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The Political Economy of Reform and Corruption in Europe

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Declaration

I certify that the thesis I have presented for examination for the MPhil/PhD degree of the London School of Economics and Political Science is solely my own work other than where I have clearly indicated that it is the work of others (in which case the extent of any work carried out jointly by me and any other person is clearly identified in it).

I declare that my thesis consists of 28,902 words.

Abstract

This thesis focuses on two related areas of the political economy of reform in Europe. First, I present preliminary evidence for the EMU, for the period preceding the Great Recession, showing that countries that experienced a higher windfall of credit implemented a lower number of reforms and experienced a higher increase in corruption. Second, I present a literature review on the political economy of reform of dual labour market systems in Europe, and an analysis of labour market reform activity in EMU countries in times of economic boom and crisis. I discuss the reasons for the puzzling persistence of duality, and provide a summary of the main drivers of duality-reducing reforms.

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Introduction

Understanding the drivers of policy reform and the persistence of bad institutions has proven to be a very elusive matter in the social sciences. Throughout the Great Recession in Europe, academics have learned of the importance of domestic power relations and European political economy dynamics to understand the success or failure of policy reform. Similarly, European policy-makers are in permanent need of better toolkits for the adequate implementation of reforms. My goal in this work is to contribute to a better understanding of the political economy of reform in Europe, with a particular focus on the interaction between credit booms and institutions, and the political economy of reform of labour markets.

The point of departure of this research project was the identification of some unresolved puzzles regarding the complex relationship between the development of the European Monetary Union (EMU) and the reform dynamics of its member states. Initially, the EMU was conceived, partly, as a mechanism that would help reduce the institutional and competitiveness gaps among European countries (see, for instance, Eichengreen and Frieden (1993)). By abandoning the possibility of currency devaluation, the theory said, the economies with weaker institutions would have no choice but to implement structural reform and modernize their economies. This would naturally lead to a convergence towards best practices in all policy areas, from labour markets, to pension systems and taxes.

Notably, the monetary straightjacket imposed by the irrevocable fixed exchange rate regime was expected to be more favourable for Southern European economies. Most of these economies were barely escaping from semi-autarkic dictatorships, where clientelism and rent-seeking were common practice. For decades, these countries had suffered from fiscal imbalances, persistent financial instability, large unemployment levels and uncontrolled inflation. The EMU would provide the indispensible anchor for these countries to abandon once and for all these bad practices and policies.

When the project to unite all the currencies into the Euro became a reality, the rhythm of reforms accelerated. Nobody wanted to be left behind and countries, particularly in the South, started, albeit at different rhythms, adapting their economies to European standards. The financial crises in the seventies and eighties and, since the 90s the EMU convergence criteria, led to deep transformations in these economies: liberalization of large economic sectors, improvements in the welfare state and tax systems, a reduction in tariffs and barriers to trade, and reforms in most areas. The Maastricht Treaty, signed in 1991, established ambitious deficit, debt and inflation objectives and the need to stabilize nominal exchange rates within the Exchange Rate Mechanism left little space for countries to avoid reforms.

In 1999 countries became finally full members of the EMU, abandoning their monetary policy autonomy. One immediate effect of the Euro was that the perception of risk by investors immediately dropped and real-interest rates fell sharply in peripheral countries. By 2001, Greece was able to borrow at German-level interest rates. The large flow of credit that went into these economies generated large internal and external imbalances. In some cases credit went to finance quickly rising public debt levels (like in Greece) and in other cases private debt and real estate booms (like in Spain). In all cases, including Ireland, external indebtedness increased abruptly.

A second effect of finally entering the Euro was that the rhythm of reforms slowed-down. Unlike what the theory had predicted, the peripheral economies, fuelled by credit-driven economic growth, had fewer incentives to implement the necessary reforms to improve productivity and correct institutional and economic imbalances. Fernandez-Villaverde et al. (2013) have called this process "political credit cycle", and argue that the flow of credit after the EMU led to a relaxation of constraints that reduced incentives for reform and led to the institutional deterioration that precipitated the Great Recession.

