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# Introduction

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1. In several economies the functioning of the labour market is altered by a set of institutions that restrict the ability of private parties to freely set quantities and prices, along with a tax system that affects the value of working and of not working, often at the expense of the former. Key examples include employment protection legislation, which restricts the firm's ability to reduce their workforce; minimum wages that put a floor on the remuneration of labour; collective bargaining agreements that impose a rigid pay scale across skills, often compressing the distribution of wages; work rules that make it easier for incumbent employees to achieve higher wages and/or lower working hours; unemployment benefits that increase the reservation wage of incumbent employees; active labour market policies where the government directly acts as a substitute for private agents in search and recruiting, etc. Furthermore, many labour market institutions manifest together, so that we witness the coexistence of competing *social models* for organizing the labour market.

Standard economic analysis holds that such institutions are harmful for job creation and typically increase unemployment. This is why they are often called 'rigid', a term that we shall use to refer to any regulation that reduces job creation. Most orthodox recipes against structural unemployment involve a reduction or elimination of such arrangements. But, if they hurt everybody, they would not be observed in practice. Indeed, many orthodox reforms of the labour market have proved difficult to implement because of the reluctance of politicians or else because they faced fierce opposition from large or powerful sectors of society. Opposition is made worse by the recognition that the orthodox recipes ultimately call into question the social model as a whole, implying that unemployment can be cured only at the cost of a radical change.

For these reasons it is important to explain why we observe such regulations. This book studies the economic conditions under which we expect a given set of labour market institutions to arise and remain stable.

It provides theoretical guidelines about the gainers and losers from a given institution, which helps to identify the constituency that supports it. It derives predictions about how a reform can be made politically viable, depending on its design and on the initial conditions prevailing at the time of its implementation.

2. Our theory is articulated around several central concepts, the most important one being that of a *rent*. By rent we refer to the difference between the welfare of an employed worker and that of an unemployed one, or, more precisely, to the difference between what an employed worker can get from his employment relationship and his *outside option*, i.e. what his welfare would be outside that relationship. In general, the outside option is exactly the value of being unemployed, but in some cases one has to be specific. The rent can be expressed in terms of wages, in which case it is the difference between the employee's wage and his alternative wage, which is the one which, if paid forever, would make him indifferent to being in work or being unemployed. In that case we call it the *inratemporal rent* or simply the *rent*. It can also be expressed as the plain welfare difference between an employed and an unemployed worker—where welfare is defined as the present discounted value of income flows—in which case we call it the *intertemporal*, or *total rent*.

The rent is one of the most appropriate measures of imperfect competition in the labour market. It tells us how far wages are from market clearing or, equivalently, how remote the unemployed are from underbidding the employed successfully. As long as the rent is positive, involuntary unemployment must arise, because in a perfectly competitive labour market any worker looking for a job could find one instantaneously. In that case the welfare of the unemployed would be equal to that of the employed, and there would not be a rent.

3. Rents arise for two sets of reasons. First, they may arise because of microeconomic frictions that prevent wages from fully adjusting downwards in situations of involuntary unemployment. Such frictions include imperfect observability of effort at the firm level; turnover costs and specific investment in the employment relationship that create a situation of bilateral monopoly, allowing workers to extract part of the surplus generated by their job; costly search and recruiting, which is a special case of specific investment; the impossibility of writing a complete contingent wage contract, etc. Second, there exist labour market institutions whose effect is precisely to give rise to such rents. They often do so by

magnifying the microeconomic frictions: for example, a hiring restriction would increase the cost of replacing a worker by another one, thus making him more specific and increasing his ability to extract part of the surplus.

Why should we expect some economies to have a greater rent, hence to be more 'rigid', than others? First of all, there may be genuine differences in the severity of microeconomic frictions. For example, if workers are less likely to move it may be more costly for a firm to locate an appropriate worker, which in turn will increase the amount of resources spent on recruiting and therefore the surplus appropriable by the worker. Second, the rent may be high because society *chooses* a set of labour market institutions that generate a high rent. In such a case, the high rent arises as the outcome of political decisions. For this to be the case, it must be that those who benefit from the rent are numerous and/or powerful enough. This raises the following question: how does the rent affect the welfare of various workers?

