Labour and Product Market deregulation
Partial, sequential or simultaneous reform

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The main findings of this paper: empirics

- Deregulation increases employment growth;

- Joint deregulation increases employment growth more than any individual reduction because of positive cross-markets effects;

- Largest effects:
  - less rigid firing rules for permanent workers and for collective dismissals;
  - barriers to entrepreneurship, investment, trade and administrative burdens;

- Internalisation of cross-markets effects delivers optimal combination of labour and product market deregulation
LAY-OUT OF THE DISCUSSION

- The hypotheses of the empirical analysis
- The empirical specification
- Deregulation and labour market reforms
PMR affects the elasticity and shifts the LD; LMR shifts LS and may increase its wage-elasticity;

The effect of deregulation in one market is higher when the level of regulation in the other market is low.

The marginal impact of a shift in LS is larger when employment is high than when is low (LD and LS are convex: the initial conditions matter).
The hypotheses of the empirical analysis: the empirical specification

\[ \Delta E_{it} = \alpha + \alpha_1 \Delta E_{it-1} + \alpha_2 RPM_t + \alpha_3 RLM_t + \gamma RLM_t RPM_t + \text{controls} + \varepsilon_{it} \]

- Deregulation has positive impact if \( \alpha_1, \alpha_2 < 0 \);

- **RLM and RPM should enter with lags**
  - (e.g. deregulation of product market determines an output effect (Blanchard-Giavazzi (2003) and an overhiring effect (Ebell and Haefke (2006)))

- But RLM and RPM have limited time variability: unsuitable for dynamic analysis

- Are the effects significant also in “steady state”?

- LD and LS are convex: the initial conditions matter
The hypotheses of the empirical analysis II: the empirical specification

\[ \Delta E_{it} = \alpha + \alpha_1 \Delta E_{it} - p + \alpha_2 RPM_t + \alpha_3 RLM_t + \gamma RLM_t RPM_t + \text{controls} + \varepsilon_{it} \]

- complementarities btw PMR and LMR captured with a Dummy

\[
RLM_t RPM_t = \begin{cases} 
1 & \text{if } RLM_t \geq \overline{RLM}_t \text{ and } RPM_t \geq \overline{RPM}_t \\
0 & \text{Otherwise}
\end{cases}
\]

- gains from cross-markets complementarities do not derive form joint reduction of PMR and LMR but from a reduction stronger than average.
Why not estimate the contribution of each sub-index of LMR and PMR?

(What happens if EPL is reduced for insider and increased for outsider?)

Why not DD estimator?

Many “measures” can influence employment growth; it is not possible to look at one in isolation.

"...reform packages seem to yield greater employment gains than separate, “piece-meal” reforms. ...so that any reform that lowers unemployment is likely to be complementary with all reforms that go in the same direction. However, the magnitude of such systemic reform complementarities is found to be moderate for the average OECD country”. (OECD 2005)
Deregulation and Labour market reforms

- Rents derive from imperfect competition in product markets. LMR facilitate the appropriation of existing rents by certain groups.
  - Reducing rents in the good markets reduces workers’ incentives to fight for a share of these rents (Blanchard-Giavazzi 2003) and increase the positive effects of the wage moderation on the unemployment rate (Estevao (2005)).

- Economic institutions in general are a source of rents.
  - There is a status-quo bias which is reinforced by the complementarity between RCI and RPI
  - Breaking the status-quo unbundling institutions

- Partial LMR may help to gain support for more deregulated arrangements (Saint Paul (2000))
Partial product market reforms not viable: not possible to unbundle product market reforms (*impossibility theorem* Boeri 2005).

Product market reforms should be radical and put pressure to reform labour markets.

But unreformed labour market with reformed product markets have worse employment outcomes. Low incentives to undertake product market reforms (Boeri (2005)).
Strictness of EPL and expenditure on unemployment benefits

Overall strictness of employment protection legislation (2003)

Unemployment benefits per unemployed as % of GDP per capita (2001)

Source: Arpaia –Mourre (2005)
Authors’ calculation on the OECD Social Expenditure database and Labour Market database. Unemployment benefits are calculated as the expenditure on unemployment benefits per unemployed as percentage of the GDP per capita. Luxembourg excluded due to data availability.
Efficiency of redistributive policies and strictness of EPL

\[ R^2 = 0.4841 \]

Source: Arpaia-Mourre (2005). Authors’ calculation on OECD and Immervoll et al. (2005); Luxembourg is missing due to the lack of data on EPL.
Concluding Remarks

- Interactions between labour and product market regulations matter.

- But there are large uncertainties of their effects in macro-panel framework.

- Packaging labour market reforms taking into account policy complementarities (tax wedge, EPL, UB, ALMPs..) may help to gain consensus.