While this remains a valid hypothesis, the truth is that there has been very little systematic empirical research linking variations in credit cycles and reform activity, with some very valuable exceptions (Vamvakidis, 2007). Surely, one reason why research in this area is still scarce is the limited availability of good data on reforms as well as the difficulties of building research designs that capture causal mechanisms in complex institutional developments, across countries, in EMU. The first chapter of this thesis provides some preliminary evidence of a positive relationship between the boom of cheap credit and a slowdown in reforms in certain EMU countries. Further research is needed to explore other mechanisms that might be involved in this, still largely unexplored, relationship.

The boom years barely lasted a decade. When the crisis began a new period for reforms started in EMU. While in previous years reform activity had been slow, particularly in the South, the first years of the crisis led to a boost in reform activity. The sudden stop of credit, the spectacular rise in unemployment and the inescapable external constraints - in some cases with very stringent IMF and EU bailout programmes - led to some major structural reforms in a number of southern European economies. Spain implemented ambitious reforms in its banking system and the labour market. Greece went through a traumatic reform process, involving deep transformations in its welfare state, pension system, labour and product markets. Portugal also implemented ambitious growth enhancing reforms and structural fiscal savings.

However, the reform process, albeit intense, did not last long either. As soon as the credit limitations started to relax, as a result of the ease in monetary conditions by the ECB, and growth returned to most countries, the rhythm of reforms slowed down significantly again. In Chapter 2 of this thesis, I discuss the labour market reform activity over the last two decades, distinguishing between the South and core European countries.

Two observations emerge when looking at reform activity in Europe. The first is not new: reforms activity increases in times of crisis. However, a second observation also emerges: we don't have a solid understanding of reform dynamics in the expansionary part of the cycle. Besides crises such as the Great Recession or external constraints, what other variables push countries to implement reform? The evidence shown in my research points to the idea that domestic political economy dynamics are crucial to understand reform activity and that different policy areas require different frameworks of study. For instance, even within the same welfare regimes, power relations in the labour market are very different from each other.

This leads me to the other initial idea that caught up my attention during my research, especially when I became a full-time politician three years ago, as a member of the Spanish parliament. As I had studied, external constraints were crucial for understanding the reform process, and they seemed key to push countries to implement reforms. However, the specific design of these reforms in many cases turned out to be far from optimal, and in some cases detrimental to solve the actual problems that countries were facing. When looking at the Spanish labour market this became sadly apparent: How was it possible that Spain, despite having evolved so well in so many areas, had still such large labour market imbalances? How was it possible that despite reaching European record unemployment levels throughout the Great Recession, the employment protection legislation of permanent workers was barely altered?

These questions led me to further investigate the political economy of specific reforms. It seemed obvious that in order to understand reforms well and do useful comparative work, one needed to look much closer at the direction, scope and ambition of these reforms and also, for instance, at what segments of the population these reforms were actually affecting. Recent work by Boeri (2011) on labour market reforms in Europe became very useful to help me understand the different dimensions of this debate. I decided to focus on the political economy of reform of dual labour markets to try to find, within the limited research available, some common patterns of reform. In my research on the politics of duality I identify some relevant gaps in the literature that seem fruitful avenues for further research.

In the first chapter, I address two straightforward questions. First, whether financial windfalls, such as booms of cheap credit, are associated with less policy reform and more corruption. Second, whether strong institutions help to mitigate the negative effects of credit windfalls. I present preliminary evidence for the EMU, for the period preceding the Great Recession, showing that countries that experienced a higher windfall of credit implemented a lower number of reforms and experienced a higher increase in corruption.

I propose two different mechanisms that might explain these correlations. First, booms act as an "institutional mirage" for the economy: everything seems to be going well, the economy grows and jobs are being created, so voters relax their demands for reforms and governments have fewer incentives to implement them. This signalling problem was first pointed out by Fernandez-Villaverde et al. (2013), and my paper supports their theory with some initial empirical evidence for the case of the EMU.

The second mechanism is related to the literature on the so-called *resource course* and, to the best of my knowledge, new in its application to credit booms: financial windfalls (like a large oil discovery), in interaction with poor institutions, may act as a catalyser for corruption. In highly politicized institutional environments, with "grabber friendly institutions" (Robinson et al., 2006) and weak checks and balances - such as those found in some Southern European economies - the flow of credit reinforces on-going perverse institutional dynamics such as rent-seeking and clientelism.

