

# Labor Reform in a Dysfunctional Labor Market

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# A dysfunctional labor market

- Poorly designed labor market institutions
  - Extreme employment protection
  - Extreme unemployment protection
  - Extreme labor income protection
  - Schizophrenic wage setting system
- Generated
  - A sclerotic labor market
  - A chronic productivity problem in the economy
  - A segmented labor market

# Unintended consequences of employment protection

- Long unemployment duration
  - The highest incidence of LTU among OECD countries
- Low arrival rate of job offers
  - The lowest among OECD countries
- Low job mobility and worker mobility
- Low productivity job matches
- Two-tier labor market

# Unintended consequences of unemployment protection

- The combination of high employment protection with generous unemployment protection, under severe economic downturns, may prove to be a time-bomb due to human capital depreciation of the long-term unemployed (Ljungqvist and Sargent, 1998).
- Unemployment benefit recipients stay longer unemployed (UB doubles unemployment duration, Addison and Portugal, 2010)
- Increases significantly the share of LTU (in particular the fraction that never return to employment, Addison and Portugal, 2003)
- Each month of potential duration of benefits decreases the transition rate out of unemployment by 4 percent (Lopes, 2010)
- The elasticity of unemployment duration to unemployment benefits is very high compared with other European countries (Addison et al., 2010)

# The incredible architecture of the wage setting system

- National mandatory minimum wage
- Nominal wage cuts are forbidden since the 1950s
- Wage negotiations between trade unions and employers' associations define wage floors by occupation category (around 30 000 job-titles)
- The wage agreement, by law, solely binds unionized workers and the firms that are members of the employer association
- There are no mechanisms that oblige unions and employers associations to disclose their constituency
- The legal conundrum is circumvented via the use of extension clauses (often to the whole industry) by the Ministry of Employment
- It is hard to conceive what kind of incentive mechanisms are at work

# The employment protection magic wand

- Changes in dismissal clauses:
  - Allow dismissals due to economic reasons
  - Extend the reasons for “just-cause”
  - Eliminate some safeguards to “unfair” dismissals
  - Eliminate rules of choice of the displaced workers
  - Reduce red-tape and administrative costs
  - Prepare **alternatives to labor courts** to decide on labor conflicts (independent agency)
- Changes in severance pay
  - Closing the gap to other European countries
- Needed changes in collective dismissals (rarely used)

