

**(II) Insiders, Outsiders,
and the Political Roots of
Labor Market Institutions**

Bocconi University, March 2009

Outline

- Insiders vs. outsiders: key definitions
- Economic models
 - Turnover costs and insiders' market power
 - Asymmetric shocks and hysteresis of unemployment
- Political economy models
 - Winners and losers of alternative institutions
 - Insiders' political power and institutions
 - Economic environment and institutions

Key definitions

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

Economic models

- Key idea: firms incur in **labor turnover costs** when they replace insiders by outsiders
- Insiders exploit this rent (market power) to push their wage above the market-cleaning level
- Insider-outsider theory originally built as micro-foundation of the existence of **unemployment** (no underbidding by unemployed workers)
- Alternative theories in this respect:
 - **Efficiency wage**
 - **Institutions** (e.g., minimum wage)

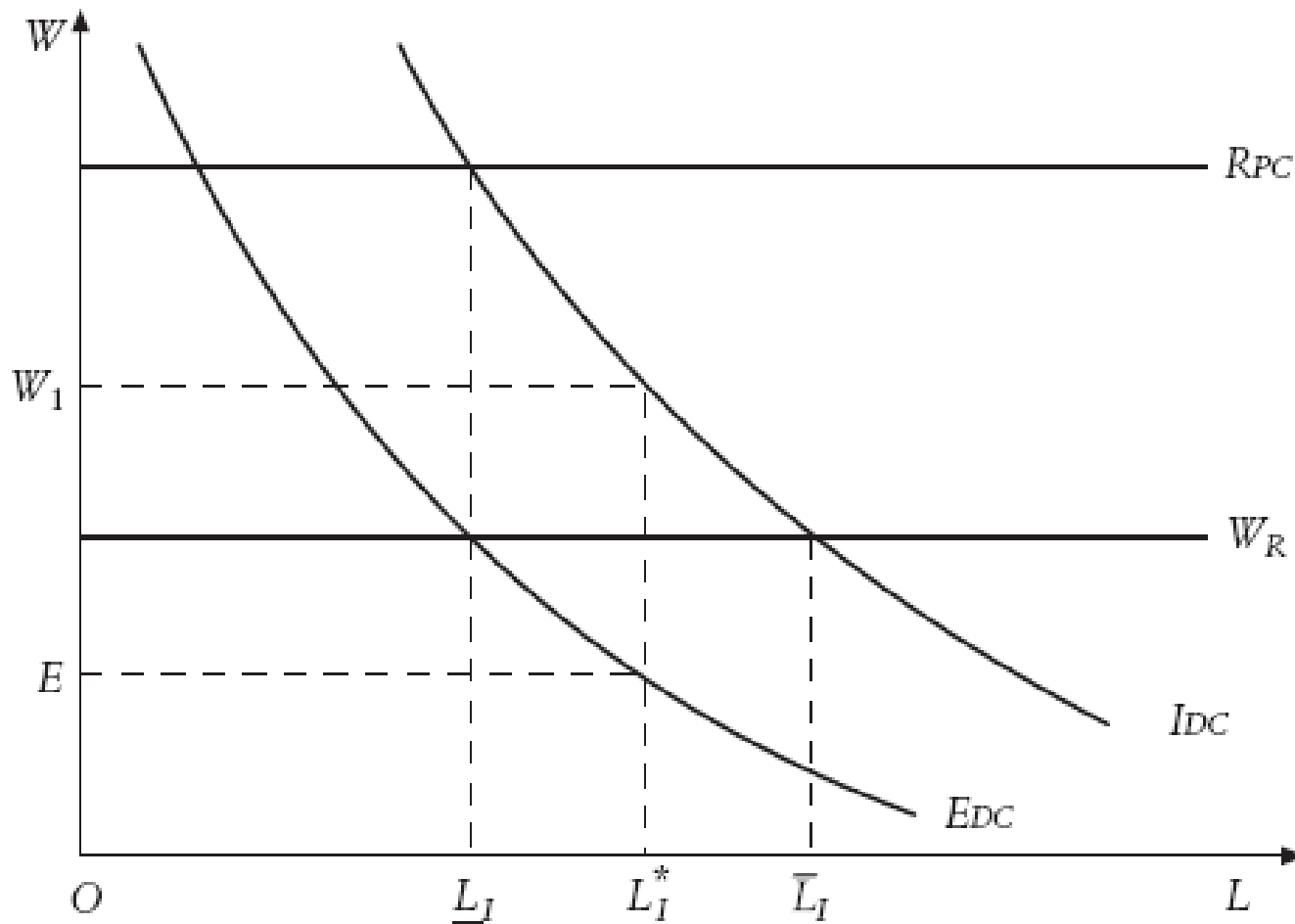
Labor turnover costs

- Labor turnover costs may be of different kind:
 - **Production-related** (selection, hiring, training)
 - **Rent-related** (severance pay, EPL)
 - **Lack of cooperation**
- They decide the degree of substitutability between insiders (L_I) and outsiders (L_O)
- Assume same productivity ($f_{LI}=f_{LO}$). Then:
 - $w_O \leq w_I \leq w_O + H' + F'$, where H' are marginal hiring costs and F' marginal firing costs (turnover costs: $H' + F'$)
 - The demand curve for insiders (outsiders) is to the right (left) of the marginal productivity curve

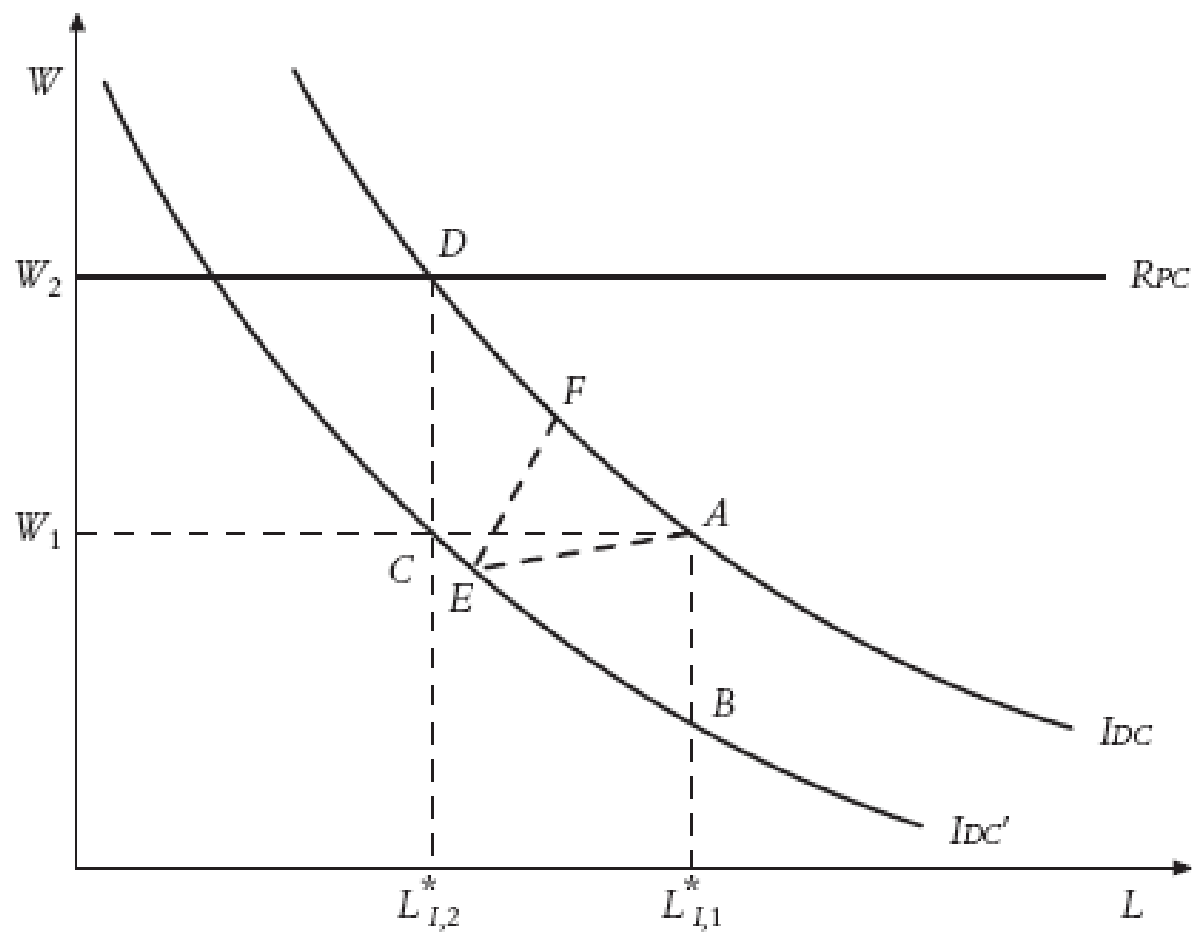
Insiders, outsiders and employment decisions