The results of my first chapter are relevant for a number of reasons. First, while the relationship between crisis and reforms has been largely explored in the literature on the political economy of reform, a lot less work has been dedicated to understanding the interaction between credit booms and reforms. My work adds to the evidence that periods of economic bonanza might be detrimental for reforms, but also provides an original hypothesis on some perverse institutional dynamics, specifically associated with financial windfalls, that deserve further investigation.

The paper also adds to the existing literature regarding reforms in the EMU. A good amount of work has been done regarding reforms in the Great Recession as well as on reforms and EMU convergence criteria. However, less attention has been paid to what happened to reforms in the period in between. In terms of policy lessons, this paper reinforces the view that European institutions should be paying special attention to reforms, particularly in times when the economy is booming.

Surely in terms of research design, the first chapter has some limitations as the initial quality of institutions is difficult to disentangle from the institutional deterioration that came after, as a result of the financial windfall. Also the measurements for the quality of institutions and corruption are far from optimal, as they are often based on perceptions, which might also be biased by the cycle.

The first chapter opens some avenues for further research. A more comprehensive theoretical framework on the relationship between financial booms and reforms needs to be built. Furthermore, the literature on corruption would also benefit from further exploring the effects of windfalls on rent-seeking behaviour by governments.

In the second chapter I review the literature on the political economy of reforms in the EMU, in this case focusing on dual labour market reforms. Dual labour markets are characterised by stark differences in job protection faced by permanent works (the so-called insiders) and temporary workers (so-called outsiders). I address an on-going puzzle, particularly relevant for Southern European economies: why are dual labour markets so persistent? Given that there is wide consensus on the negative effects of dual labour market systems on the economy, I try to contribute to understanding why the insider-outsider divide is still widening, rather than narrowing, in so many European countries.

This question is of utmost importance for policy makers because temporality, youth unemployment and work precariousness are central concerns for governments, and these are directly linked to duality. My hope is that this review may help to shed some light on how to overcome the difficulties encountered by governments in reforming two-tier labour markets.

While most of the literature focuses on the effects two-tier systems on labour market outcomes and other economic variables, much less attention has been paid to the actual *drivers* of duality. I document some theoretical and empirical insights that might help to provide a more coherent understanding of the persistence of duality, as well as on when and why the wedge between insiders and outsiders might be reduced.

Duality is persistent by nature, as insiders tend to outnumber outsiders and are better organized. The political influence of insiders in designing the policy agenda today clearly outweighs that of the outsiders, despite the latter group having grown in size persistently over time. This influence is exercised mainly through two mechanisms: trade unions and political parties. This review reinforces the idea that despite the deep transformations that have occurred in the labour markets over the last decades, trade unions have not managed to internalize in any meaningful way the interests of outsiders, and continue to represent the preferences of insiders across different European welfare regimes.

While trade unions have lost a significant amount of social support, they have managed to preserve a strong influence, mainly through collective bargaining structures, which emerge as a crucial, often overlooked factor to explain the persistence of duality. It is through these bargaining tables that trade unions manage to, *de facto*, influence wage levels and firms' flexibility to adapt to the economic cycle, which are crucial to determine the insider-outsider divide. A first conclusion from this finding is that in order to understand the reasons for the stickiness of two-tier labour markets, further research should focus on the varieties of collective bargaining structures across European welfare regimes.

Secondly, this review concentrates on another issue that remains puzzling in the literature: do outsiders actually show political preferences that are systematically different than those of insiders?

I don't find conclusive evidence that supports the central assumption in the classic insider-outsider theory that insiders and outsiders have different political preferences. If that assumption does not hold, and the political preferences of insiders do not actually diverge from those of outsiders, it would be absurd to expect outsiders to organize themselves to fight duality, thus becoming also agents of the status-quo.

