the early stages of the Covid-19 pandemic. Many workers losing their jobs did not appear in the unemployment head counts because, due to the circumstances, they were not actively searching. One way to assess whether or not this is the case is to look at the responsiveness of wages to these additional measures of labor slack. The reason wages are informative as to the extent of labor slack can be grasped with the help of figure 1.13. Suppose that the labor supply measured by the standard definition is the continuous line crossing labor demand at w_0 . If unemployment is negligible but there are individuals classified as inactive who are actually looking for jobs and workers underemployed in some secondary labor market, then the true labor supply would be the dotted line crossing labor demand at w_1 .

1.6 Documenting Reforms in Labor Market Institutions

As stressed earlier, it is difficult to properly identify the causal effects of labor market institutions on stocks and flows in the labor market. However, it is sometimes possible to establish the effect of a change in labor market institutions on outcomes of interest. Two methods widely used by the literature to overcome this identification problem are

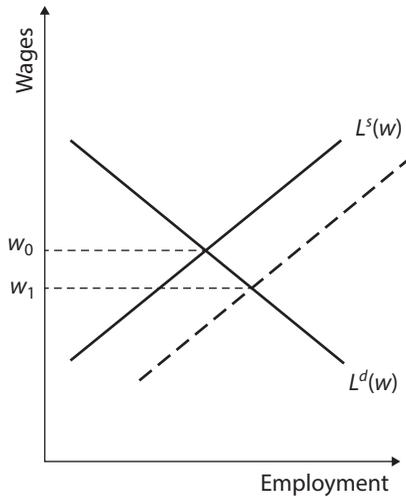


FIGURE 1.13. Measured (continuous line) and effective (dotted line) labor supply

difference-in-differences and regression discontinuity design (see boxes 1.4 and 1.5).

Labor market institutions have been subject to frequent policy changes in the past 30 years. This activism can be preliminarily characterized by looking at cardinal indicators of institutional intensity—notably some widely used indexes devised by the OECD—whose properties and shortcomings are discussed in detail in various chapters. The graphs in figure 1.14 display the level of these indexes in the mid-1980s or mid-1990s (horizontal axis) and for the most recent observation available (vertical axis). Countries located below the bisecting line through the origin have reduced over time the level of any given institution, whereas those located above the diagonal have increased it. Only countries located along the bisecting line have been keeping their institutions unchanged with respect to the initial year of observation.

Difference-in-Differences

BOX 1.4

To establish the effect of a reform in labor market institutions it is sometimes possible to use a *difference-in-differences* approach. This is possible if there is a group that is affected by a policy reform (the *treatment group*) and a group that is not affected by the reform (the *control group*). Then, by comparing an economic outcome Y before and after the policy change is introduced between the two groups we can make inferences on the

effect of the reform. After the reform the economic outcome for the control group will be affected by any change in economic circumstances. After the policy reform the economic outcome for the treatment group will be affected by any change in economic circumstances as well as by the policy reform. The difference-in-differences method is illustrated as follows:

	Treatment Group A	Control Group B
Period 0	Y_0^A	Y_0^B
Period 1	Y_1^A	Y_1^B
Δ	$\Delta E_{01}^A + Pol$	ΔE_{01}^B
$\Delta\Delta$	Pol	

Comparing period 0 before the policy change and period 1 after the policy change, the variation in the economic outcome of interest for the treatment group is equal to the effect of the change in economic circumstances ΔE_{01}^A and the effect of the policy change Pol : $Y_1^A - Y_0^A = \Delta E_{01}^A + Pol$. Similarly, for the control group it holds that $Y_1^B - Y_0^B = \Delta E_{01}^B$. The crucial identifying assumption to establish the effect of the policy change on the outcome of interest is that the effect of the change in economic circumstances is the same for the treatment and the control group: $\Delta E_{01}^A = \Delta E_{01}^B$. Moreover, in the absence of the policy change, the difference between the treatment and the control group should be constant over time (so-called *common trend* assumption). Finally, the policy change should be unexpected; there should not be *anticipation effects*. Otherwise changes in outcomes would occur prior to treatment.

An example is provided by the estimate offered by Imbens et al. (2001) of the income effect, a crucial parameter to predict the labor supply response to wage and policy changes. The effect of income on labor supply is hard to identify as most policies involve simultaneous transfers of income and changes in work incentives, which make it hard to separately identify income and substitution effects. Lotteries provide an ideal setup as they induce exogenous shocks in unearned income of the winners of lottery prizes, hence they represent a pure income effect. Imbens et al. (2001) carried out a survey of two samples playing the lottery in Massachusetts in the mid-1980s: a winners sample (including a big winners subset) with a mean prize of more than US\$1 million, and a nonwinners

sample. The key identifying assumption is that the magnitude of the lottery prizes is random. They observed, for each individual, social security earnings for six years preceding the time of winning the lottery, for the year the person won (year zero), and for six years following winning. The average earnings for nonwinners and winners over the six pre-lottery years and the six post-lottery years (in US dollars) were as follows:

Average earnings	Nonwinners	Winners
Pre-lottery years	16,715	12,815
Post-lottery years	17,163	10,938
Δ	448	-1,877
$\Delta\Delta$	-2,325	

One can see a modest decline in earnings for the full winner sample compared to the nonwinners after winning the lottery. The estimate for the marginal propensity to earn (mpe) out of unearned income can be based on the ratio of the difference in the average change in earnings before and after winning the lottery for two groups and the difference in the average prize for the same two groups. Given a difference in average prize of US\$55,000 for the winner/nonwinners comparison, the estimated mpe is $-2,325/55,000 = -0.042$. For the big-winners/small-winners comparison, this estimate is -0.059 .

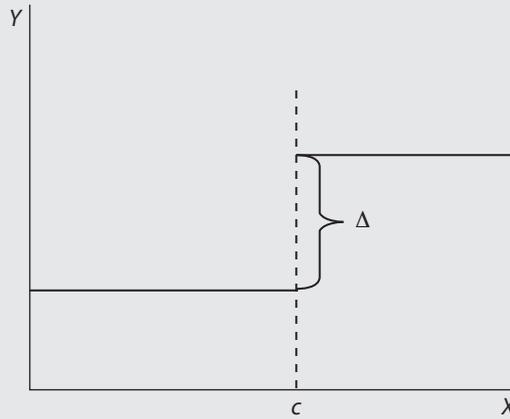
Source: Imbens et al. (2001).

Regression Discontinuity Design

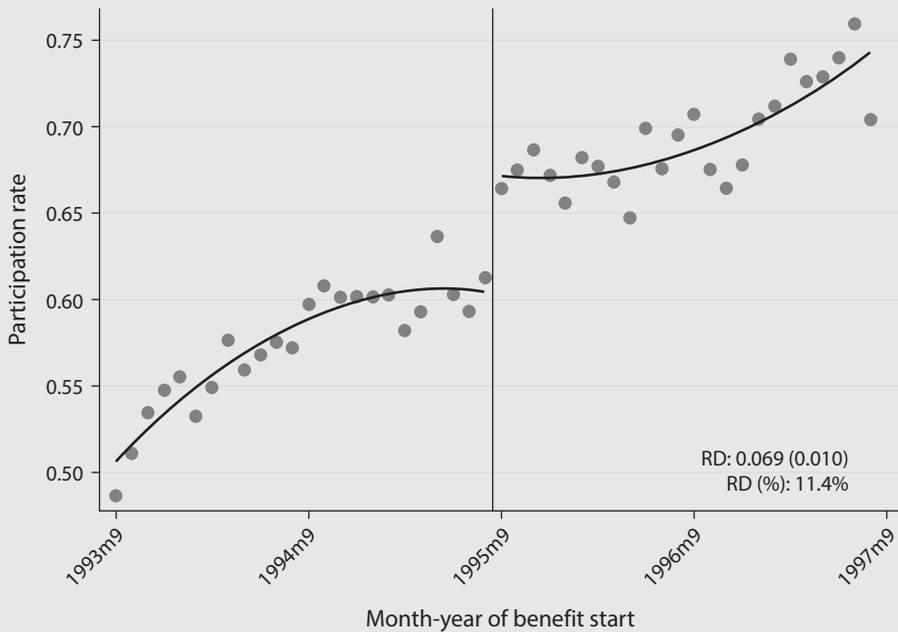
BOX 1.5

To establish the effect of a labor market institution it is sometimes possible to use a *regression discontinuity design*. This happens when there is a continuous characteristic where a policy does not apply before a certain threshold while it does apply after that threshold. This situation is illustrated as follows:

Provided that along X the only variation is related to a policy change, the effect of the policy Pol can be established as $Pol = \Delta = (Y|X \geq c) - (Y|X < c)$. In other words, the focus is on a tiny interval around the policy discontinuity to compare units that are similar in all respects except along the policy dimension.



An example of application of this technique is provided by the estimation of the income effect by Giupponi (2019) who applied a regression discontinuity design in spousal death date to identify the effect of unearned income on labor supply. Giupponi takes advantage of a policy change that introduced an exogenous, large, and permanent discontinuity in the fraction of the deceased pension received by survivors on the basis of their spouse death date. For survivors whose benefit started on or after September 1, 1995, the reduction in the expected lifetime benefit was about 100,000 euros (or 31 percent of the mean in the pre-reform regime). The effects of the policy change on labor supply are shown in the figure below: Labor force participation is 7 percentage points higher



to the right of the cutoff. This large income effect is attributable to both increased entry into the labor market by younger survivors and delayed retirement by older survivors.

Source: Giupponi (2019).