The two main variables that determine a worker's welfare are wages and the fraction of time he or she expects to spend in unemployment. That fraction is smaller for the currently employed than for the currently unemployed. It depends on the two key transition rates that characterize the state of the labour market. These are the job loss rate, which we also call *exposure*, and the job finding rate, also called *labour market tightness*. When the rent increases, each individual worker asks for a higher wage. This reduces firms' incentives to hire. In general equilibrium, wages must be brought in line with productivity, which means that they cannot increase by the full amount of the rent. In order to bring wages down, the outside option, or alternative wage, must fall, meaning that the unemployed are necessarily worse off. Consequently, the unemployed will always be against an increase in the rent. In fact, we are able to show a more general result implying that under certain conditions the unemployed will generally favour free markets and oppose government interventions in the labour market.

4. Therefore, the support for rents must come from a subset of employed workers. Because the rent reduces employment, it typically reduces the job finding rate and may also increase the job loss rate. This effect harms employed workers, so that if some of them gain it must be that they have greater wages. Hence we conclude that labour market institutions are supported by a group of employed workers because this allows them to increase their wages. It is exactly as if these workers were organized

in a labour union that achieved monopoly power on labour supply and set wages above market clearing in the pursuit of its members' self-interest. Here, instead, workers vote for an economywide institution which alters the environment in which wages are set, in such a way that they expect wages to actually rise in equilibrium by enough to make them better off. We refer to that mechanism as the *political insider mechanism*.<sup>1</sup> Workers may be unable to coordinate in order to form a labour union, but by voting in favour of an institution that raises rents they are able to collectively achieve a higher wage level exactly as if they were organized in a union. Labour market rigidities allow insiders to monopolize the market at the economywide level even though their bargaining power may be quite reduced at the firm level.

Just as in the case of a labour union, there must exist a favourable enough trade-off between wages and employment for the political insider mechanism to give rise to enough support for the rent-raising institution. Under constant returns to scale to labour, such a trade-off does not exist as equilibrium wages are pinned down by the marginal product of labour, which is constant. In such a case there is no support for the rent. This suggests that there must be decreasing returns to labour in order for the mechanism to be effective—then, a reduction in employment will be associated with a rise in workers' marginal product and therefore wages.

5. Under what circumstances are there decreasing returns to labour at the aggregate level? Economic theory teaches us that there must be some fixed factor whose quantity does not adjust when the labour input changes. Otherwise the standard argument that one could replicate the existing production structure would automatically lead to the presumption of constant returns to scale. If there exists such a fixed factor, then by reducing the amount of complementary input, wage increases redistribute from such a fixed factor to labour, while at the same time reducing the return to the fixed factor. Hence, labour market institutions are a device to redistribute income between factors of production.

It is tempting to think that this fixed factor is capital; one would then be talking about the traditional 'class struggle' between labour and capital, and labour market institutions would be one weapon that labour could use, in a democracy, to resolve that conflict in its favour. However, in this book we take a different view, which, while more unusual, is more in line with orthodox economic theory and at the same time, I

<sup>1</sup> See the work of Lindbeck and Snower (1988), who have studied how microeconomic frictions increase incumbent employees' bargaining power.

believe, more in line with the realities of distributive conflict in modern societies.

The main characteristic of capital is that it is not fixed, but accumulable. Any change that reduces its remuneration, such as a decline in the complementary labour input, induces a fall in investment and a subsequent reduction in the capital stock, up to the point where the return to capital is restored to its desired level.<sup>2</sup> Conversely, wages must have fallen back to their equilibrium level. In other words, when one takes into account the adjustment of the capital stock, in the long run everything is as if there were constant returns to labour as capital adjusts one-for-one to changes in employment, thus leaving wages and rates of return unaffected.