As regards to the drivers of reforms that reduce the duality wedge, this paper also adds two relevant contributions. First, I point to the economic cycle as a key driver of reforms in EMU. While most of the existing literature focuses on the politics of reform in the bad part of the cycle, I provide some evidence on what happens to labour-market reforms in periods of bonanza. What the data shows is that over expansionary periods in EMU the rhythm of labour-market reforms drops abruptly and the insider-outsider wedge does not change.

The second finding might open a relevant nuance for the study of the political economy of reforms of dual labour markets in Europe: while there is no conclusive evidence in the literature that crisis lead to duality reducing reforms, this paper shows that the interaction between economic hardship and EMU surveillance seems to be more effective at reducing the insider-outsider divide.

The main contribution of the paper is that it is, to the best of my knowledge, the first attempt to provide a comprehensive survey of the specific literature on the *reasons for the persistence* and the *drivers* of reform in dual labour markets in Europe, which might be useful for both further research and policy guidance.

.Overall, I believe this thesis is original in its approach to the study of policy reforms in EMU, as it contributes to enrich, drawing on evidence from a variety of sources and disciplines, the empirical and theoretical work in two areas of research within the field that are underexplored.

Chapter 1

Financial Windfalls and Institutional Deterioration: Evidence from the EMU

Abstract: Is cheap credit going to harm your institutions? In this paper I argue that while financial windfalls pose an important test to the economy, their effects will depend crucially on the institutional quality at the beginning of the windfall. I present some preliminary evidence for the European Monetary Union to support that hypothesis. I observe that those countries that experienced the highest windfall have experienced the sharpest institutional deterioration. However, I show that initial institutions crucially mitigate the negative effects of windfalls on institutions. Moreover, I propose a political mechanism to explain why this may occur. I argue that weak institutions in interaction with a financial windfall may easily be appropriated by the initial "winners of the bubble", leading to a self-fulfilling reproduction of the bubble and more intense institutional deterioration.

1.1 Introduction

The Economist defines Windfall Gains as "income you do not expect, such as winning a lottery prize". Paradoxically, evidence shows that countries experiencing unexpected inflows of money do not necessarily improve their performance. For instance, resource booms, such as oil windfalls, have been found to be detrimental for growth, either through market or institutional mechanisms (Frankel, 2010). Similarly, aid transfers, instead of promoting development, have been associated with rent-seeking and institutional deterioration through a shift in interest groups incentives Svensson (2000); Casella and Eichengreen (1994). In the same way, financial windfalls, such as booms of cheap credit, have been linked to a general relaxation of constraints, lower reform capacity and, ultimately, poor growth performance (Vamvakidis, 2007).

Large windfalls of income pose a challenge to those that receive them. However, the detrimental effects of windfalls are not inevitable. The extensive literature on the resource course has focused on the interaction of resources and institutions to explain the different developmental paths followed by resource abundant economies like Norway and Venezuela. In the same way, while in many parts of Africa aid has not been used for productive activities, evidence shows that it has helped others, such as Botswana, to develop (Acemoglu et al., 2002). Recently, some political economists have pointed to the importance of the political interaction between windfalls and institutions: For instance, (Robinson et al., 2006, p. 247) argue that:

> "The overall impact of resource booms in the economy depends critically on institutions since these determine the extent to which political incentives map into policy outcomes."

Fernandez-Villaverde et al. (2013) explore these ideas in a recent work in relation to the European Monetary Union (EMU) experience. They argue that due to the credit windfall in the periphery, during the years that followed the entrance in the Euro, reforms were abandoned and institutions deteriorated. They also point to the idea that politics played a central role in the way financial windfalls interacted with institutions, and open the door for an interesting empirical investigation.

In this paper I present some preliminary evidence in support of four hypotheses as regards to the relationship between financial windfalls and institutions: I argue that (1) financial windfalls pose a test to existing institutions, but institutional deterioration is not inevitable and (2) crucially depends on the initial quality of institutions. These explain why the effects of financial windfalls are non-homogeneous; at the same level of windfall shock countries with worse initial institutions deteriorate relatively more than those with good - defensive - institutions. Finally, (3) the crucial mechanism by which windfalls become detrimental is political rather than economic.