We consider the following four institutional indicators: the index of strictness of employment protection legislation (EPL), the unemployment benefit (UB) net replacement rate, the ratio of active labor market policy (ALMP) expenditure to GDP, and the total tax wedge on low wages. The first measure is widely used in the literature and draws on detailed information about national regulations and is increasing in the strictness of EPL. Details on the OECD “overall strictness of EPL” index are offered in chapter 10. The UB net replacement rate is also widely used. It measures the level of the unemployment benefits at the 24th month after the beginning of the unemployment spell as a fraction of the last wage for a single person without children earning two-thirds of the average wage. The ALMP budget includes a variety of so-called activation programs providing job counseling, placement, and subsidized hiring typically at low durations of unemployment or among youngsters and sanctioning with benefit reductions those who did not actively seek employment (see chapter 12 for details). Finally, the total tax wedge on low pay captures a wide array of employment-conditional incentives (ECI) introduced to increase incentives to work at relatively low wages. It relies on detailed information on national tax and benefit systems collected in the OECD tax database (see chapter 14). Reference is made also in this case to a single worker earning two-thirds of the average worker pay.

The message delivered by these figures is one of much activism. There are only six countries (out of 20) that did not change EPL over time, only four countries (out of 26) that did not modify UB generosity, only two countries (out of 17) that did not adjust significantly (by more than 0.1 percentage points) the size of ALMP programs, and three countries (out of 36) that did not adjust taxes and benefits for low-wage earners. Most of the countries are located below the bisecting line through the origin denoting a reduction of the strictness of EPL and the generosity of UBs and ALMPs, as well as of the tax burden.

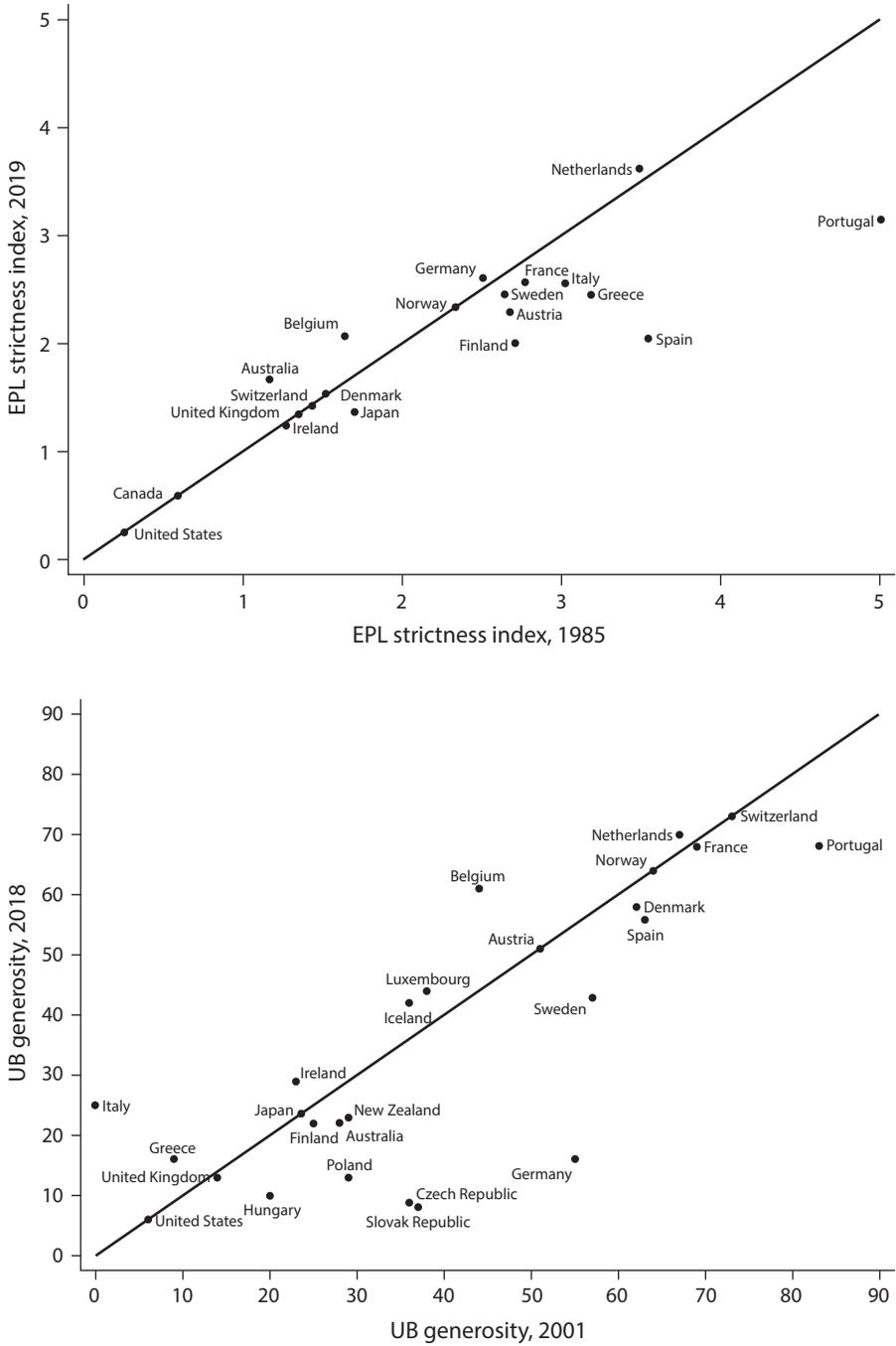


FIGURE 1.14. Evolution of the strictness of EPL, UBs, expenditures on ALMP, and taxes
 Note: EPL = employment protection legislation, UB = unemployment benefits, ALMP = active labor market policy.

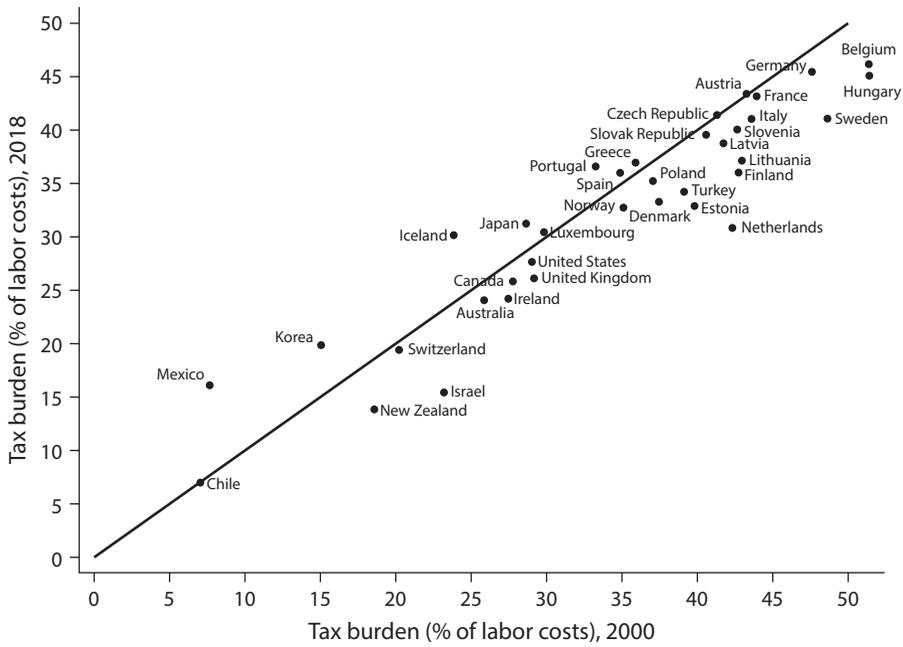
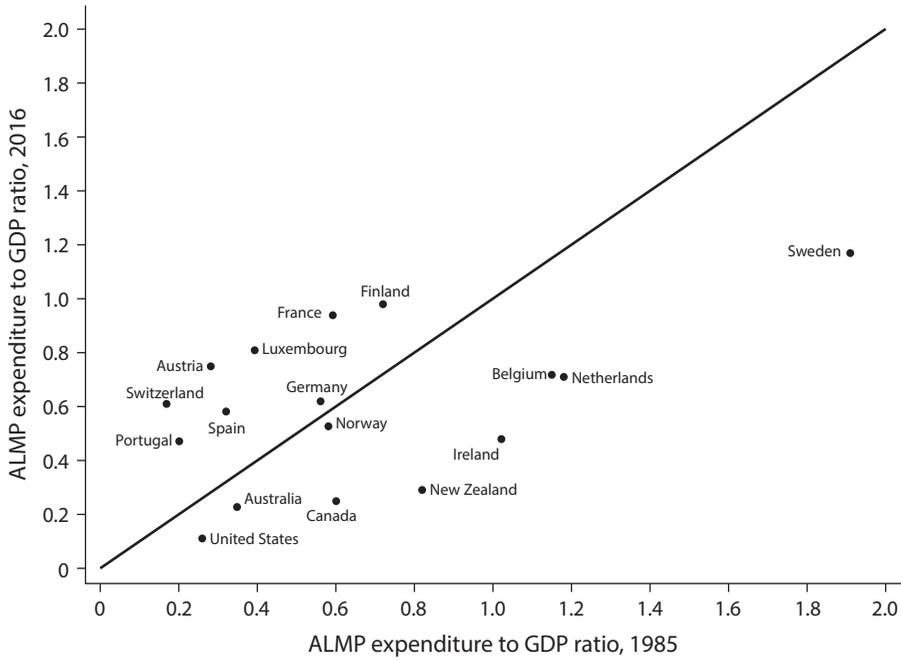


FIGURE 1.14. Continued.