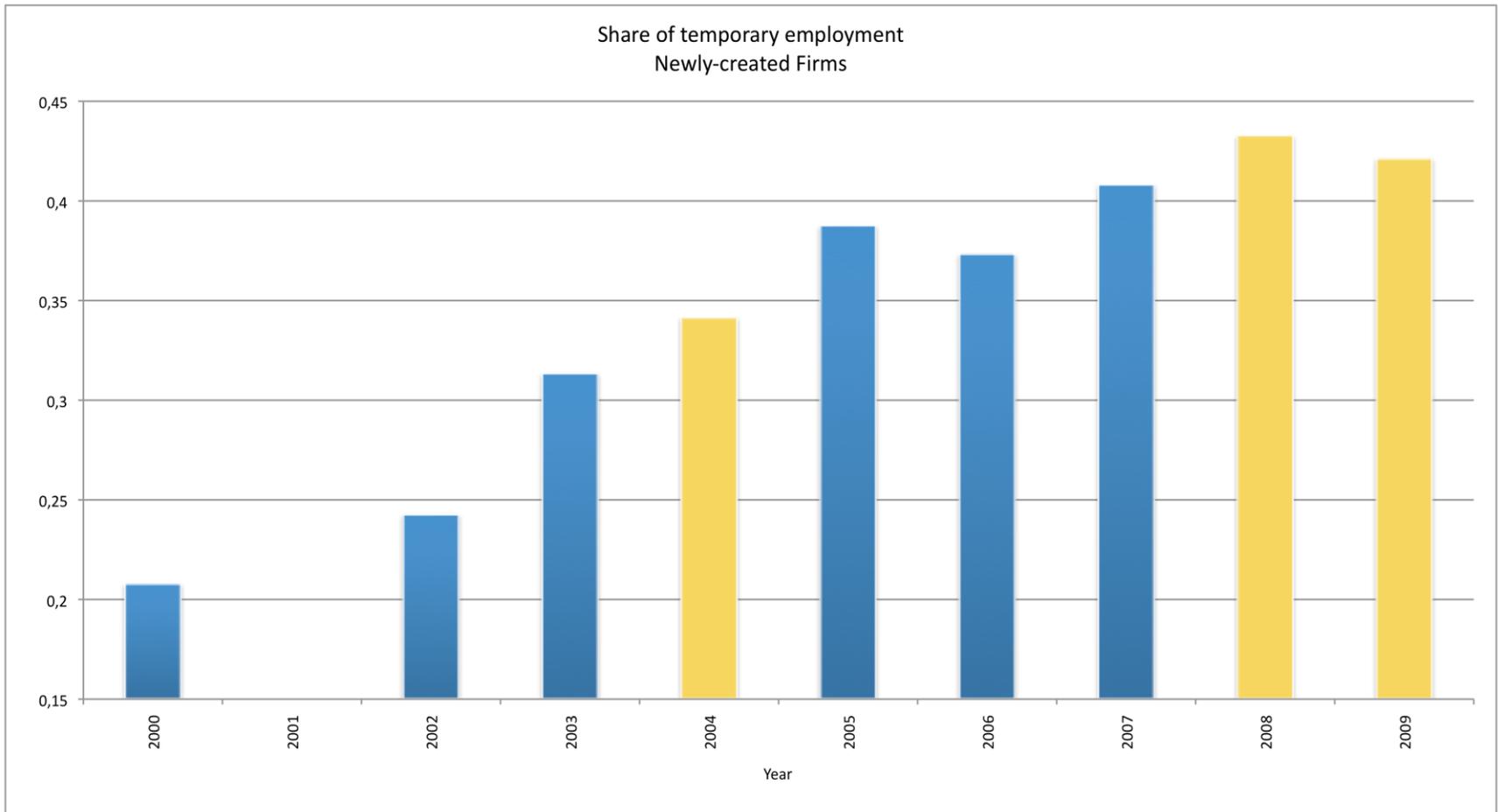
# The unemployment insurance magic wand

- Changes in unemployment insurance:
  - Cap at the maximum amount (close to 2.3 IAS)
  - Cap at maximum duration of benefits (26 months?)
  - Introduce a declining replacement rate rule
  - Decrease eligibility criterion (1 year of work)
  - Extension to employers and other “self-employed”
  
  - **No simple rule based on contributions (60 different categories?)**
  - **No change for cases where the replacement rate is near or above 100 percent?**