- Assumptions:
 - firm takes decisions in two stages (first wages and then employment levels);
 - perfect competition in the product market;
 - same productivity of L_I/L_O : $Y=f(L_I+L_O)$
- **Real profitability constraint:** $w_I \leq f_L + F'$
- **Relative profitability constraint:** $w_I \leq w_r + F' + H'$
(where w_r is the reservation wage of outsiders)
- Three possible scenarios: **retention** ($\underline{L}_I < L_I^* < L_I$); **firing** ($L_I^* > L_I$); **hiring** ($L_I^* < \underline{L}_I$). See next graph

Insiders, outsiders and employment decisions (cont.)



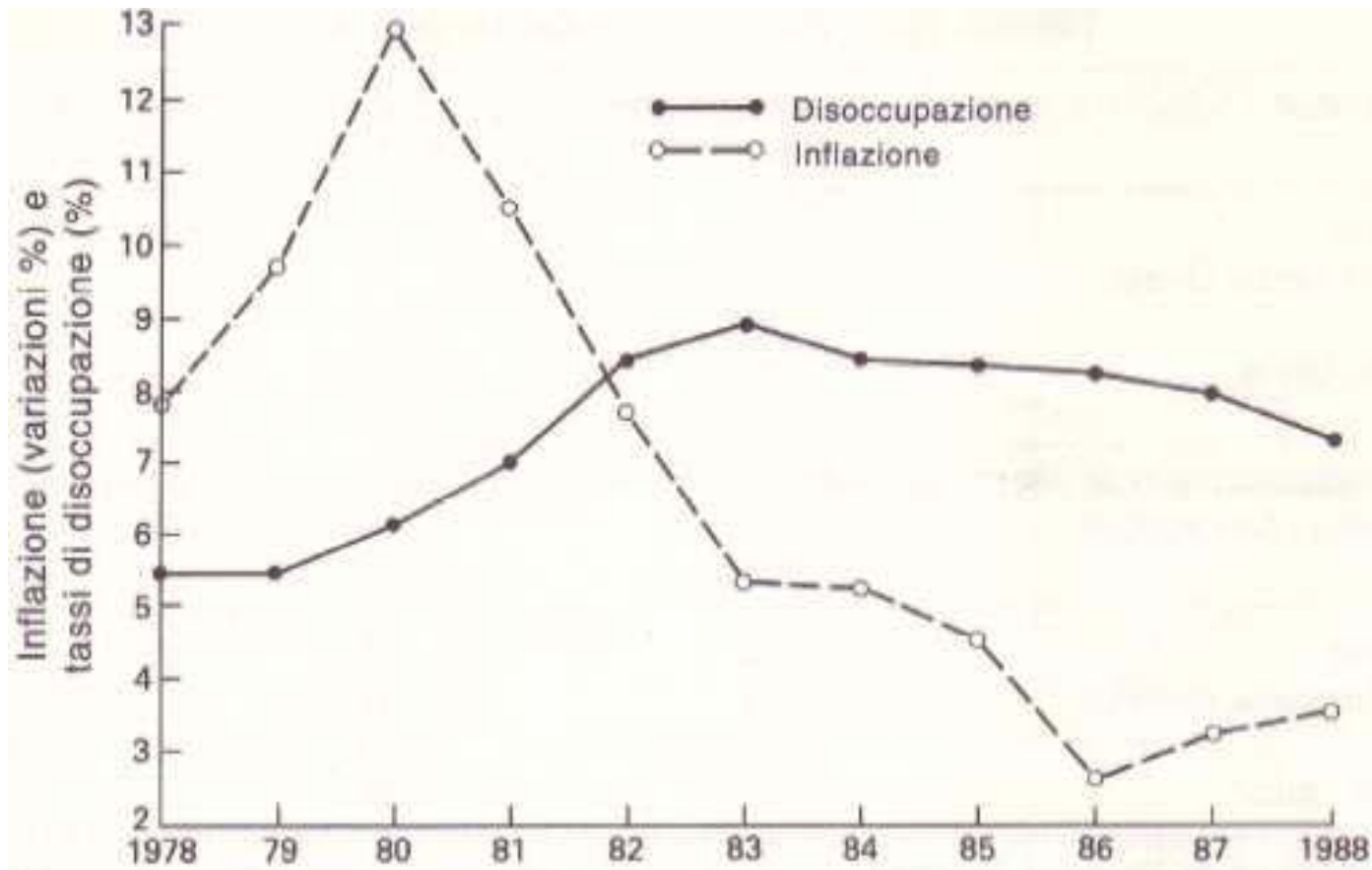
Asymmetric shocks: theory



Asymmetric shocks: theory (cont.)

- After a negative shock (from I_{DC} to I_{DC}'), different scenarios are possible:
 - from A to C (if seniority rule);
 - from A to B (if cohesive workforce);
 - from A to E (middle ground between above hp).
- After a positive shock (from I_{DC}' back to I_{DC}), different scenarios are possible:
 - from C to D (if seniority rule);
 - from B to A (if cohesive workforce);
 - from E to F (middle ground between above hp).

Asymmetric shocks: evidence



Political economy models

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

The political roots of labor market rigidities

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

Labor market institutions and the decisive voter

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

Labor market institutions and the decisive voter (cont.)

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