TABLE 1.3 Labor market reforms in Europe by orientation and scope

Reform area	Number	Effect on the wedge (%)		Scope of the reform (%)	
		Decreasing	Increasing	Two-tier	Complete
<i>EPL</i>					
1970–1990	24	63	37	42	58
1991–2013	75	73	27	55	45
Total	99	71	29	52	48
<i>UB</i>					
1970–1990	24	17	83	27	73
1991–2013	44	64	36	34	66
Total	68	47	53	32	68
<i>ALMP</i>					
1980–1995	59	83	17	42	58
1996–2007	183	94	6	57	43
Total	242	91	9	53	47
<i>ECI</i>					
1980–1995	27	81	19	41	59
1996–2007	92	96	4	71	29
Total	119	92	8	64	36
<i>ER</i>					
1980–1995	25	44	56	64	36
1996–2007	39	69	30	82	18
Total	64	59	41	75	25

Sources: Duval et al. (2018) for EPL and UB; Fondazione Rodolfo Debenedetti-Institute for the Study of Labor (FRDB-IZA) Social Policy Reform database for AP, ECI, and ER. Data from the FRDB-IZA database have also been used to compute the EPL and UB percentages related to the scope of the reforms.

Note: The reform programs related to EPL and UB are those defined as *major measures* in the dataset by Duval et al. (2018)—that is, only those programs that satisfy at least one of the alternative criteria set up by the authors. EPL = Employment Protection Legislation, UB = Unemployment Benefits, AP = Activation Programs, ECI = Employment Conditional Incentives, ER = Early Retirement.

Table 1.3 provides information on the number and characteristics of reforms carried out in the European Union in the field of labor market and social policies in the period from 1970 to 2013. It draws on two datasets. On the one hand, the “Social Policy Reform Inventory,” assembled by the Fondazione Rodolfo Debenedetti (recently in cooperation with the Institute for the Study of Labor), takes stock of reforms carried out in Europe in the field of EPL, UBs, activation programs, ECI, and early retirement (ER) plans. The full details on each reform are offered on the webpage of the Fondazione Rodolfo Debenedetti (www.frdb.org). The second dataset is the inventory of major reforms of EPL and UBs compiled by the OECD (Duval et al. 2018).

Many reforms of labor market institutions are taking place. In the 1980–2007 period FRDB counted 883 reforms in just 14 countries, which

is more than two reforms per year and country. FRDB covers all reforms, unlike Duval et al. (2018), which covers only major reforms. There are many reforms going in both directions, increasing and decreasing the wedge, notably in the areas of EPL, UB, and ER. This may be related to political opposition to reforms. There is much more consistency in activation programs and ECI reforms.

Most reforms appear to reduce the wedge in each policy area, except for ER in the earliest period. Moreover, the share of reforms reducing the wedge is increasing over time (table 1.3). This trend can be explained as a reaction to pressures arising from *globalization*. When product market competition increases because of imports from countries with low labor costs (Autor et al. 2013), it flattens out the demand for labor, increasing the employment bias of labor market institutions (Bertola and Boeri 2002). At the same time, greater competition in product markets increases the political resistance to the downscaling of institutions protecting against labor market risk. Social norms or cultural factors supporting redistributive (typically, wage compressing) institutions may become more important at times of globalization (Agell 1999). This helps explain why several reforms also go opposite to the direction implied by increased product market competition. Moreover, several empirical studies (Rodrik 1998; Wacziarg and Welch 2008) found a positive correlation between exposure to product market competition—measured in terms of trade openness—and the presence of redistributive institutions, pointing to stronger demand for protection in competitive environments. Demands for transfers to displaced workers under globalization shocks go hand in hand with political preferences for protectionist measures (Di Tella and Rodrik 2020).

Reforms can also be categorized by considering whether they are two-tier or complete. In particular, we can look at the *target share*—that is, the share of the population potentially affected by the reform which was actually targeted by the reform. If the “treatment group” of the reform represents less than 50 percent of the potentially eligible population (i.e., it is only young people out of the entire working-age population or temporary workers out of the total dependent employment), then the reform was classified as a *two-tier reform*. As shown by table 1.3, two-tier reforms are predominant in all institutional areas except UBs. Not all two-tier reforms necessarily increase the dualism of regulatory regimes, as they may also reduce pre-existing asymmetries among the different regimes. However, four two-tier reforms out of five actually widen the asymmetries in regulatory regimes.

Whatever the reasons for the reforms of labor market institutions, many of them occur every year. This offers a great opportunity to understand their effects on the labor market. Most of the empirical evidence presented in this book relies on studies that use reforms as *policy experiments*, allowing researchers to better isolate the effects on the labor market of any specific institution and identify the underlying causal relationships. Often not only do institutions affect labor market outcomes, but also the underlying conditions of the labor market affect the institutions. The labor market itself gives rise to political pressures to introduce, preserve, or reform these institutions.

At the same time, it is important to be aware that most reforms are marginal and they may frequently involve the creation of two-tier regimes with the coexistence of reformed and unreformed segments of the labor market. Even when regulations do not allow for within-country variation, they are indeed often not enforced uniformly. There is often a sizable informal sector where most regulations are weakly enforced or not enforced at all. Thus, considering an institution at the country level may conceal significant within-country variation and the coexistence of, say, “rigid” and “flexible” segments in the same labor market may involve nontrivial interactions between the two. An explanation for the strong rise in unemployment in Spain during the Great Recession is that its labor market is characterized by a dual structure, with a flexible temporary fringe alongside a rigid stock of regular contracts. This dualism could have increased labor market response to adverse business conditions precisely in those countries displaying the strictest employment protection provisions for regular contracts. Studying the interactions between these segments and defining a theory of two-tier reforms providing guidance to empirical work in this area is perhaps one of the most challenging areas of research in labor economics. From a normative standpoint it is important to acknowledge that the effects of reforms may vary over the business cycle. What is desirable in the long run may not be desirable in the short run, notably during deep recessions. This was one of the lessons of the Great Recession. Better understanding the cyclical properties of labor market reforms is another rather unexplored and extremely relevant area of research. Finally, technological change is deeply affecting not only the environment in which institutions are operating but also the functioning itself of the institutions, as technology intervenes directly in the enforcement of labor market policies. In this chapter we dealt specifically with the effects of globalization, which

are largely concentrated on labor demand. Most governments seem to have learned these lessons, at least judging from their labor market policy response to the Covid-19 crisis.

Technological change is another key development affecting not only the impact but also the design of labor market institutions. The Covid-19 pandemic has brought about an acceleration of technological progress in two main directions. On the one hand, there has been a dramatic increase in so-called *smart working*; that is, jobs that can be carried out remotely, potentially from home. This is bound to deeply modify the organization of work and the structure of working hours, and potentially result in remuneration packages unavoidably putting more emphasis on individual productivity. On the other hand, firms are heavily investing in automation to safely carry out those tasks that would have required physical proximity among workers for example, along assembly lines. Paradoxically, it is just those technologies that have historically created a lot of anxiety among workers (Mokyr et al. 2015) that can now preserve jobs, provided that workers are duly trained on the job to be complementary to robots. The challenges imposed by this technological revolution are immense and already involve all branches of science at this stage. Labor economics is one of the most important, if not *the* most important, field in this context. It could contribute to governing this revolution, maximizing the well-being of society at large.

1.7 Review Questions and Exercises

1. What happens to the participation rate if unemployment goes up?
2. Who are the discouraged workers? In the presence of discouraged workers, what happens to unemployment if employment goes up?
3. Why is the wage elasticity of labor supply always positive for nonparticipants?
4. What happens to labor supply if wages go up and leisure is an inferior good?
5. Why is the reservation wage higher with restrictions on hours?
6. What is the difference between a two-tier and a complete reform?
7. Under what conditions can labor market institutions increase labor market efficiency?
8. Why is labor demand called derived labor demand?

9. Why is the labor supply curve always upward sloping?
10. Andrea's utility function is $U(c, l) = (c - 40) \times (l - 40)$, where c denotes consumption and l leisure. Andrea earns 10 euros per hour, can at most work 84 hours per week, and has no nonlabor income.
- (a) Please display Andrea's budget line. Would it be different if she had some nonlabor income?
 - (b) What is Andrea's marginal rate of substitution when $l = 50$ and she is on her budget line?
 - (c) What is Andrea's reservation wage?
 - (d) Compute the amount of consumption and leisure, c^* and l^* , that maximize Andrea's utility.
11. Mike's preferences over consumption c and leisure l are given by $U(c, l) = cl$. The hourly wage is 20 euros and there are 168 hours in the week.
- (a) Write down Mike's budget constraint and graph it.
 - (b) What is Mike's optimal amount of consumption and leisure?
 - (c) What happens to employment and consumption if Mike receives 200 euros of nonlabor income each week?
12. (Advanced) Revenues of employers are given by

$$f(L) = \frac{A}{1 - \eta} L^{1 - \eta},$$

with $0 \leq \eta < 1$, in which L is labor input and A and η are constants. Labor supply is specified as $L^s = w^{\frac{1}{\varepsilon}}$, where ε is a constant.

- (a) Show that a government trying to maximize the joint surplus obtains the perfect labor market outcome.
- (b) Specify the outcome of Nash bargaining over the market surplus, where β represents the bargaining power of the workers.
- (c) Show under which conditions the bargaining outcome is equal to the perfect equilibrium outcome.
- (d) Assume that employers have all the bargaining power, then illustrate that the magnitude of their power depends on the slope of the labor supply curve.
- (e) Provide an intuition for these results.