For this reason we believe that the most relevant conflict that lies at the root of labour market rigidities in modern societies is that between more and less skilled workers. Any observer of European labour markets in the last thirty years of the twentieth century would agree that it is a good stylized description of these markets to think of the labour market for high-skill workers as in equilibrium, with wages that adjust to offset demand and supply imbalances, while the low-skill labour market is in disequilibrium, with involuntary unemployment and unresponsive real wages. We will henceforth assume that the labour force can be partitioned in two groups, that we label for simplicity skilled and unskilled, although by unskilled we mean a wider group than is usually referred to, i.e. the bulk of low and medium skilled workers who are most affected by minimum wages, employment protection and collective agreements.<sup>3</sup> Labour market rigidities impose binding constraints on unskilled labour but not on skilled labour, whose market remains in equilibrium, so that employment of skilled labour remains essentially unchanged in response to a fall in unskilled employment.<sup>4</sup> It is therefore reasonable to treat

<sup>2</sup> This is true in a variety of growth models. If there is perfect international capital mobility the rate of return, in the long run, cannot be different from the world rate of return, adjusted for country-specific factors representing risk, etc. In closed economy models such as the Ramsey model, the rate of return to capital cannot be different from the rate of time preference of consumers. In the Solow model, the national savings rate pins down the capital/output ratio in the long run, and thus wages. See Blanchard and Fischer (1989) and Romer (1996) for a discussion of growth models.

<sup>3</sup> At the bottom there may exist a 'secondary sector' of the labour market, which may be able to escape such regulations. Workers in this sector are essentially paid their outside option and for our purposes will support the same policies as the unemployed.

<sup>4</sup> This obviously depends on the supply elasticity, which it is reasonable to consider as small.

skilled labour as a fixed factor.<sup>5</sup> Consequently, labour market rigidities mostly redistribute between skilled and unskilled labour.

6. The above discussion suggests that the political support for labour market rigidities would come from unskilled workers—and not all of them, only those who are employed. Unemployed unskilled workers and skilled workers lose from them and thus oppose it.

If this was the end of the story, societies where labour rigidities are observed would be very conflictive: even though the group we label unskilled may be numerous or powerful enough to impose the institutions that suit it, we should observe constant political activity of the skilled group against such institutions. Yet this does not square with reality, and we believe that this is because of the *cohesion* effects that labour market rigidities exert upon the employed workforce.

Such cohesion effects exist because even without rigidities, redistributive conflict would arise between skilled and unskilled workers. To the extent that the latter are poorer than the former, they have an incentive to expropriate from them, i.e. to vote for any institution that results in a transfer being made to the unskilled by the skilled. They would indeed be able to impose such a transfer if they are more numerous, or more politically powerful, than the skilled—i.e. more generally, if the decisive voter is poorer than the mean.

Labour market institutions provide another way to achieve such redistribution, although to a well trained economist it is a far-fetched and inefficient way of redistributing income, since it forces part of the workforce to be idle and excludes the poorest, i.e. the unemployed, from that redistribution. But the key point is that rigidity is supported by a very different *coalition* than fiscal redistribution. By increasing the wage income of unskilled workers, rigidity reduces their shortfall from the skilled, thus lowering the incentive to expropriate from them. As a result, part of the skilled will *also* support rigidity, because they recognize that less rigid institutions would intensify the redistributive conflict between skilled and unskilled workers. That is, rigidity reduces their wages but

<sup>5</sup> It is interesting to study why the argument made about the adjustment of capital does not carry to the case of skilled labour. Obviously, its supply is not nearly as elastic, in the long run, as that of capital. But leaving that aside, let us consider a rise in the wages of unskilled labour, which triggers a fall in unskilled employment. Clearly, the skilled wage falls. But, at the same time, the job prospects of a worker who would enter the labour market as unskilled also fall because of the rise in unskilled unemployment. Consequently, the returns to skill need not fall, they may even rise. See Saint-Paul (1994a, 1996a) and Cahuc and Michel (1996).

also reduces the transfer that the unskilled extract from them, and if the latter effect is stronger than the former, they will indeed support the rigid institution.