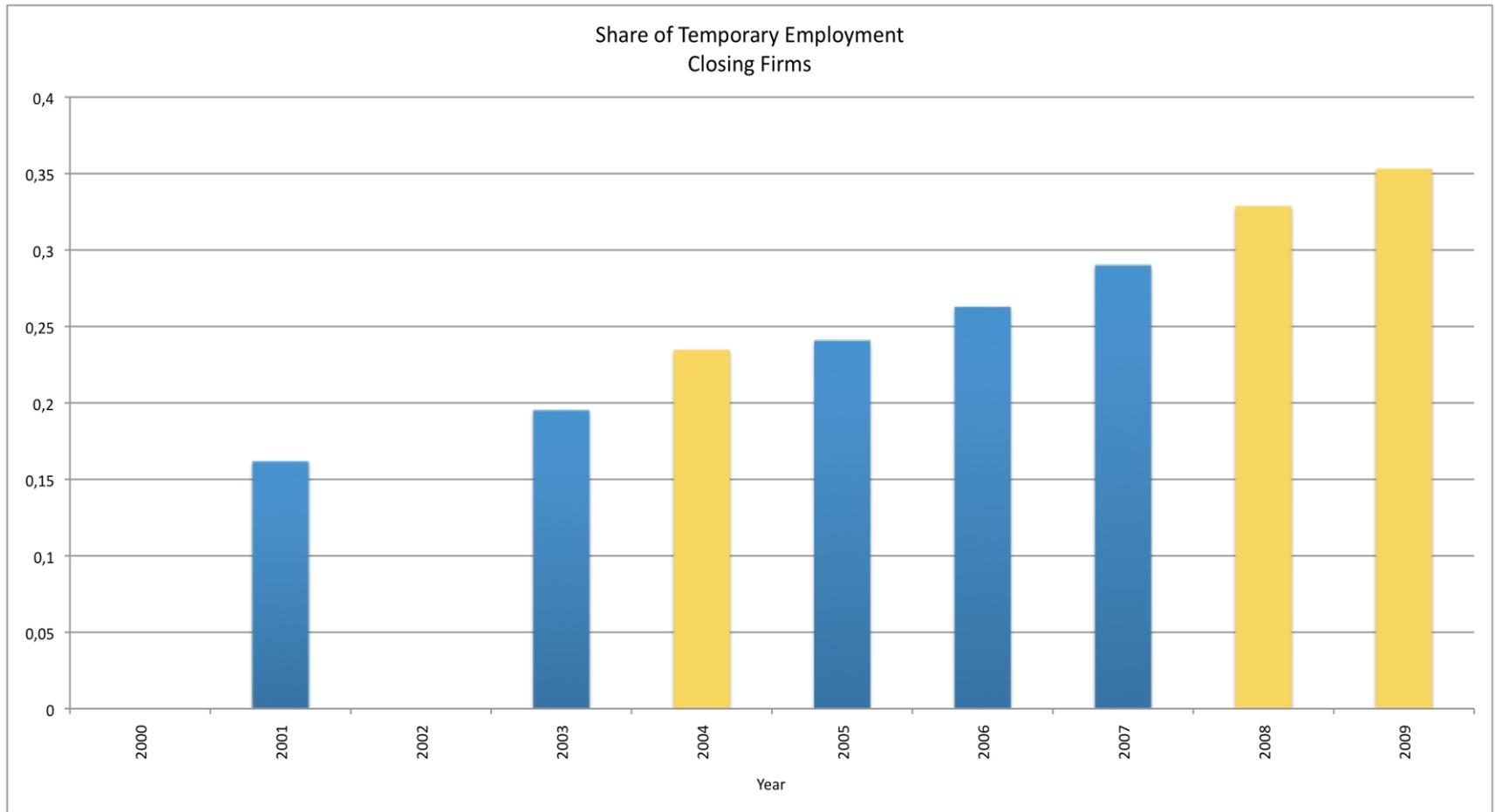
# The wage setting magic wand

- Changes in the wage setting system:
  - A prudent freeze on minimum wages
  - **A cautionary approach to the use of extension mechanisms** (a freeze, for the moment)
    - So large firms no longer impose wage hikes to smaller firms
  - A request to **reveal the actual constituency of unions and employer associations**
  - Decentralize wage bargaining
    - Allow opting-out for firms
    - Prepare opting-in options for future