1.8 Technical Annex: Competitive Pressures and Institutions

A simple static model originally developed by Bertola and Boeri (2002) can be valuable in characterizing equilibriums in competitive labor markets, as well as the role of labor market institutions.

1.8.1 A Competitive Labor Market

In the model that follows, a crucial role is played by labor demand and supply elasticities, defined as the percentage change in labor demand and supply, respectively, associated with a one percentage change in the wage. On the demand side of the market, profits are maximized when the marginal wage cost, w , is equal to the marginal value of production, y . In the short run (when capital is fixed) there is no loss in generality in assuming that the marginal value of a job is a decreasing (at a constant elasticity) function of the employment rate L —that is, $y = AL^{-\eta}$, where A is an index of the production function and the index of the (inverse) labor demand elasticity η takes values between 0 (flat labor demand at A) and 1. We can then write the labor demand schedule as

$$L^d = \left(\frac{A}{w}\right)^{\frac{1}{\eta}}. \quad (1.4)$$

The supply side of the labor market is given by the cumulative distribution function of the reservation wages, which is, by construction, increasing with w . We assume also that this schedule has a constant-elasticity functional form so that

$$L^s = G(w) = w^{\frac{1}{\varepsilon}}. \quad (1.5)$$

The elasticity parameter may range between 0 (in which case the labor supply is flat and normalized to unity) and plus infinity: larger values of ε denote increasingly inelastic labor supply schedules, and as ε tends to infinity, labor supply becomes perfectly vertical.

We consider first the equilibrium in a competitive and wedge-free labor market where $y = w^r = w^*$. By equating the two schedules, solving for L , and substituting the result in the labor supply function, we obtain

$$L^* = (A)^{\frac{1}{\varepsilon+\eta}}, \quad w^* = A^{\frac{\varepsilon}{\varepsilon+\eta}}. \quad (1.6)$$

It is easy to show that this equilibrium maximizes the total surplus from labor exchange. The profit of the employer is equal to the difference between the area under the demand curve and the labor costs:

$$\int_0^L Ax^{-\eta} dx - wL = \frac{A}{1-\eta} L^{1-\eta} - wL. \quad (1.7)$$

Similarly, the total surplus of workers is given by

$$wL - \int_0^L x^\varepsilon dx = wL - \frac{L^{\varepsilon+1}}{\varepsilon+1}. \quad (1.8)$$

Maximizing the joint surplus (the *sum* of a firm's profits and of the workers' surplus from employment),

$$\begin{aligned} \max_L \left(\left[\frac{AL^{1-\eta}}{1-\eta} - wL \right] + \left[wL - \frac{1}{\varepsilon+1} L^{\varepsilon+1} \right] \right) \\ = \max_L \left(\frac{AL^{1-\eta}}{1-\eta} - \frac{1}{\varepsilon+1} L^{\varepsilon+1} \right), \end{aligned} \quad (1.9)$$

yields the wedge-free, perfect labor market wage and employment levels (1.6). Hence the competitive outcome has the desirable property of maximizing the total surplus of production over the opportunity cost of employment or the size of the economic pie generated by the labor market. Since maximization entails equality at the margin of the value of a job for the employer and workers' reservation wages, the competitive outcome also features no welfare loss from unemployment. Yet as long as w^* lies on a flat segment of the function $G(w)$, at the equilibrium there may be individuals unemployed, meaning in this particular case that they are indifferent between working and not working.

1.8.2 Labor Market Institutions

As discussed in this chapter, the presence of labor market institutions can be rationalized in terms of market failures as well as distributional tensions, either related to general interest redistribution in favor of workers or special interests of specific categories of workers-citizens.

Market failures may arise from imperfect or asymmetric information or because of an excessive concentration of power in the hands of employers (monopsony power), forcing both employment and wages to be lower than at the optimum. Distributional concerns may arise with and without market failures. In the absence of lump-sum redistribution, even equilibriums that maximize the joint surplus (the equilibrium in a competitive economy) do not necessarily address distributional tensions in the economy.

1.8.3 The Wedge

All labor market institutions operate by introducing a wedge between labor supply and demand. Their rationale can be illustrated by comparing the institution-free, *laissez-faire* equilibrium with the solution of a government problem involving the choice over the size of this wedge. If the wedge is zero, the solution of the problem coincides with the *laissez-faire* equilibrium and there is no role for labor market institutions. The size of the wedge measures the deviation of the social optimum (or the equilibrium imposed by bargaining over the distribution of the surplus) from the *laissez-faire* equilibrium.

In particular, consider an institution introducing a wedge between labor supply and demand in terms of a proportional tax on labor income, t . Suppose that the government maximizes over t a Bernoulli-Nash social welfare function of the type

$$W = \max_t \left(\left[\frac{AL^{1-\eta}}{1-\eta} - w(1+t)L \right]^{(1-\beta)} \left[w(1+t)L - \frac{1}{\varepsilon+1}L^{\varepsilon+1} \right]^\beta \right), \quad (1.10)$$

where the parameter β measures the distribution weight of labor—that is, the importance given by the planner to the (functional) share of the pie going to the workers. Conversely, $(1 - \beta)$ is the distribution weight of employers.

By taking the logs of (1.10) (a monotonic transformation that does not alter the first-order conditions) and imposing that employers and workers are optimizing their choices over labor and leisure (employers on the labor demand and workers on their labor supply) we can rewrite the maximization problem as

$$\begin{aligned} \max_t (1 - \beta) \log \left(\frac{AL^{1-\eta}}{1 - \eta} - (1 + t)AL^{1-\eta} \right) \\ + \beta \log \left((1 + t)L^{\varepsilon+1} - \frac{L^{\varepsilon+1}}{1 + \varepsilon} \right), \end{aligned} \quad (1.11)$$

where we substituted $w = AL^{-\eta}$ in the definition of the employers' surplus and $w = L^\varepsilon$ in the definition of the employees' surplus, or

$$\begin{aligned} \max_t (1 - \beta) \log \left(AL^{1-\eta} \left(\frac{\eta - t(1 - \eta)}{1 - \eta} \right) \right) \\ + \beta \log \left(L^{\varepsilon+1} \left(\frac{\varepsilon + t(1 + \varepsilon)}{1 + \varepsilon} \right) \right). \end{aligned} \quad (1.12)$$

The first-order condition is

$$\frac{AL^{1-\eta}(1 - \beta)}{AL^{1-\eta}(\frac{\eta}{1-\eta} - t)} = \frac{L^{\varepsilon+1}\beta}{L^{\varepsilon+1}(\frac{\varepsilon}{1+\varepsilon} + t)}.$$

Then simplifying

$$\frac{(1 - \beta)}{(\frac{\eta}{1-\eta} - t)} = \frac{\beta}{(\frac{\varepsilon}{1+\varepsilon} + t)}$$

and then solving for the wedge, we obtain

$$t = \beta \frac{\eta}{1 - \eta} - (1 - \beta) \frac{\varepsilon}{1 + \varepsilon}, \quad (1.13)$$

which implies that the wedge is zero if and only if

$$\frac{\beta}{1 - \beta} = \frac{\varepsilon}{(1 + \varepsilon)} \frac{(1 - \eta)}{\eta}. \quad (1.14)$$

In other words, a laissez-faire equilibrium when governments care about the (functional) distribution of income requires that the ratio of the distribution weight of employees to that of employers equals a product of the labor demand and supply elasticities. The larger ε is, the lower the elasticity of labor supply will be, and the larger the distribution weight of employees justifying a laissez-faire equilibrium should be. Analogously, the larger η is, the lower the elasticity of labor demand will be, and the

higher the distributional weight of employers justifying a laissez-faire equilibrium should be. The economic intuition behind these results is that, in line with optimal taxation theory, it is better to tax more the less elastic side of the market, as this maximizes tax revenues. Only a strong distributional concern of this less elastic side of the market could move the equilibrium away from this optimal taxation rule.

Importantly there is no reason to expect a priori that the condition (1.14) is satisfied, as β bears no systematic relationship with labor demand and supply elasticities. Put another way, it can only be by chance that (1.14) is satisfied. In the general case, when distributional concerns are relevant, it is optimal to have some wedge between labor supply and demand, even at the cost of deviating from the equilibrium, which maximizes the joint surplus. Redistribution is one of the key functions of the labor market institutions discussed in this book. The other cases for labor market institutions arise when the laissez-faire equilibrium does not maximize (1.12) and hence labor market institutions do not necessarily involve an efficiency-equity trade-off.

1.8.4 Product Market Competition and the Employment Bias of Institutions

Notice that the distribution weight compatible with the competitive, laissez-faire equilibrium is decreasing with the elasticity of demand and supply. By the same token, the *disemployment bias* of labor market institutions (the reduction in employment induced by the wedge with respect to the institution-free outcome) is larger in the presence of a larger elasticity of demand. In particular, by denoting by the superscript I the presence of some institution, the disemployment bias is given by the wedge t , where

$$1 + t = \frac{(1 - \eta) + \beta(\eta + \varepsilon)}{(1 - \eta)(1 + \varepsilon)}. \quad (1.15)$$

Let $\mu \equiv 1 + t$ denote the markup imposed by institutions over the competitive wage. The above result suggests that the equilibrium with institutions involves lower employment than at the laissez-faire competitive equilibrium when the markup is greater than 1.⁷

7. When the markup is strictly lower than 1, it is labor supply that is the short side of the market. Also in this case there is less employment than at the competitive equilibrium.