One can show, as is done in Chapter 3, that if we consider an economy with a large number of worker types, rather than just two types, then the preceding argument carries through, in the sense that rigidity will typically be supported by a ‘middle class’ of employed workers with intermediate skill levels. It will be opposed by the unemployed, who are the great losers, by the most skilled, who would gain most from an increase in the employment of complementary labour inputs and would thus prefer to have greater wages even though they would pay more taxes, and by the poorest workers, whose wage income is so low that they would be better off with greater transfers.

Therefore, while rigidity, just as fiscal transfers, redistributes from skilled to unskilled workers, relative to fiscal transfers they actually increase the cohesion of the middle class. The losers from rigidity—the unemployed and the two extremes of the distribution of income—are likely to be less powerful politically than the losers from redistribution. For this reason we expect rigidity to arise even though it is an inefficient way to solve the distributive conflict between skilled and unskilled workers.

In some sense, cohesion among those who keep their jobs is increased because the poorest are excluded from the redistributive game. This alleviates the redistributive conflict, because those who remain in that game are made more homogenous. At the same time the total amount of resources that can be shared among the ‘ins’—the employed—is larger because those who have been excluded are precisely those who contributed less to the total surplus. Here we clearly see that there are two redistributive conflicts going on. One is between the skilled and the unskilled workers; we call it *internal conflict*. The other is between the unemployed and the employed; we call it *external conflict*. A key insight is that external conflict is more likely to arise, the more intense the internal conflict, i.e. the greater inequality among employed workers. If all workers had the same marginal product, they would all contribute the same to total output, and excluding some of them would not affect output per capita for those who remain. By contrast, when inequality is greater, the poorest contribute much less to total output than the richest, and excluding the former substantially increases what can be redistributed to each remaining worker.

7. Whether or not we expect rents to be a stable political equilibrium depends on three underlying parameters that characterize the functioning of the labour market.

*Exposure* tells us how often workers expect to lose their jobs. It depends on technology, which determines the frequency at which firms want to destroy jobs, on people's preferences and other sociological factors, which determine how often they may want to quit their jobs, and on institutional factors such as home ownership or other labour regulations such as employment protection. The lower the exposure, the more the employed expect to keep their job for a long time. Exposure enters as the weight of the unemployed's welfare in the employed's welfare. When it is lower, this weight is lower because the event of becoming unemployed is more remote and thus more heavily discounted. Therefore, when exposure is lower, the employed care less about harming the unemployed and are more likely to support high rents or, more generally, institutions that reduce the job finding rate. This result tells us that we expect rent-creating institutions to prevail in societies which, for other reasons, have low labour turnover and low mobility.

*Elasticity*, which we define as the elasticity of labour demand for unskilled labour, tells us how big the scope for wage increases is when employment of unskilled workers is reduced. It is the standard parameter that intervenes in any analysis of a union's preferred wage or, more generally, of any monopolistic price-setting behaviour. The greater that elasticity, the less wages rise when employment of unskilled workers increases, and the lower the political support for employee rents. Elasticity is intimately linked to the degree of complementarity between skilled and unskilled workers. It is smaller, the more the two are complements in production. This tells us that rigidity is good at redistributing between groups of people who cooperate strongly in the market.

*Inequality*, i.e. the gap between the skilled and unskilled productivities, determines the intensity of internal conflict. As we have argued, it is because of that internal conflict that it pays the middle class coalition to opt for rigid labour market institutions. Therefore we expect that the support for rents will be greater, the greater the inequality. This is actually true over some range, if inequality is low enough. But past a certain threshold inequality reduces the support for rents, because at high inequality levels the cost of rigidity in terms of job loss is too big.

8. The existence of rents acts as a catalyst for other labour market rigidities, because they increase the employed's support for such rigidities.