I give support to the first two hypotheses by analysing data on 12 EMU countries. The results are coherent with the predictions: (1) as argued by the literature, the EMU Financial Windfall is strongly correlated with our two measures of Institutional Deterioration in the selected sample; (2) our variables

Initial Institutions in 1999 - when the 12 countries entered the Euro parity - are strongly correlated with the Institutional Deterioration experienced during the EMU years and (3) the interaction between Financial Windfall and Initial Institutions is statistically significant for the four different measures of Initial Institutions. That is, at the same level of windfall shock, countries with worse initial institutions deteriorated relatively more than those with good ones. This would support the idea of the non-homogeneous character of the relationship between financial windfalls and initial institutions.

Finally I present a case study on the political economy of the Spanish Boom as an example of the importance of initial political dynamics and institutions in determining the way financial windfalls map into economic outcomes. I argue that a specific type of historical, political and financial institution and certain regulatory changes allowed the initial "winners of the bubble" (real estate developers and local saving banks) to capture political power (at the municipal level). My point is: if existing institutions allow the "winners of the bubble" to lock in their economic power today by transforming existing institutions to their interest, the country will inevitably suffer a (financial) windfall course. If, on the contrary, institutions are prepared to counteract the test posed by the boom, the country may avoid the detrimental effects of the financial windfall.

The remainder of the paper is organised as follows: Section 1.2 covers the literature review in two different subsections, one that focuses on windfalls in general and another on institutions. Section 1.3 presents the theoretical framework. Section 1.4 presents the empirical strategy and preliminary results. In section 1.5 I present a short case study on Spain. Section 1.6 concludes.

1.2 Related Literature

In this section, I explore the core ideas for conceptualising the relationship between financial windfalls and institutions. In the first subsection, I propose a new classification of different windfall views into three large groups: (1) the economist view, which focuses on the economic effects of windfalls (2) the institutionalist view, which looks at the effects of windfalls on institutions, and the (3) political economy view, which focuses on the political dimensions of the interaction between windfalls and institutions. I draw from the literature on the resource course, financial booms, aid and development and the political economy of reform. In the second section I present an overview of the literature on institutions and the quality of governance.

1.2.1 Resources, Windfalls, Reforms, Institutions and Politics: Three Views

Empirical studies show that being wealthy in resources can be, paradoxically, a course for currently developing nations. Sachs and Warner (2001) show that, countries with abundant resources have had lower average growth rates in the postwar period than resource-poor economies. Even though it is conventional wisdom that resource abundance may represent a challenge for development, there is no agreement in the literature as regards to what are the mechanisms that might explain this paradox.

The economist view is associated with the so-called Dutch Disease theory.[1] That is, a resource boom - such as a boom in the prize of oil in an oil exporting country - leads to a sectorial reallocation of productive factors (crowding out) in response to a favorable shock emanating from either a resource discovery or an increase in the price of some commodity. Typically this draws factors of production out of relatively more productive activities producing traded commodities - to be substituted by imports that become relatively cheaper - and into non-traded sectors. As a consequence, a resource boom hinders growth via a market mechanism, notably an appreciation of the real exchange rate (Sachs and Warner, 2001).

The problem of the economist view is that by ignoring institutions it misses part of the story. While in countries such as Venezuela or Sierra Leone resource wealth has led to institutional deterioration, rent seeking and stagnation, in places like Canada, Norway or Australia, resources have been important drivers of growth (Mehlum et al., 2006). Gelb (1988), in his comprehensive study of six oil-exporting countries, argues that it is the efficiency with which the extra revenues are used what will determine the effect of the boom in the economy. He focuses attention on the interaction between institutions and resources.

Institutionalist Views Gelb (1988) is in fact the first to point out two of the most important effects of windfalls on institutions: the (1) fiscal and (2)

[1] See Frankel (2010) for a comprehensive summary of broader arguments within the economist view category.

rent-seeking effects. He argues that windfall gains relax the general constraints in the economy, reduce the incentives for monitoring others and lead politicians to focus on obtaining gains for their own constituency.