Institutions, politics, and the economic environment

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

Reform design

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

Partisan aspects

- Do political ideologies/parties affect the design of labor market institutions?
- **General discussion.** Left-wing parties usually pro-labor. But what kind of labor? And it might be the case that right-wing policies are undertaken by left-wing parties, and vice versa
- **Empirical findings.** Endogeneity problem and RDD studies (Pettersson-Lidbom 2008; Ferreira and Gyourko 2008)

A simple model

- During the course, we'll also contrast the above “political economy” insights with the available empirical evidence
- We'll do that when studying specific institutions: minimum wage, employment protection, unemployment benefits
- Now, to sum up, let's consider a simple analytical model capturing some of the issues raised so far

A simple model

We'll now study a political economy model of unemployment insurance (Saint-Paul, 1996) to exemplify the above channels and decisions.

Notation and assumptions:

- Replacement ratio: ρ_t
- Labor market rigidity: X_t
- Probability of remaining employed: $p_t = p(l_{t-1}, \theta_t, w_t)$
- Wage formation schedule: $w_t = w(X_t, \rho_t)$
- Tax rate applying to all incomes: τ_t
- Balanced budget constraint: $\tau_t = \frac{\rho_t(1-l_t)}{l_t + \rho_t(1-l_t)}$
- Probability of finding a job: $q_t = q(l_{t-1}, \theta_t, w_t)$

A simple model (contd.)