The clearest example is that of employment protection legislation. When rents exist, losing one's job is associated with a welfare loss, precisely equal to the total rent. The employed therefore have an incentive to reduce the likelihood of job loss by means of an employment protection legislation that prevents firms from freely reducing their workforce in a downturn. That incentive is greater, the greater the rent, i.e. the less competitive the labour market. In a perfectly competitive labour market the rent would be equal to zero and being unemployed would be equivalent to being employed because anyone could find a job instantaneously at the going wage. Thus there would be no support for employment protection.

Therefore, rigidities that create rents are likely to lead to other rigidities that protect rents, which further deteriorates the competitive performance of the labour market. Furthermore, it is also true that employment protection itself increases the political support for high rents. This is because employment protection reduces exposure to unemployment, and because the employed's most desired rent is greater, as we have seen, the less exposed they are. The causality therefore goes both ways: rent-creating and rent-protecting institutions reinforce each other. We say that there is a *politico-economic complementarity* between the two types of institution because if one exists, support for the other is greater. Politico-economic complementarities explain why labour market institutions work together, i.e. why we observe consistent competing social models rather than menus of institutions that span the whole range of possibilities.

9. While our theory is successful at explaining why rigid wages coexist with employment protection, it is harder to understand why generous unemployment benefits are also typically part of the picture. That is, the case in favour of politico-economic complementarities between rents and unemployment benefits is much weaker than for employment protection. At face value, one would be tempted to claim that in the absence of rents, there is no involuntary unemployment, and thus no need for workers to insure themselves against the unemployment risk. Closer examination, however, suggests that this is a fallacy. For when unemployment is very low, so is the financial cost of benefits, so that insurance is cheaper even though it is less desired. Indeed, if workers were voting under a veil of ignorance—i.e. not taking into account whether they are initially employed or unemployed but instead assigning an objective probability to each event based on the actual unemployment rate—they would elect full insurance regardless of the unemployment rate.

If unemployment benefits are merely set to provide insurance against job loss, it is essentially incorrect to treat them as a 'rigidity' in the same way as minimum wages or employment protection. True, they increase unemployment, as these other institutions. But while 'rigidities' typically benefit the employed at the expense of the unemployed, unemployment benefits obviously redistribute in the other direction. While the political system is likely to deliver, as we show, too much of these other rigidities relative to the social planner's optimum, it is likely to deliver too little unemployment insurance. While a reduction in exposure increases the support for rents and also the support for employment protection (as is discussed in Chapter 4), it reduces the employed's most preferred unemployment benefit level, since they care less about becoming unemployed. Finally, the financial burden of benefits reduces the scope for complementarities with other institutions: if unemployment is greater, say because minimum wages are higher, the tax cost of benefits is larger which reduces the employed's support for unemployment insurance.

Things are different, however, if unemployment benefits, which increase the worker's outside option in the wage formation process, are used by incumbent employees to achieve higher wages in equilibrium. They will be used as an instrument to achieve higher wages if other institutions cannot be perfectly manipulated in order to target the employed's most preferred wage level, say if there exists some ceiling on minimum wages or on the degree of wage compression that collective agreements may specify, or some constitutional limits on work rules that can be imposed on employers. In such a case the logic of the political insider mechanism applies to unemployment benefits as well, and they vary in a similar way to other rigidities. The unemployed will then want less insurance (at the margin) than the employed; the political system will deliver too generous benefits relative to the social optimum; and lower exposure will increase the employed's most desired benefit level. Furthermore, it may well be that benefits are more efficient at boosting wages when the rent is higher, which may generate a politico-economic complementarity between unemployment insurance and other institutions that allow insiders to achieve greater wages.