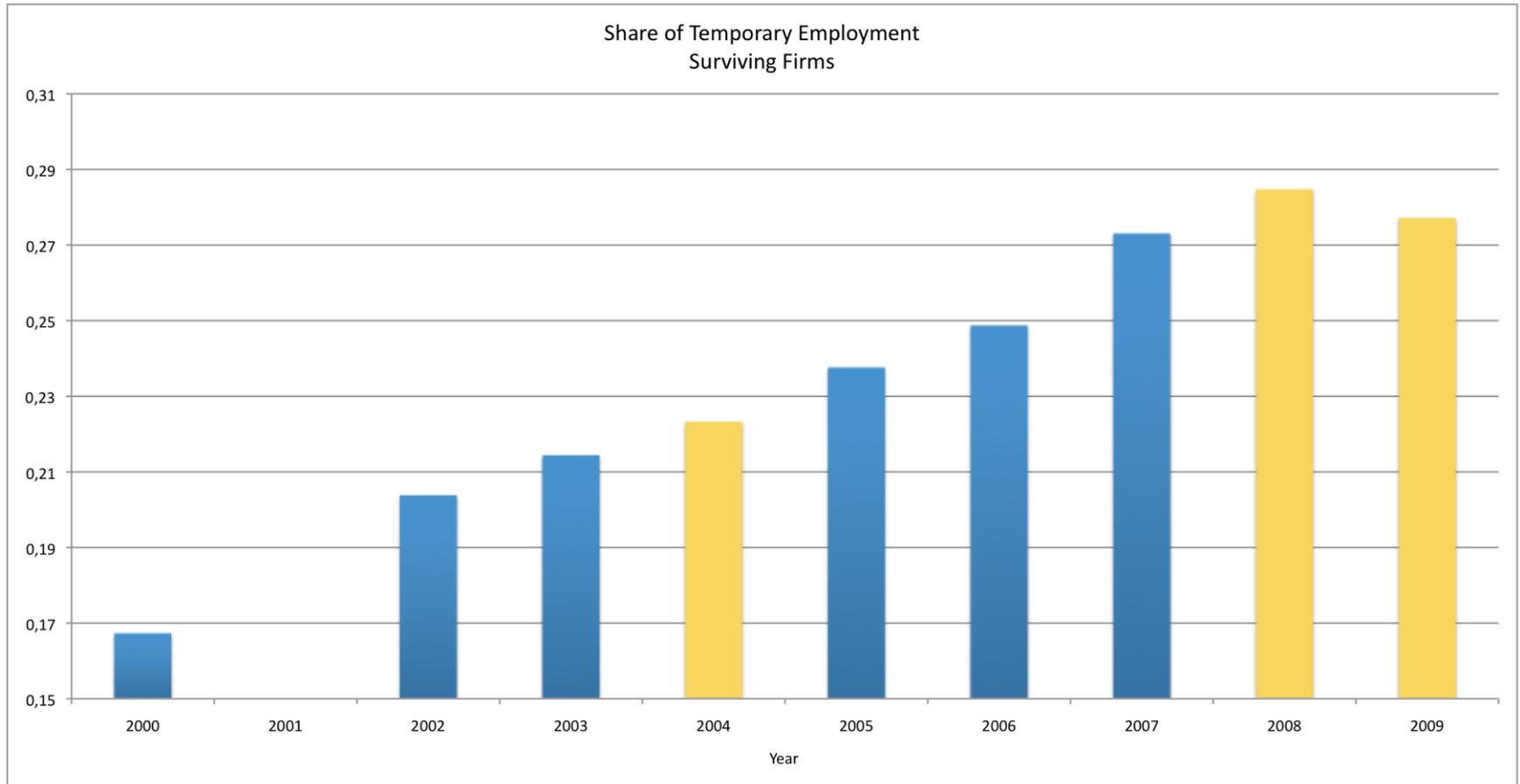
# Incidence of FTC (new firms)



# Incidence of FCT (closing firms)



# Incidence of FCT (continuing firms)



# Transition rates from FTC into OEC



# Two Portuguese political think tanks proposed the “Contrato único” along the same lines of Cahuc, Dolado, Bentolila, and Boeri

- A single open-ended contract
  - Covering solely new hires (it does not apply to those currently employed)
  - Ruling out fixed-term contracts and other forms of temporary work (“falsos recibos verdes”)
  - Extending the trial period (say, 6 months)
  - Granting that the changes in dismissal legislation actually allow (non-discriminatory) displacements for economic reasons
  - Severance pay should increase with tenure, more intensively during the initial period of the contract
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- A way to equalize job protection and promote the social value of work
  - To attenuate unproductive churning
  - To redirect job creation towards longer-lasting labor relationships where firm-specific human capital investment plays a more important role
  - To break gradually the insider-outsider gap in wage determination and work conditions
  - To enhance the job opportunities for the young

# The electoral platform of the main opposition party promised:

*To weight the introduction of a single labor contract for new-hires, phasing out gradually fixed-term contracts, and allowing for a longer trial period and taking away from the courts labor disputes over dismissals.*

The government commits himself, in the program  
approved by the parliament

*To weight the introduction of a single labor contract for new-hires, phasing out  
gradually fixed-term contracts, and allowing for a longer trial period and  
taking away from the courts labor disputes over dismissals.*

# So far...

It increased the maximum duration duration of fixed-term contracts.

# Important (practical) issues

- The name of the contract
  - Equal opportunity contract
- Interaction with other labor market institutions
  - - job protection
  - - wage setting
- Policy sequencing
  - - change severance pay and dismissal rules first (if possible)
- Long-term consequences of labor market institutions
  - - Sectoral employment composition
  - - Size distribution of firms
  - - TFP distribution

- “Portugal is in serious trouble. Productivity growth is anemic. Growth is very low. The budget deficit is large. The current account deficit is very large.”
- “This is where Portugal is today. In the absence of policy changes, the most likely scenario is one of competitive disinflation, a period of sustained high unemployment until competitiveness has been reestablished.”

Olivier Blanchard, 2005