Suppose now that labor demand becomes more elastic (moving, say, from η_0 to η_1 where $\eta_1 < \eta_0$), for example, as a result of a globalization shock involving greater competition in product markets. Insofar as labor market institutions do not automatically adjust to the changes in the economic environment, the employment levels before and after globalization (denoted by the subscripts 0 and 1) are given by

$$\beta L_1^I = A\mu_0^{-\frac{1}{\varepsilon+\eta_1}} < L_0^I = A\mu_0^{-\frac{1}{\varepsilon+\eta_0}}.$$

Thus, if the wedge remains at its optimal level (μ_0) before the globalization shock and does not adjust to the changes in the labor demand elasticity parameter, an increase in product market competition leads to lower employment, and by (1.8) there is a larger employment bias of labor market institutions with respect to the laissez-faire outcome. Increased product market competition may also involve improvements in production technologies (a larger A). This may increase the laissez-faire equilibrium employment level with respect to its level before the shock, shifting the labor demand schedule upward. But under greater product market competition, the employment bias of labor market institutions with respect to the laissez-faire outcome is larger. Put another way, if the rationale for labor market institutions is only in terms of (functional) income distribution, then the wedge should be downscaled after globalization because there is a steeper efficiency-equity trade-off.

Overall, an increase in product market competition leads to pressures to reduce the wedge that labor market institutions entail with respect to the competitive outcome. At the same time, however, unreformed labor markets have worse employment outcomes than before globalization. Thus, stronger competitive pressures in product markets also increase the risk of job loss, potentially creating strong constituencies against the retrenchment of institutions that protect against unemployment risk, like nonemployment benefits, employment protection, and ALMPs, whose reform pattern is characterized in table 1.3.

The above framework is also used in chapters 2, 3, and 14.

Subject Index

Page numbers followed by *b*, *f*, and *n* refer to boxes, figures, and notes, respectively.

- Ability bias, 344
- Absenteeism: disability and, 575–580, 578*f*, 595–599; employment protection legislation and, 458–460; monitoring of, 601–602; theory on, 589–590, 589*f*
- Accidents. *See* Workplace accidents
- Accounting effect, 635
- Activation policies, 552–553; for unemployed workers, 569–570
- Active labor market policies, 515–517; activation policies, 552–553; empirical evidence on, 547–552; future of, 556–557; in imperfect labor markets, 533–535; interactions with other labor market institutions, 554–556; international comparisons on, 522–523, 522*f*, 523*f*; payroll taxes and, 635; in perfect labor markets, 523–526; ratio to GDP of, 41, 43*f*
- Administrative procedures, 422
- Admission procedures (for migrants), 372
- Advance notice period, 422
- Adverse selection, 27, 92, 300, 508, 556
- Affirmative action policies, 180–183
- Age: competition between young and older workers, 278–281; demand for older workers, 254–255; discrimination by, 173–174, 180; early retirement plans for, 237–238; earnings test for older workers, 626–627*b*; employment legislation protection specific to, 454–456, 465; job loss among older workers, 252–254; minimum wage for youth, 85–91, 86*f*, 87–89*b*; optimal retirement age, 277–278; productivity and, 255–258, 274; at retirement, 240, 241*f*, 249–251*f*; of self-employed workers, 500; of union members, 140
- Aggregate labor supply, 14–16
- Annuitization (of pension payments), 239
- Anonymous applications, 178–180
- Anticipation effects, 38
- Anti-discrimination legislation, 149–150; black-white wage gap, 168–169*b*; empirical evidence on, 164–165; family policies and, 318; future of, 184–185; in imperfect labor markets, 158–164; international comparisons of, 150–153, 151*f*, 165–168, 166*f*, 167*f*; on labor market discrimination, 169–177; minority quotas and, 180–183; other labor market institutions and, 183–184; in perfect labor markets, 153–158; policy issues in, 177–179; theory of, 153
- Apprenticeships, 352–353
- Asylum seekers: in labor markets, 411–413; policies on, 373
- Audit studies, 170
- Augmented wage curve, 502
- “Ban the box” (BTB) policies, 174–175*b*
- Benefit accrual, 240
- Beveridge curve, 533–535, 548, 568–569
- Bilateral monopolies, 67
- Black-white wage gap, 168–169*b*
- “Blind” auditions, 176–177*b*
- Blinder-Oaxaca decomposition, 168–169*b*
- Brain-drain effect, 410
- Budget constraints, 9

- Capital markets, 490–491
- Childcare, 282, 284*f*, 285–286; costs of, 291–294, 292*f*; facilities for, 323–324; formal and informal, 296; in imperfect labor markets, 300–301; responsibilities for, 305–306; social customs and, 319–320; subsidized, 291, 307–309
- Child penalty, 314–316, 320
- Chinese Exclusion Act (US, 1882), 369
- Citizenship, 373
- Coefficients of discrimination: employer-specific, 154, 188; market discrimination, 154–155, 156*f*
- Collective bargaining, 100–101; centralization of, 106–109, 108*f*; characteristics of collective bargaining system, 130–134; coverage of, 105–106; empirical evidence on, 125–127; employment protection legislation and, 465; extensions of, 108*f*, 109–112; in imperfect labor markets, 114–125; as labor market institution, 24–25; minimum wages and, 91, 97–98; regulation of working hours by, 225; wage floors established by, 56. *See also* Unions
- Collective models of household behavior, 301
- Common trend assumption, 38
- Compensating wage differentials, 583
- Competitive labor markets, 49–50; anti-discrimination legislation and, 184; impact of minimum wages in, 61; prejudices in, 188–189; taxation effect in, 527; unemployment benefits in, 523–524. *See also* Perfect labor markets
- Complete insurance, 461
- Congestion externalities, 384, 488–489
- Contagious presenteeism, 597
- Contingent payments, 556
- Contract curves, 118–120, 146–148
- Contractos temporales* (fixed-term contracts), 421
- Control groups, xxviii–xxix, 37
- Correspondence studies, 170, 175–176, 190–191
- Covid-19 pandemic, 47; economic layoffs banned during, 462; future of family policies and, 320; impact on immigration policies of, 414; impact on workplace safety of, 603–604; self-employed workers during, 481–484, 507; short-time work during, 226; smart working in response to, 193, 231
- Coworker prejudices, 156–157
- Credit market, 492
- Criminal history, discrimination by, 174–175*b*
- Customers, prejudices of, 157–158
- Deadweight costs (effects), 227, 240
- Deaths of older workers, 267–268
- Deferred compensation, 246
- Defined benefit (DB) pension programs, 239, 242–244*b*
- Defined contribution (DC) pension programs, 239, 243–244*b*
- Delalande tax (France), 455–456
- Demand curve, 64
- Dentists, 137–138*b*
- Difference-in-differences, 37–39*b*, 74
- Direct job creation, 517
- Disabilities, 575–580
- Disability benefits, 572, 585, 597–599
- Disciplinary dismissals (layoffs), 422, 433–434; burden of proof in, 435–437*b*; economic layoffs versus, 434–435*b*
- Discouraged workers, 35, 36
- Discrimination, 149–150; anonymous applications to reduce, 178–179*b*, 179–180; black-white wage gap, 168–169*b*; in competitive labor markets, 188–189; direct effects of, 184–185; economic efficiency and, 164; by gender, 153–158; by gender, monopsonies and, 189; in labor market, 169–177; quotas and, 180–183; statistical, 160–162, 161*f*; taste-based, 158
- Disemployment bias, 53–54
- Dismissals, 422, 426*f*, 427*f*; burden of proof in, 435–437*b*; collective, 426–427; disciplinary versus economic, 434–435*b*; empirical evidence on, 448*f*; individual, 425–426
- Dual employment, 36
- Dual labor markets: minimum wages in, 69–71, 70*f*, 93; self-employed workers in, 481; employment protection in, 462–463
- Dynamic reservation wage, 527–528*b*, 560–561