10. If, in a given country, the underlying economic conditions are such that a set of 'rigid' institutions provides a political equilibrium, it would be foolish for an economist or an international body to recommend that

they make their labour market more 'flexible'.<sup>6</sup> A government attempting such a reform would necessarily face political opposition, and could be forced to withdraw its reform to maintain itself in power. Even if the reform was made politically viable by some clever design to compensate losers (which is possible, as we discuss in Chapter 8), the resulting situation would be unstable and people would soon vote for a return to the previous arrangement. The reform would only have brought turbulence and policy uncertainty, and thus may have eliminated any of its positive employment effects.<sup>7</sup>

On the other hand, it may be that changes in underlying parameters make society less willing to keep its rigid institutions. This would happen, for example, if faster technological change increased exposure; if biases in that change increased inequality in the zone where it reduces the support for rigidity; if greater international capital mobility increased elasticity; or if some innovation increased substitutability between unskilled workers and some other factor, perhaps capital, again increasing elasticity. In such a case the support for rigidity would automatically be reduced, not least because it is more costly in terms of jobs.<sup>8</sup> If the change is strong enough then society would eventually shift from rigid to flexible institutions, even without any recommendation by economists.

The problem of reform, however, becomes more interesting if several stable outcomes may coexist. For example, underlying parameters may change in such a way that an economy which is originally flexible would not want to become rigid, but that an economy which is originally rigid would remain so, despite the fact that the support for the status quo would be lower than without the change in underlying parameters. That is, the support for rigidity is greater if it is originally the status quo than if it is not, i.e. there is *status quo bias*.

Status quo bias implies that an economy in a stable political equilibrium with reform imposed on it by a dictator would end up in another situation that would also be stable, i.e. once the dictator was gone there would not be sufficient political support to revert to the old ways. The problem of reform becomes meaningful if there is status quo bias be-

<sup>6</sup> Unless, obviously, the political support for rigidity arises from ignorance about its adverse economic effects. In that case, however, policy recommendations are not really needed: dissemination of economic theory and evidence should be enough.

<sup>7</sup> For a convincing example, see Bertola and Ichino (1995).

<sup>8</sup> See Krugman (1995) for an argument that skill-biased technical change has increased unemployment in Europe in the 1970's because relative wages have failed to adjust, although Card *et al.* (1995) find a much more mixed picture.

cause the economy may be locked into an ‘undesirable’ situation (from the viewpoint of some social welfare measure that differs from the decisive voter’s objective) and could be led, by some properly designed reform, to a more desirable, equally stable, equilibrium. Status quo bias also implies that institutions are persistent, and that different social models may be observed across two economies with similar underlying characteristics because one of them experienced some specific shocks in the past, which led to institutions that survived into the present even though the shock has finally died out.<sup>9</sup> Complementarities are likely to increase the status quo bias, particularly if a comprehensive reform of the labour market cannot be written on the political agenda.

11. Status quo bias arises when a given set of institutions typically create their own constituency. The existence of high rents is a powerful source of status quo bias. Any reform implies some labour reallocation, and those who expect to lose their jobs are likely to oppose the reform. Clearly, the greater the rent, the more these people expect to lose, and the greater their opposition to the reform. When rents are large, institutions may create their own constituency by maintaining a fraction of the workforce in activities that exist precisely because of that institution. This is what we call the *constituency effect*. The strength of the status quo bias generated by the constituency effect is greater, as we saw, the greater the rent (without rents job loss does not make the worker unhappy); it is also greater, the lower the political weight of the unemployed. The unemployed are those whose job finding prospects are improved by change, so they provide a counterweight to the constituency of job losers; the lower their political power, the smaller that counterweight. Finally, the constituency effect generates a stronger status quo bias, the more sluggish the job creation process, because those who expect to find jobs because of the reform again provide less of a counterweight to those who expect to lose their jobs.

The constituency effect is particularly prominent when one considers institutions such as employment protection. Employment protection prevents firms from getting rid of their workers when hit by a shock that should make them obsolete. Consequently, there exists a mass of workers whose jobs would be instantaneously destroyed if that regula-

<sup>9</sup> In Saint-Paul (1997a), I speculated that the tight labour markets that Europe experienced in the post-war period subsequently allowed insiders to get high rents, which eventually led to a set of rigid institutions that persisted beyond the period of tight labour markets.

tion were slashed, who provide a powerful constituency in favour of the status quo. Clearly, these workers would not exist if the economy did not have employment protection, for any job which becomes obsolete would then be instantaneously destroyed.