Employment determination:

$$l_t = l_{t-1}p(l_{t-1}, \theta_t, w_t) + (1 - l_{t-1})q(l_{t-1}, \theta_t, w_t)$$

The expected utility of insiders is thus given by:

$$V = p_t u[(1 - \tau_t)w_t] + (1 - p_t)u[(1 - \tau_t)\rho_t w_t] \quad (1)$$

with $u'(\cdot) > 0$ and $u''(\cdot) < 0$.

The first order condition for the choice of X_t by insiders is:

$$\frac{\partial V}{\partial w} = \frac{\partial p}{\partial w}[u_E - u_U] + [(1 - \tau_t) - w_t \frac{\partial \tau}{\partial w}][p_t u'_E + (1 - p_t)\rho_t u'_U] = 0$$

where $u_E = u[(1 - \tau_t)w_t]$ and $u_U = u[(1 - \tau_t)\rho_t w_t]$.

A simple model (contd.)

The first order condition for the choice of ρ_t by insiders is:

$$\begin{aligned} \frac{\partial V}{\partial w} \frac{\partial w}{\partial \rho} - w_t \frac{\partial \tau}{\partial \rho} [p_t u'_E + (1 - p_t) \rho_t u'_U] + (1 - p_t)(1 - \tau_t) w_t u'_U &= 0 \\ -w_t \frac{\partial \tau}{\partial \rho} [p_t u'_E + (1 - p_t) \rho_t u'_U] + (1 - p_t)(1 - \tau_t) w_t u'_U &= 0 \end{aligned}$$

where the first component captures the *loss* due to increased taxation and the second the *benefit* due to higher income when unemployed (both following a marginal increase in the replacement ratio ρ_t).

Rearranging terms, we can write:

$$\frac{u'_E}{u'_U} = \frac{-(1 - p_t) \rho_t}{p_t} + \frac{(1 - p_t)(1 - \tau_t)}{p_t (\partial \tau / \partial \rho)}. \quad (2)$$

A simple model (contd.)

By plugging the balanced budget constraint into (2), we get:

$$\frac{u'_E}{u'_U} = \frac{(1 - p_t) l_t}{(1 - l_t) p_t}. \quad (3)$$

It follows that:

- if $p_t = l_t \Rightarrow u'_E/u'_U = 1$, we get full insurance as the employed and unemployed are equally exposed (**no insider effect**);
- if $p_t > l_t \Rightarrow u'_E/u'_U < 1$, we get **underinsurance** as the insiders are protected from unemployment;
- if $p_t < l_t \Rightarrow u'_E/u'_U > 1$, we get **overinsurance** as the insiders are more exposed to unemployment than the rest of the labor force.

Review questions for topic I

- If the individual labor supply is negatively sloped, which effect dominates the other: income or substitution?
- Where the aggregate labor supply is flat: a) for many individuals the substitution and income effects are equal; b) many individuals have the same reservation wage; c) there is a mistake in the graph.
- In a competitive equilibrium, a labor market institution/wedge decreases both employment and wages. True or false?
- In a monopsonistic equilibrium, a labor market institution/wedge increases both employment and wages. True or false?
- What's the effect of labor demand elasticity on the unemployment cost of labor market institutions?

Review questions for topic I (contd.)

- In a competitive equilibrium, labor market institutions decrease both efficiency and equity. True or false?
- In a monopsonistic equilibrium, labor market institutions always increase efficiency. True or false?

Review questions for topic II

- Can turnover costs explain involuntary unemployment?
- The wage of insiders is never higher than outsiders' reservation wage plus marginal firing costs minus marginal hiring costs. True or false?
- In the presence of a very cohesive group of insiders, employment responds asymmetrically to productivity shocks. True or false?
- What are the political interactions between employment protection legislation and unemployment benefits?
- What are the effects of the minimum wage on skilled/unskilled workers? When is the minimum wage more politically feasible?

Review questions for topic II (contd.)

- After recessions, will insiders favor employment-reducing institutions more or less?
- The higher unemployment turnover, the lower the political feasibility of unemployment insurance. True or false?
- The higher unemployment, the lower the political feasibility of unemployment insurance. True or false?