- However, unbundling labour market reforms may make viable reform process.

- But it is important to reduce risks of reversals putting pressures on policy makers.
The hypotheses of the empirical analysis: Sources of complementarity II

High employment

Potential Heterogeneity in response to LMR

Low employment
The hypotheses of the empirical analysis II: potential heterogeneity

\[ \Delta E_{it} = \alpha + \alpha_1 \Delta E_{it-1} - p + \alpha_2 RPM_t + \alpha_3 RLM_t + \gamma RLM_t RPM_t + \text{controls} + \varepsilon_t \]

- Potential heterogeneity bias. Pooled estimators inconsistent (Pesaran and Smith (1995))
  - Solution I: MGE
  - Solution II: allow slope \( \alpha_2, \alpha_3 \) to vary with some aspect of the cross-sectional distribution of \( \Delta E_i \) (Haque, Pesaran and Sharma (1999))
  - Solution III: cross-section on time averages
The hypotheses of the empirical analysis II: the empirical specification

\[ \Delta E_{it} = \alpha + \alpha_1\Delta E_{it-1} + \alpha_2 RPM_t + \alpha_3 RLM_t + \gamma RLM_t RPM_t + \text{controls} + \varepsilon_{it} \]

- **complementarities btw PMR and LMR captured with a Dummy**

  \[ RLM_t RPM_t = \begin{cases} 1 & \text{if } RLM_t \geq \overline{RLM}_t \text{ and } RPM_t \geq \overline{RPM}_t \\ 0 & \text{Otherwise} \end{cases} \]

- **Positive effects from joint deregulation if } \gamma < 0**

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<th></th>
<th>RLM 1990</th>
<th>RLM 2003</th>
<th>RPM 1990</th>
<th>RPM 2003</th>
<th>RLMXP 1990</th>
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<td>2.0</td>
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<td>1.5</td>
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The empirical analysis: Main concerns

- In practice not many countries change their relative position over time

- No much time variation in regulatory indicators (ftn 17)

- Hard to distinguish the effect of complementarities from other country specific unobservable effects

- Solution: purging from country FE and then compute correlation
  - OECD (2005) finds no correlation between unemployment and EPL
The optimal (social planner) level of deregulation depends on:

- deregulation of costs;
  - small costs relative to benefits and symmetric → reform LM and PM (in sequence or simultaneously)
  - high and asymmetric → a partial reform
  - high and symmetric → no reforms
  - If costs are not too high → always comprehensive reform

- strength of the interaction;

- perspective of the policy makers;
Political costs are excluded.

Benefits are modelled as linear in RLM; RPM; RLMxRPM;

Only 2 levels of regulation: High and Low

Costs of deregulation in each market are linear \( \Delta RLM \);

If marginal benefits are decreasing in LM and marginal costs increasing in LM then under a market by-market perspective
The empirical analysis: Main concerns

- The impact of deregulation: scope and effort
  - **Scope:** comprehensive \((\Delta R_i \leq 0 \text{ and } \Delta R_{\neq i} \leq 0)\)
    partial \((\Delta R_i \neq 0 \text{ and } \Delta R_{\neq i} = 0)\)
  - **Effort:** large (75th to 10th percentile)
    small (50th to 10th percentile)
  - *(Table 5 not clear in which market deregulation takes place)*

- What is the reference distribution?
The empirical analysis: Main concerns

BLACK dot mean black line median
if median > (<) mean distribution has long left (right) tails

- PMR_90
- PMR_03
- LMR_90
- LMR_03
Hence a large deregulation effort in product markets is not the same as a large deregulation effort in labour market.

\( \Delta RLM \)
- 75th → 10th: from 2.2 (S, B, D) to 0.75 (UK, Can) = 65% decline
- 50th → 10th: from 1.9 (I, Cz) to 0.75 (UK, Can) = 60% decline

\( \Delta RPM \)
- 75th → 10th: from 1.7 (F, Cz, Sw) to 1 (UK, US) = 42% decline
- 50th → 10th: from 1.4 (D, Sv, A, NL, B) to 1 (UK, US) = 30% decline

e.g. A reduction of 40% in PMR ("large" change in PMR) corresponds to decline of LMR from France to Italy.
lower unemployment is associated with lower tax wedges ..., and more important, lower employment protection, perhaps cushioned by higher levels of unemployment benefits for limited time.

greater employment also means active labor market policies, ..., as well as targeted benefits like child care and generous policies for parental care so as to encourage more women to participate ....

It means wage support programs such as earned income tax credits and in-work benefits, ....

The Ludwig Erhard Lecture
By Raghuram G. Rajan, Economic Counsellor and Director of the International Monetary Fund's Research Department
December 8, 2005, Brussels