Workers' uncertainty about whether they will end up in the pool of losers or gainers from the reform is also likely to strengthen the status quo bias by virtue of a mechanism which we call the *identifiability effect*. People know for sure their situation under the status quo, but may be uncertain about where they will end up after a reform. If the decisive voter is employed, then an increase in uncertainty typically increases his likelihood to end up unemployed as the outcome of the reform, which, as long as rents are positive, reduces his support for the reform. If the losers from the reform were perfectly identified, to the extent that they are a minority, the decisive voter would typically expect to keep his job, and would support the reform. It is because it redistributes losses from nondecisive to decisive voters that uncertainty increases status quo bias. In a world where the decisive voter is employed and where losers are job losers, this condition is likely to be satisfied.

12. How can reform, other than implemented by a dictator, overcome the status quo bias and lift the economy from an undesirable, stable political equilibrium to a more desirable one? This is a vast topic which we only deal with in part and for specific cases. Two general principles emerge, that are illustrated by the examples studied in the second part of this book.

First, reform should be designed so as to redistribute gains from nondecisive to decisive voters. For example, in Chapter 8 we study how reform can be made viable by means of a two-tier system that preserves the privileges of the originally employed workers while the new legislation applies only to future hires. It is shown that the financial burden of such reform falls upon the firms that employ the incumbent workers. Firms have zero political weight in our analysis, so that the reform design clearly redistributes gains from nondecisive agents to decisive ones. If these firms could vote, they would not accept the reform. Another example is that of a reform which specifies that the redundancies that take place during a certain period around the date of the legislative change should proceed according to some ranking of employees by seniority. Such a clause would overcome the identifiability effect by guaranteeing the decisive employed voter that he will not lose his job because of the reform.

Second, one can take advantage of initial conditions such that the support for the status quo is small. For example, in the case of employment protection, an economic boom reduces the share of old, obsolete jobs in total employment, and therefore the constituency against reform. Or, the support for reduction in wages may be greater at the start of a recession when the employed are more exposed to unemployment.

With this discussion of reform we conclude the general presentation of the theory. It is now time to go into the details. The book is divided in two parts: the first part, Chapters 1–5, discusses the political support for labour market institutions. The second part, Chapters 6–9, analyses the obstacles to reform and draws conclusions about how it should be designed.

## Appendix. Some notes on the literature

This book is not meant to be a survey or a textbook but aims to bring together my research results over the last seven years and articulate them into a coherent theory of labour market institutions. The reader can refer to my articles and working papers cited in the bibliography, although the present book contains a large number of new results and new interpretations of previous results.

There are, however, several strands of literature connected with this work, which we discuss here.

First, there is the vast literature on the effect of labour market rigidities on employment performance, which is often cast in the European context. For surveys, the reader can refer to Layard *et al.* (1991) for a thorough exposition of the modern theory of equilibrium unemployment, as well as Bean (1994a, b), Blanchard (1996), and Siebert (1997) for more policy-oriented views. All these surveys more or less support the ‘orthodox’ view that labour rigidities are the key responsible for high unemployment, a view shared by the OECD (1995), while Alogoskoufis *et al.* (1995) are more balanced, and Manning (1995) challenges the orthodox view. Finally, Bertola (1998) provides a detailed survey on the impact of microeconomic rigidities on aggregate employment, while Phelps (1994) develops a general equilibrium theory of economic activity where labour rigidities play a central role. This literature inevitably leads to a derivative one which discusses the impact of policies to cure unemployment; a good panorama can be found in de la Dehesa *et al.* (1997), while Calmfors (1994) focuses on active labour market policy.

Second, the present work is related to the traditional, but still active, literature on political economy and endogenous policy determination. The existence of a redistributive system of taxes and transfers plays a key role in determining the political support for labour market institutions, as we argue in Chapter 3, and this has been studied in a voting context by Meltzer and Richard (1981) which forms the basis of the fiscal model of Chapter 3. Along with that there exists a vast literature on the political economy of fiscal policy, see e.g. Alesina (1994) and Persson *et al.* (1997).