- Earliest retirement age, 240
- Early retirement plans, 237–238; age for, 241*f*; education and, 356; flexibility in, 264–266; future of, 273–275; in imperfect labor markets, 245–246; interactions with other labor market institutions, 271–273; international comparisons of, 238–241; mandatory retirement and, 266–271; notional defined contribution systems for, 247–248*b*; optimal age for, 277–278; payroll taxes and, 634–635; in perfect labor markets, 241–245; pull factors for, 258–264; push factors for, 252–258
- Earned income tax credit (EITC), 625, 626, 630, 635–636
- Economic layoffs, 433–434; during Covid-19 pandemic, 462; disciplinary layoffs versus, 434–435*b*
- Education, 326–329; benefits and costs of, 335*f*; early tracking in, 354–355; empirical evidence on returns to schooling, 343–350; future of, 357–358; in imperfect labor markets, 337–340; interactions with other labor market institutions, 355–356; international comparisons of, 329–333, 330*f*, 331*f*, 333*f*, 340–343, 341*f*; international expenditures on, 328*f*; lotteries for dental schools, 137–138; minimum wages and, 70–71, 91; nonformal, 333*f*; optimal years of schooling, 361–363; in perfect labor markets, 333–337; quality of, 350–351; of self-employed, 499–500. *See also* Training
- Effective labor supply, 529
- Efficiency, 25
- Efficiency wages, 22, 68; minimum wages and, 98–99; unemployment benefits and, 530–531*b*
- Efficient contracts, 118–120, 119*f*
- Eligibility (for unemployment benefits), 516
- Employees, 428–429; coworker prejudices, 156–157; employers' searches for, 529
- Employers: discrimination by, 155*f*; prejudices of, 154–156; search for employees by, 529; tax credits and subsidies for, 633–634. *See also* Firms
- Employer-specific coefficient of discrimination, 154, 188
- Employment: of children of immigrants and native-born, 405–407, 406*f*; definition of, 32; by education, 340–343, 341*f*; elasticity in, minimum wages and, 71; of foreign-born men, 404–405, 405*f*; impact of employment protection legislation on, 446–450; impact of minimum wage on, 74–76; of mothers, 302–304*f*, 303–306, 319–320, 319*f*; myths about, 2–6; parental leave policies and, 309–310; rates of, 3*f*; rates of, by gender, 3*f*; rates of, for native and foreign-born workers, 388*f*; self-employment in, 493–494, 494*f*; transition from temporary to permanent, 446*f*
- Employment protection legislation (EPL), 421–423; anti-discrimination legislation and, 184; early retirement plans and, 271; empirical evidence on, 447–460; flexibility in, 469–475; future of, 465–466; graded security contacts as, 462–464; in imperfect labor markets, 431–446; index of strictness of, 41, 42*f*; interactions with other labor market institutions, 464–465; international comparisons on, 423–428; optimal level of, 460–462; in perfect labor markets, 428–431; training and, 356; unemployment benefits distinguished from, 554–556; working hours regulations and, 230
- Employment rate, 3*f*, 20–21
- Endogeneity (of migration), 392
- Endowment point, 9
- Entitlement effects, 532–533, 563–565
- Entitlements, 516
- Entrepreneurship, 477, 484–488, 495–496, 496*f*; promotion of, 503–507
- Equal pay legislation, 177
- Equity, 26
- Erga omnes clauses, 109–111
- Ex ante effects, 530
- Experience rating, 461
- Ex post effects, 530
- Externalities, in labor markets, 384, 529
- External rate of return, 335
- Factory Acts (Britain), 571
- Fair Labor Standard Act (US, 1938), 55
- False self-employment, 492, 496–498
- Family policies, 282–283; childcare, 284*f*, 285–286; empirical evidence on,

- Family policies (*continued*)
306–316; encouragement of paternity leave, 316–317; encouraging mothers with young children to work, 317–318; future of, 319–320; in imperfect labor markets, 299–301; interactions with other labor market institutions, 318–319; international comparisons on, 285–290, 301–306; parental leave, 286–290, 287*f*, 289*f*; payroll taxes and, 635; in perfect labor markets, 291–299, 292*f*, 295*f*, 298*f*; working hours regulations and, 230
- Fast-food industry, effects of minimum wage hikes in, 74–76*b*
- Featherbedding, 120
- Fertility, 297–299, 298*f*, 301–303; employment of mothers and, 302*f*
- Finance and labor market, 490–492
- Firms: adjusting workforce levels by, 428–429; health-related labor policies and, 604; incorporated and unincorporated, 478; minimum wage and profitability of, 77–78*b*; minimum wage studies on level of, 72–73; quotas for boards of, 180–183; relocation of, 380–382, 381*f*; search for employees by, 529; training specific to, 336–337; training subsidized in, 354; turnover and growth of, 452–455
- Fiscal externalities, 384
- Fiscal substitution effects, 548
- Fixed-term contracts (*contractos temporales*), 421. *See also* Temporary contracts
- Flexicurity, xxvii, 464, 556
- Flow measures, 33–34
- Formal childcare, 296
- Fraction affected, 7
- Free-rider problem, 106, 122
- Frictions, 21
- Gender, xxvii; age at retirement by, 248, 249*f*; “blind” auditions to reduce bias by, 176–177*b*; employment rates by, 3–4, 3*f*, 340–343, 341*f*; monopsony and wage gap by, 159–160, 159*f*, 189; parental leave policies promoting equality of, 289–290; part-time employment by, 216–219, 217*f*, 218*f*; personality traits and, 153; quotas by, 180–183; union wage premiums by, 129; wage gap by, 165–168, 166*f*, 167*f*. *See also* Women
- Generosity (in unemployment benefits), 516
- Ghent system, 105
- Global Entrepreneurship Monitor, 495–496
- Globalization, 45–47
- Graded security contracts, 462–464
- Great Recession (2008–2009), 1; financial markets during, 492; short-time work during, 196, 226, 228–229; in Spain, 46; unemployment benefits during, 540; unemployment rates during, 29–32, 30*f*, 463
- Health and Safety at Work Etc. Act (HSWA; UK; 1974), 572
- Health-related labor policies, 571–573; benefits of workplace safety regulations, 600–601; on disability and absenteeism, 575–580; future of, 602–604; in imperfect labor markets, 585–590, 586*f*, 588*f*, 589*f*; interactions with other labor market institutions, 604; international comparisons of, 573–580; monitoring of absenteeism, 601–602; in older workers, 274; in perfect labor markets, 580–585, 581*f*, 583*f*; reporting of workplace accidents, 606–608; workplace accidents and safety policies, 590–595; on workplace safety, 573–575, 574*f*
- Hedonic wage function, 582
- Hicks paradox, 123–125, 124*f*
- Hold-up problem, 135, 357
- Home care leave, 286, 287*f*
- Home production, 193, 203, 263, 603; surplus from, 324
- Hours. *See* Working hours
- Households: collective models of household behavior, 301; family policies and, 323–324; minimum wage studies on level of, 72–73; unitary and collective models of, 324–325
- Human capital, 326; Becker’s theory of, 327, 339; discrimination and, 150, 168, 185; early retirement plans and, 271; economic growth tied to, 357–358; investment in, 334; investments in training and, 351–352; migration as investment in, 417–419; Mincer equation

- on, 364–365; minimum wages and, 70, 91; parental leave and, 295; productivity, age, and, 256, 257; school attainment as measure of, 349–350
- Human capital investment, xxvii
- Hurricane Katrina, 398–399
- Illegal migrants, 375
- Immigrants and immigration: discrimination against, 172; points system for, 408–410; relocation of, 380–382; to United States, 367–370, 371*f*. *See also* Migration policies
- Immigration Act (US, 1924), 369
- Immigration Act (US, 1990), 369
- Immigration and Nationality Act (US, 1965), 369
- Immigration surplus, 377
- Imperfect capital markets, 490–491
- Imperfect labor markets: active labor market policies in, 533–535; anti-discrimination legislation in, 158–164; early retirement plans in, 245–246; education in, 337–340; employment protection legislation in, 431–446; family policies in, 299–301; health-related labor policies, 585–590, 586*f*, 588*f*, 589*f*; impact of minimum wages in, 63–71; labor market equilibrium in, 21–24; migration policies in, 382–387, 383*f*, 386*f*; payroll taxes in, 620–622, 642–645; regulation of working hours in, 207–214, 208*f*, 211*f*, 213*f*; self-employment in, 488–493; unemployment benefits in, 526–533; unions and collective bargaining in, 114–125
- Implicit coordination, 107
- Inactive people, 33; problems with measurements of, 34–36
- Income effect, 12–14, 14*f*, 38–39*b*
- Income taxes, 615–617, 616*f*. *See also* Payroll taxes; Taxes
- Indifference curves, 8–9
- Informal childcare, 296
- Informal sector employment, 46; in dual labor markets, 69, 70*f*; impact of minimum wage on, 73; outside minimum wage coverage, 58
- Injury risks, 580–582, 581*f*, 587
- Innate ability, 335
- Insiders, 29
- Institutions. *See* Labor market institutions
- Instrumental variable technique, 254
- Internal rate of return, 335
- International Adult Literacy Survey (IALS) scores, 409, 409*f*
- International Standard Classification of Education (ISCED), 328*f*, 329–330
- Involuntary part-time employment, 203–205, 204*f*
- Involuntary unemployment, 24
- Isocost of labor curve, 205–206, 213*f*
- Isolabor curve, 205, 206*f*, 212*b*
- Jack-of-all-trades, 485
- Job polarization, 342, 358
- Jobs: turnover in, 450, 452–455; vacancies in, 7; value of, 17
- Job search theory, 9, 529
- Kaitz index, 57*n*, 72
- Kurzarbeit program (Germany), 226
- Labor costs, 234–236
- Labor Day, 192
- Labor demand, 16–19; payroll taxes and, 618; wedges between supply and, 51–53
- Labor force, 33
- Labor market equilibrium: in imperfect labor market, 21–24; in perfect labor market, 19–21
- Labor market institutions, xx, 24–29, 50–51; anti-discrimination legislation and, 183–184; disemployment bias of, 53–54; effects of, 29–32; minimum wages interacting with, 91–92; payroll taxes and, 635; reforms in, 36–47, 44*f*; unions and, 138–139
- Labor markets: capital markets and, 490–491; competitive, 49–50; definition of, 7–8; discrimination in, 169–177; externalities in, 384; flow measures of, 33–34; immigrants in, 370–372; imperfect, 21–24; labor demand decision in, 16–19; labor supply decision in, 8–16; measure of, 32–33; monopsony and gender wage gap in, 159–160, 159*f*; mothers in, 303*f*; perfect, 19–21, 20*f*; problems with standard measures of status in, 34–36; turnover in, 450, 452–455
- Labor market training, 517