Some papers have formalised Gelb's idea that resource windfalls produce an alteration of incentives leading agents to non-cooperative rent-seeking activities. Lane and Tornell (1996) argue that the combination of a weak institutional structure and fractionalisation inside the governing elite generates slow growth, through the "voracity effect". Torvik (2009), on the other hand, argues that a greater amount of natural resources increases the number of entrepreneurs engaged in rent-seeking and reduces the number of entrepreneurs running productive firms. Similar institutionalist arguments have been explored in the literature on development aid and the political economy of reforms. Casella and Eichengreen (1994) show that the prospect of aid exacerbates the delay in stabilisation by inducing social groups to postpone making sacrifices.[2] Closer to the hypotheses presented here, (Svensson, 2000, p.457) recognises that "the effects of development aid critically depend on the political equilibrium of the recipient country", but pictures windfalls as having a somehow depoliticised and monotonic effect on institutions depending on the number of competing social groups.

Similar to the empirical analysis presented here, Vamvakidis (2007) extends the argument to include foreign borrowing by the private sector and provides empirical support to the idea that easily available external financing causes a relaxation of institutional constraints. The argument is simple: when budget constraints become looser or there is easy access to financial capital, through aid or cheap external financing, governments tend to delay adjustment. Incumbents do not reform until things get "really bad" in the economy. The proxy he uses for financial windfalls is the External Debt-to-GDP ratio. Similarly, Borio (2012) argues that during financial booms not only the balance sheets of financial institutions improve, but also the fiscal accounts of governments due the pro-cyclical nature of public revenues.

In their analysis of the financial windfall caused by the Euro, Fernandez-Villaverde et al. (2013) add one more mechanism to the idea that financial windfalls may be detrimental for the economy:(3) the signalling effect. Financial

[2] They use a classic war of attrition game theoretical model proposed by Alesina and Drazen (1991)

windfalls, they argue, affect the ability of principals to extract the right signals from the economy by altering selection (bad managers and politicians remain) and incentives (less effort is needed to win elections). In their paper they point to a political effect of windfalls although they do not elaborate on its implications (it is not the focus of their paper). They argue that:

> "Weakened institutions affect the political-economic equilibrium by strengthening the forces against reform and providing few rewards for those in favor. Normally political success will reflect economic success: if a group grows richer, its lobby power will be larger ... " (Fernandez-Villaverde et al., 2013, p. 11)

The missing link of the institutionalist arguments is the actual interaction of the windfall with the existing distribution of power among the different interest groups at the domestic level, and how this turns into institutional deterioration or not. Crucial redistributive effects of windfalls and more nuanced dimensions of power explain, I will argue, the non-homogeneous effect of windfalls in the economy.

The Political Economy View I see an essential difference between the political economy view and the two views presented above. While the other views focus their attention on a specific direction of causality - the effects of financial (resource or other type of) windfalls on the economy or existing institutions - political economists look at the actual interaction between windfalls and institutions.

Mehlum et al. (2006) use the same data by Sachs and Warner (2001) to present the opposite argument as regards to the resource course. The authors argue that it is the quality of institutions what actually determines whether countries avoid the resource course or not. Interestingly they differentiate between "grabber friendly" and "producer friendly" institutions and conclude that "natural resources put the institutional arrangements to a test, so that the resource curse only appears in countries with inferior institutions" (Mehlum et al., 2006, p. 6).

Robinson et al. (2006) move a bit further in the same direction and propose an explicitly political model of resource extraction. In their model, resource income can be used in either of two ways; the incumbent can consume the income or he can distribute it as patronage - in the form of public sector employment- to influence the outcome of an election. They argue that:

> “Low quality institutions invite bad policy choices since they allow politicians to engage in inefficient redistribution in order to influence the outcomes of elections. High quality institutions make such political strategies infeasible or relatively unattractive.”
> (Robinson et al., 2006, p. 450)

They point crucially at the initial role of institutions as a key political driver of the effects of windfalls on institutions. Rather than changes in the economic structure, they believe that shifts on political incentives triggered by resource booms are the main drivers of the resource course.