One difficulty with the political economy approach is that there is no canonical model of how collective decisions are made; in this book we follow the tradition of the median voter theory, which states that policy is determined by the preferences of some decisive voter, which is often the median of the relevant distribution of tastes, and will, importantly, be considered as employed. But we take it more as a useful metaphor than as an exact description of the complex process of political decision making. Alternative approaches could be considered where competing interest groups devote resources to lobbying activities, as in Krueger (1974), Becker (1983, 1985), Bernheim and Winston (1986), and Grossman and Helpman (1994).

Third, various works, other than mine, have studied the political economy of specific labour market institutions from a political economy perspective. These include both works on the determinants of specific institutions, as well as works more specifically concerned with reform. Here one has to mention the important literature on corporatism, which studied the impact on macroeconomic performance of economy-wide wage setting arrangement by centralized unions and employer organizations, in a context where government policy was sometimes treated endogenously. See, for example, Calmfors and Driffill (1988), Calmfors and Horn (1985), Burda (1997), Teulings (1997), Driffill and Van Der Ploeg (1993), and Newell and Symons (1987) for recent developments. Olson's well known work (1982) should also be mentioned. It approaches rigidities from a very different angle from this book, based on the view that there is a tendency for rigidities to rise over time because interest groups tend to become more powerful in stable environments.

Among the recent papers that bear some connection with the present work we should mention Acemoglu and Robinson (1998), who develop a theory of how inefficient redistribution may arise; Robinson (1998), who studies the political support for worker bargaining power in an overlapping generations model, and shows that policy cycles may emerge;

Grüner (1999), who shows the impossibility of using transfers to make a labour market reform viable whenever there is incomplete information; Hassler *et al.* (1998) who, following Wright (1986), study some aspects of unemployment benefits that are complementary to the ones studied in Chapter 5; Frederiksson (1997), who went further in the analysis of the political support for active labour market policy; and Krusell and Rios-Rull (1996), who do not study labour market institutions but whose analysis of the political economy of stagnation is related to our discussion of employment protection in Chapter 4.

Empirical work is inevitably fragile and complicated, and we have preferred to leave these aspects aside in this book, whose focus is theoretical. In Saint-Paul (1996c, 1999a) I have found some empirical evidence consistent with the theory elaborated here, but it is subject to many different interpretations. One should also mention the work by Gray (1998, 1995), on the determinants of French assistance programmes, and Di Tella and McCulloch (1995), on the determinants of unemployment benefits. There exists also an empirical literature in the American tradition on congressional voting records, that has studied the determinants of preferences for things such as unemployment benefits and minimum wage rates: see Blais *et al.* (1989), Lipford and Yandle (1987), Silbermann and Durden (1976), and Uri and Mixon (1980). Lastly, Rodrik (1999) has found that democracies pay higher wages than nondemocracies, in accordance with the view that the decisive voter is likely to be an employed worker.

Finally, one should mention that there exists a strand of literature which approaches labour market institutions from a very different perspective, seeing them as the proper response of a benevolent policymaker to labour market imperfections. Such a view can be found in the works, for example, of Agell (1999) and Agell and Lommerund (1992), who insist on the role of rigidities as social insurance; of Guesnerie and Roberts (1987), who argue that if taxes are too distortionary minimum wages are an optimal second best redistribution tool; and of Acemoglu (1996), who makes a case in favour of employment protection in search markets, because there can be too little investment in human capital. While the present book mostly takes a positive perspective, at various points we will also look at the social optimum. Our results generally support the conclusion that if the decisive voter is employed, there will be too much rigidity relative to the social optimum, but that the social optimum may well involve a positive level of labour market regulation. It is unlikely, however, that the rigidities that are observed in practice

are the most adequate policy instruments in order to cure labour market failures. For a discussion in the case of employment protection, see Chapter 4.

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