- Labor supply, 8–16; effective, 529; elasticity of, benefits and, 640–642; payroll taxes and, 617–618*b*, 622–623, 625; wedges between demand and, 51–53
- Labor unions. *See* Unions
- Layoffs, 421; of older workers, 455–456. *See also* Dismissals
- Legal minima, 422
- Legislation: abolishing mandatory retirement, 269; anti-discrimination, 149–150; on dismissals, 422; employment protection legislation, 421–423; on immigration, 414; on minimum wages, 98; protective, 177; restricting immigration, 369. *See also* Employment protection legislation; Regulations
- Length of stay (for migrants), 372
- Licensing, occupational, 136–138
- Lighthouse effect, 73
- Lotteries, 38–39*b*
- Lump of labor theory, 210–212*b*, 249; mandatory retirement and, 266
- Lump-sum taxes and transfers, 26–27
- Mandatory retirement, 266–271
- Marginal willingness to pay, 18
- Mariel boatlift, 396–398*b*
- Marketization hypothesis, 283
- Marriage bars, 162–163
- Maternity leave, 286–288, 287*f*, 289*f*
- Median wages, ratio to minimum wages of, 57–58, 57*n*, 58*f*, 60*f*
- Migration policies, 367–370; compensation tied to, 402–411; education scores for migrants, 408*f*, 409*f*; empirical evidence on, 387–402; employment, unemployment rates, and, 388*f*; employment and unemployment rates for migrants and their children, 406*f*; future of, 413–415; in imperfect labor markets, 382–387, 383*f*, 386*f*; interactions with other labor market institutions, 413; international comparisons of, 370–375, 371*f*, 373*f*, 374*f*; net gains from migration, 417–419; in perfect labor markets, 376–378, 378*f*; refugees in, 411–413; relocation of workers, firms, and migrants in, 380–382; on skilled and unskilled workers, 378–380
- Mincer equation, 364–365
- Minimum guaranteed income (MGI) schemes, 615–617, 627–629, 628*f*, 632–633
- Minimum wages, 55–57; collective bargaining and, 97–98; in dual labor markets, 70*f*; effects of, in fast-food industry, 74–76*b*; efficiency wages and, 98–99; empirical evidence on, 71–72; employment elasticity and, 71; firm profitability and, 77–78*b*; future of, 92–94; in imperfect labor markets, 63–71; interactions with other labor market institutions, 91–92; international comparisons of, 57–61, 60*f*; migrant workers and, 382–383, 383*f*, 387*n*; monoposonies and, 96–97; pass-through to customers of, 80–81*b*; in perfect labor markets, 61–62, 62*f*, 63*f*; in poverty reduction, 83–85; ratio to median wages of, 58*f*; studies of, based on employer-employee data, 78–83; studies of, based on firm-level or household data, 72–73; studies of, based on natural experiments, 73–78; for youth, 85–91, 86*f*, 87–89*b*
- Minority quotas, 180–183
- Monopolies, labor demand of, 16–17*b*
- Monopoly unions, 115
- Monopsonies: gender wage gap and, 159–160, 159*f*, 189; impact of minimum wages in, 64–68, 64*f*, 65–66*b*, 81–82, 96–97
- Moral hazards, 27; in childcare programs, 300; in employment protection legislation, 461, 464; in self-employment, 490, 508; in unemployment benefits, 517, 542, 545, 553, 554, 556
- Mortality risks, 584–585*b*
- Nash product, 116*b*
- Natural experiments, 73–74
- Net present value, 490
- Neutrality result, 429–430
- Noncognitive skills, 339
- Nonemployment rate, 21
- Normal goods, 8
- Normalization rules, 33
- Normal working hours, 209
- Notional defined contribution (NDC) systems, 239–240, 274–275; labor market and, 247–248*b*; retirement age and, 265
- Obesity, discrimination against, 173
- Occupational crowding, 162–164, 163*f*

- Occupational licensing, 136–138
Occupational safety, 571–572. *See also*
 Health-related labor policies
Occupational Safety and Health Act
 (OSHA; US; 1970), 572, 592
Oligopsonies, 67
On-call work contracts, 196, 231
On-the-job training, 351–354, 356; Mincer
 equation on, 364–365
Option value, 242
Orchestras, “blind” auditions for, 176–177*b*
Outsiders, 29
Over-education, 338–339
Overtime, 194; part-time employment
 and, 200–201, 201*f*; pay premiums for,
 213–214
- Parental leave, 282–283; empirical evidence
 on, 309–312; international comparisons
 on, 286–290, 287*f*, 289*f*; in perfect labor
 markets, 294–295, 295*f*
Participation effect, 524
Part-time employment, 192, 217*f*; increase
 in, 216–219; overtime and, 201*f*; for
 single mothers on welfare, 631–632;
 training for, 353–354; of women, 218*f*,
 224–225
Passive labor market policies, 516
Paternity leave: daddy month in Swe-
 den, 310–311; empirical evidence on,
 312–314; encouragement of, 316–317;
 international comparisons of, 286, 287*f*,
 288–289, 289*f*; in perfect labor markets,
 296–297
Pay-as-you-go (PAYG) pension systems,
 238
Payment wedges, 479–481
Payroll taxes, 609–610; education and,
 355–356; empirical evidence on, 622–
 627; family policies and, 318; future
 of, 636; in imperfect labor markets,
 620–622, 642–645; interactions with
 other labor market institutions, 634–
 636; international comparisons on,
 610–613, 612*f*, 614*f*; in perfect labor
 markets, 614–619, 616*f*, 617*f*, 619*f*,
 620*f*, 639–642; policy issues in, 627–634;
 unemployment benefits and active labor
 market policies financed by, 554. *See also*
 Taxes
Pensions: awareness of, 263–264; to finance
 early retirements, 238–239; immigrants
 and, 413; notional defined contribution
 systems for, 247–248*b*; pensioners in
 union membership, 102; reforms of,
 273; reforms of, to delay retirement, 264;
 training and, 272–273. *See also* Early
 retirement plans
Pension wealth, 240, 244, 245*f*
Perfect labor markets: anti-discrimination
 legislation in, 153–158; early retirement
 plans in, 241–245; education in, 334–
 337; employment protection legislation
 in, 428–431; family policies in, 291–299,
 292*f*, 295*f*, 298*f*; health-related labor
 policies, 580–585, 581*f*, 583*f*; impact of
 minimum wages in, 61–62, 62*f*, 63*f*;
 labor market equilibrium in, 19–21,
 20*f*; migration policies in, 376–378,
 378*f*; payroll taxes in, 614–619, 616*f*,
 617*f*, 619*f*, 620*f*, 639–642; regulation of
 working hours in, 200–207, 201*f*, 202*f*,
 204*f*, 206*f*; self-employment in, 484–
 488, 486*f*, 487*f*; unemployment benefits
 and active labor market policies in, 523–
 526; unions and collective bargaining
 in, 113–114. *See also* Competitive labor
 markets
Phase-in (phase-out) regions, 629
Platform work, 231
Pledgeability, 491
Points systems, 372, 408–410
Policy experiments, 46
Policy failures, 26
Potential benefit duration (of unemploy-
 ment benefits), 565
Potential workers, 34–35, 36
Poverty, impact of minimum wages on,
 83–85, 93
Prejudices: in competitive labor mar-
 ket, 188–189; of coworkers, 156–157;
 of customers, 157–158; of employers,
 154–156
Presenteeism, 597
Price-based institutions, xxvii
Private sector employment, union density
 in, 104
Productive externalities, 384
Productivity: age and, 255–258, 274;
 employment protection legislation and,
 456–459; increased by education and
 training, 357–358; increased by general
 training, 339; on-the-job training and,
 352

- Product markets, impact of minimum wages in, 62
- Profiling, 161–162
- Programme for International Student Assessment (PISA) test scores, 407, 408*f*
- Proportional taxation, 524
- Publication bias, 584
- Public employment services, 517, 533; decentralizing, 548–550*b*
- Public sector employment: collective bargaining in, 131–132*b*; union density in, 104
- Pull factors, 245
- Push factors, 245
- Quantity-based institutions, xxvii
- Quotas: in anti-discrimination policies, 180–183; in migration policies, 372
- Race: black-white wage gap, 168–169*b*; labor market discrimination by, 171–172
- Refugees: in labor markets, 411–413. *See also* Asylum seekers
- Regression discontinuity design, 39–41*b*
- Regulations: on dismissals, 423–428, 426*f*; of self-employment, 479–484; of working hours, 192–196, 195*f*, 209–212, 225; workplace safety regulations, 600–601
- Relocation of workers, 380–382, 381*f*
- Remote working, 47
- Rents, in imperfect labor markets, 21–22
- Replacement rates, 226, 240
- Reservation utility, 587, 588*f*
- Reservation wages, 9–11, 10*f*, 15*f*, 20; dynamic reservation wage, 527–528*b*, 560–561; impact of constraints of hours on, 11–12*b*, 13*f*; injury risks and, 588; unemployment benefits and, 524–525*b*
- Retirement, 237; age of, 240, 249*f*–251*f*; alternative exit routes to, 259–260; empirical evidence on, 248–252; employment protection legislation and, 465; mandatory, 266–271; optimal age for, 277–278; pathway to, 265; work after, 262–263. *See also* Early retirement plans
- Retornados (immigrants in Portugal), 395
- Risk aversion, 209; in employment protection legislation, 461; self-employment and, 487, 500; workplace safety regulations and, 600
- Risks: injury risks and wages, 580–582, 581*f*, 587; mortality risks, 584–585*b*; perceptions of, 586–587; workplace safety regulations and, 600–601
- Rybczynski theorem, 380
- Safety policies, 583–584; accidents and, 592–595; benefits of workplace safety regulations, 600–601. *See also* Health-related labor policies
- Scale effect, in long-run labor market, 18, 19*f*
- Scale of production, working hours and, 206–207
- Schooling: early tracking in, 354–355; in imperfect labor markets, 337–340; investment in, 334–336; optimal years of, 361–363; returns for, 343–351, 344*f*. *See also* Education; Training
- Segregation, 169–170
- Selectivity, 345
- Self-employment, 476–477; empirical evidence on, 493–499; future of, 509–510; in imperfect labor markets, 488–493; interactions with other labor market institutions, 509; international comparisons of, 477–484, 480*f*, 482*f*, 483*f*; labor and financial frictions for, 512–514; in perfect labor markets, 484–488, 486*f*, 487*f*; promotion of, 503–507; self-selection into, 511–512; social insurance for, 507–508; two faces of, 499–502
- Separating equilibrium, 338
- Severance pay policies, 422, 545
- Sexual orientation, discrimination by, 172–173
- Short-time work (STW), 196–200, 198*f*, 207–209, 208*f*; government subsidies for, 226–229; international comparison of, 227*f*, 230
- Sick leave, 601–602*b*. *See also* Absenteeism
- Sickness absences, 595–596
- Signaling theory, 337–339, 363–364
- Skill downgrading, 382
- Skilled workers: migration of, 378–380, 379*f*, 410; relocation of, 381–382
- Slavery, 297
- Smart working, 47, 193, 231
- Social insurance, for self-employed workers, 481–484, 483*f*, 507–508
- Social security, 609; early retirement plans financed by, 239; international comparisons on, 613; part-time employment, 195–196