1.2.2 Institutions and the Quality of Governance

There is no agreement in the literature as regards to what “governance” actually means. While some have focused mainly on functionalist approaches defining it as “good-for-economic-development” (La Porta et al., 1999, p. 233), others have highlighted more normative criteria. For instance, Rothstein and Teorell (2008) link quality of government to the concept of impartial government institutions: “when public officials who implement policies do not take anything about the citizen/case into consideration that is not beforehand stipulated in the policy or the law”. On the other hand, several scholars have pointed out to the difference between governance and democracy. If quality of government was considered to be the same as democracy, “the importance of how power is actually exercised would be left out” (Charron et al., 2010).

In this paper, for practical purposes, I use the definition of the World Bank, the most widely used in the literature. Governance is defined as “the traditions and institutions by which authority in a country is exercised”. This includes: “(1) the process by which governments are selected, monitored, and replaced, (2) the capacity of the government to effectively formulate and implement sound policies, and (3) the respect of citizens and the state for the institutions that govern economic and social interactions among them.” (Kaufmann et al., 2009, p. 3).

While I recognise that no definition is self-sufficient, it is not my intention to explore here all the nuances of the theoretical debate in the literature. I follow the high degree of consensus as regards to certain concepts on which we should focus. I take as a reference The World Governance Indicators (WDI) five dimensions of governance : (1) corruption; (2) rule of law; (3) government effectiveness; (4) voice and accountability and (5) regulatory quality.[3]

Quality of Governance in Europe Although quality governance issues have been generally a topic in the study of developing economies, quality of governance matters also in the EU. Recent studies have pointed to the large variation across (and within) countries of governance indicators (Tabellini, 2010; Charron and Lapuente, 2011). Looking at the evolution in recent years of these different governance indicators there are substantial differences among countries. Overall, the data does not suggest relevant improvements since 1995s. Conversely, what we see is a negative trend starting in 2008 - 2009 when the crisis first hit Europe. This trend seems to affect more acutely those countries in the periphery that suffered a larger financial windfall (Charron et al., 2012).

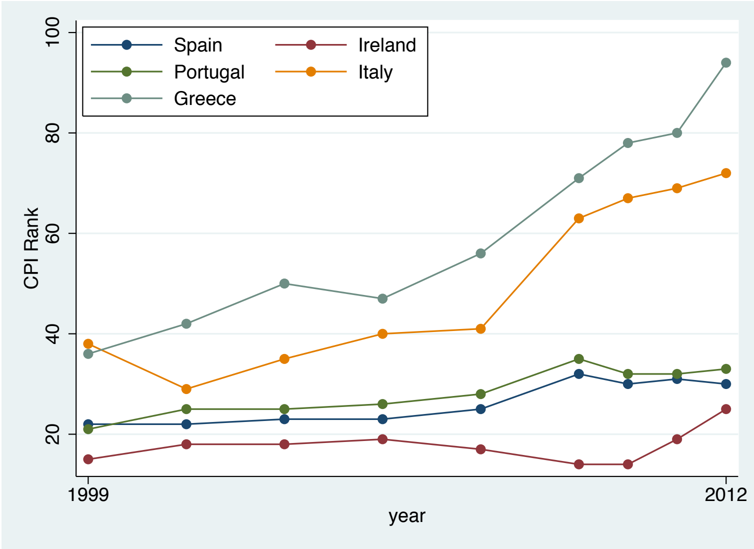
1.3 Theoretical Framework

When the EMU was booming differences in the quality of government did not seem to be so important and some of the countries that are experiencing today, some embarrassing cases of corruption (such as Ireland) were performing among the world's best. When the boom ended, however, the crisis brought to the surface the effects of years of unseen deterioration. A way of capturing such deterioration is by looking at the performance in the ranking of perception on corruption of Transparency International Corruption Perception Index (CPI). Figure 1.1 below shows the deterioration in CPI rank for selected EMU countries. At similar levels of windfall, we can clearly see that there is a wide variation in terms of the change in the CPI ranking.