- Solo self-employment, 477–479, 481, 492–493, 497–499, 501–502
- Solow condition, 99
- Spikes, 72
- Standard retirement age, 240
- Statistical discrimination, 160–162, 161*f*
- Stayer coefficients, 34, 35
- Steady state (dynamic) equilibrium unemployment, 34
- Stereotyping, 161–162
- Strikes, 112–113, 113*f*, 123–124
- Subsidized employment, 517
- Substitution effect, 12–13, 14*f*; in long-run labor market, 18, 19*f*
- Supply curve, 64
- Supreme Court (US), 55
- Surplus of the employer, 20
- Targeted Jobs Tax Credit (TJTC) program, 633
- Target efficiency, 92
- Target share, 45
- Taxation effect, 524, 527
- Tax component (of EPL), 422
- Tax credits, 633–634
- Taxes, 609–610; Delalande tax (France), 455–456; employment protective taxes, 437–441; progressiveness of, 642; on self-employment, 479; structure and level of, 613; total tax wedge on low wages, 41, 43*f*; unemployment benefits financed by, 524, 554. *See also* Payroll taxes
- Technological change, 47; early retirement plans and, 274; education of workers for, 342; immigration policies and, 414; minimum wages and, 93–94; skill-based, 358; working hours and, 231
- Telework, 231
- Temporary work agency (TWA) contracts, 428
- Temporary contracts, 421–422, 462–464, 473–475; employment protection legislation and, 459–460; regulations on, 423–424; restrictions on hiring of, 427–428, 428*f*; risk of workplace accidents for, 591–592, 603, 604; transition to permanent employment by, 446*f*. *See also* Fixed-term contracts
- Thick markets, 505
- Time-use surveys, 193
- Total surplus, 20
- Trade externalities, 384
- Trade unions. *See* Unions
- Trading externalities, 488–489
- Training, 326–329, 337*f*; financing, 366; formal, informal, and nonformal, 332–333, 333*f*; future of, 357–358; general and firm-specific, 336–337; governmental subsidies for, 354; labor market training, 517; minimum wages and, 70–71, 91; on-the-job training, 351–354; pensions and, 272–273. *See also* Education
- Transfer component (of EPL), 422
- Transition matrices, 33–34, 34*f*, 35*f*
- Treatment groups, xxviii–xxix, 37
- Trial costs, 422
- Turnover in labor markets, 450; growth of firms and, 452–455
- Twin studies, 346
- Two-tier reforms, 45
- Underemployment, 36; part-time, 216–218
- Unemployment, 5*f*; activating unemployed workers, 569–570; Beveridge curve on vacancy rates and, 533–535; of children of immigrants and native-born, 405–407, 406*f*; definition of, 32; EPL taxes and, 440; among foreign-born men, 387–389, 389*f*; during Great Recession, 29–32, 30*f*, 492; impact of employment protection legislation on, 446–450; in imperfect labor markets, 22–23*b*; interregional migrations and, 393*f*; involuntary, 24; among older workers, 238, 252–254; post-unemployment outcomes, effect of benefits on, 546–547; problems with measurements of, 36; rates of, for native and foreign-born workers, 388*f*; retirement from, 259, 265, 271; union density and, 126–127; among youth, 85, 86*f*, 267*f*
- Unemployment assistance (UA), 516
- Unemployment benefits, 515–517; administered by unions, 105; changes in generosity of, 41, 42*f*; early retirement plans and, 271; effect on post-unemployment options of, 546–547; effect on unemployment duration of, 537–545; employment protection legislation and, 464–465; future of, 556–557; in imperfect labor markets, 526–533; interactions with other labor market institutions, 554–556; international comparisons on, 517–523,

- Unemployment benefits (*continued*)
519*f*, 535–537, 536*f*; one-sided search model of, 560–566; optimal level of employment protection legislation and, 460–461; payroll taxes and, 621–622, 635; in perfect labor markets, 523–526; self-employed workers not covered by, 481–484; two-sided search model of, 566–567; varying generosity of, 553–554
- Unemployment insurance (UI), 516
- Union free-rider puzzle, 122
- Unions, 100–101; centralization and coordination in, 106–109, 107*f*, 108*f*; coverage of, 105–106; early retirement plans supported by, 274; education and, 356; effects on wages of, 127–130; efficiency and, 134–136, 143–146; empirical evidence on, 125–127; future of, 139–140; health-related labor policies and, 604; in imperfect labor markets, 114–125; labor market discrimination and, 183–184; in licensed occupations, 136–137; other labor market institutions and, 138–139; payroll taxes and, 634; in perfect labor markets, 113–114; regulation of working hours by, 225, 229–230; strike activities by, 112–113, 113*f*; union density rates, 101–105, 103*f*, 104*f*
- Union wage gap, 125, 127–128*b*
- Unitary model of household behavior, 300–301
- Universal Declaration of Human Rights, 184
- Unskilled workers, migration of, 378–380, 379*f*
- Vacant jobs, 7
- Value-added taxes (VATs), 613
- Value of jobs, 17
- Value of statistical life (VSL), 584–585
- Vietnam War, 346
- Vocational education, 350; tracking for, 354–355
- Voluntary part-time employment: in perfect labor markets, 203–205, 204*f*; regulation of, 194–196
- Wage-compressing institutions, xxvii, 7
- Wage effect, 530–532
- Wage gaps: black-white wage gap, 168–169*b*; gender wage gap, 159–160, 159*f*, 165–168, 166*f*, 167*f*, 189; union wage gap, 125, 127–128*b*
- Wage insurance, 92
- Wages, 8, 168; black-white wage gap, 168–169*b*; collective bargaining over, 115–116*b*, 120–121; differentials in, 582–583; education and, 343–345, 344*f*; effects of unions on, 127–130; floors for, established by collective bargaining, 56; gender gap in, 165–168, 166*f*, 167*f*, 177–178; government polices on, 4–5; impact of employment protection legislation on, 440–441, 461; impact of migration on, 389–402; impact of self-employed workers on, 502; impact on labor market of, 12–13; injury risk and, 580–582, 581*f*; mandatory retirement and, 268–269; mortality risks and, 584–585*b*; productivity and, 256–258; rigidity in, 382–384, 383*f*, 419–420; unemployment benefits and, 527–528*b*; union wage gap, 125. *See also* Minimum wages
- Wedges, 25, 51–53
- Welfare: migration and, 410–411; work incentives in, 627–633
- Women: age at retirement of, 248, 250*f*; childcare responsibilities of, 283; child penalty for, 314–316; on corporate boards, quotas for, 181–182*b*; costs of childcare for, 291–294, 292*f*; effects of minimum wage on employment of, 71–72; encouraging mothers with young children to work, 317–318; gender wage gap against, 159–160, 159*f*; maternity leave for, 286–288; as mothers, employment of, 302–304*f*, 303–306, 319–320, 319*f*; occupational crowding of, 162–164, 163*f*; parental leave policies and employment of, 309–310; part-time employment of, 216–219, 218*f*, 224–225; prejudices against, 153–158; self-employed, 500; as single mothers on welfare, 631–632. *See also* Gender
- Worker's surplus, 20
- Workfare programs, 516–517, 553
- Working Families Tax Credit (WFTC; UK; 1999), 630, 634
- Working hours: anti-discrimination legislation and, 184; bargaining over, 120–121; costs of labor in, 234–236; effects of reductions in, 220–225; empirical

- evidence on, 214–219; family policies and, 318; future of, 231–232; impact of minimum wage on, 81; in imperfect labor markets, 207–214, 208*f*, 211*f*, 213*f*; interactions with other labor market institutions, 229–231; international comparisons of, 193–200, 195*f*, 215*f*; in perfect labor markets, 200–207, 201*f*, 202*f*, 204*f*, 206*f*; regulation of, 192–193, 225; scale of production and, 206–207; training and, 353–354
- Workplace accidents, 573–575, 574*f*, 576*f*, 577*f*; reporting of, 606–608; safety policies and, 590–595
- Workplace safety policies, 583–584; accidents and, 592–595; benefits of, 600–601; future of, 603
- Work tests, 517
- Youth: competition between young and older workers, 278–281; cut in payroll tax for, 623–624; mandatory retirement and employment of, 266–268; migrations by, 402; minimum wage for, 85–91, 86*f*, 87–89*b*; unemployment rates among, 267*f*; young children, 303–306
- Zero-hours contracts, 231