The variation in this index from 1999 (year in which the parities were fixed to the Euro) to 2012 is the proxy I will use to measure Institutional Deterioration in the empirical analysis. Just a first look table 1.1 suggests three interesting ideas. Firstly, we see that all countries worsen their position in the ranking, which would give support to the idea explored in the literature that the EMU Financial Windfall had a detrimental effect on institutions (Fernandez-Villaverde et al., 2013). Secondly, we observe that the two countries that deteriorate the most are the two countries that were originally worst positioned in the ranking. This suggests that the initial level of governance is relevant as regards to the

[3] I exclude a sixth indicator on Political Stability and the Absence of Violence because it is not relevant for the purpose of this study.

Figure 1.1: Institutional Deterioration from 1999-2012 for selected EMU Countries



Notes: CPI Rank data from Transparency International.

impact of the financial windfall on institutional deterioration. Bad institutions seem to be drivers of even worse institutions. This could be explained by the size of the windfall: larger windfalls cause larger deterioration. Yet, (this is the third observation) the size of the windfall does not have an homogeneous impact. For example, while Spain suffered a credit windfall larger than Italy (as measured here) its effects on overall perceived corruption were not closely as significant. The idea is even more clear if we look at Belgium: At a similar level of windfall as experienced by Italy, it saw its position in the CPI rank increase by 13 positions. The point that I am trying to make with this anecdotal evidence is that what matters to understand the full effect of windfalls is the quality of institutions when the windfall begins.

In line with the literature on the resource course (Boschini (2007), Mehlum et al. (2006), Robinson et al. (2006)) I argue that the important question for financial windfalls as well is whether the country has good quality of institutions at the time when the financial windfall starts. Depending on that, windfall gains will be used wisely in the benefit of national welfare or be extracted by the elite and cause institutional deterioration.

Financial windfalls have crucial redistributive effects. They have winners and losers. The way domestic power rebalances when a windfall occurs is crucial in

Table 1.1: Windfalls and Change in Corruption Index (CPI) Rank

Country	Av. Credit to private Sector (1980-1998)	Av. Credit to private Sector (1999-2008)	Variation average credit (%)	CPI Rank 1999	CPI Rank 2012	Variation CPI Rank
Austria	0.86	1.42	65%	17	25	-8
Belgium	0.74	1.65	124%	29	16	13
Denmark	1.14	1.70	50%	1	1	0
Finland	0.89	1.38	55%	2	2	0
Germany	0.91	1.27	40%	14	13	1
Greece	0.18	0.77	338%	36	94	-58
Ireland	0.68	1.88	175%	15	25	-10
Italy	0.40	0.91	130%	38	72	-34
Netherlands	0.93	1.93	107%	8	9	-1
Portugal	0.67	1.85	176%	21	33	-12
Spain	0.46	1.34	193%	22	30	-8
Sweden	1.06	1.78	68%	3	4	-1

Notes: *Change in Credit*: Percentage increase in the average total adjusted credit to the private sector from 1980-1998 versus 1999-2008, Source: Bank for International Settlements, Long series on credit to private non-financial sectors. *Change in CPI Rank*: Difference between the Transparency International Corruption Perception Index ranking in 1999 versus the ranking in 2012, Source: Transparency International.

determining the outcome of such windfall. The economic winners in a boom will see their political position reinforced with the windfall. “When a particular group becomes rich relative to others, this will increase its de facto power and enable it to push for economic and political institutions favorable to its interests” (Acemoglu and Robinson, 2008). The point is whether existing institutions will resist the push or not. Certain types of institutions - “grabber friendly institutions” - will allow the relative economic winners of a boom to transform their economic power into de facto political power. This is the crucial mechanism that leads to rent-seeking, corruption, overspending and general institutional deterioration. But these effects are not inevitable. I argue that the financial windfall will not weaken institutions in a homogeneous manner. In the same way that in Norway an oil boom does not lead to institutional deterioration, in Belgium or the Netherlands the EMU Financial Windfall was not detrimental for the economy.

The three hypotheses I am considering here and test in the next section are the following:

H1: Financial windfalls do not have a homogeneous effect on institutional deterioration. While they pose a test to existing institutions, the variation is not a linear function of the size of the windfall.

H2: The effect of financial windfalls on institutional deterioration depends crucially on the quality of institutions at the beginning of the bubble. Countries that suffer from "grabber institutions" (Robinson et al., 2006) will see their institutional quality deteriorate while countries enjoying "producer friendly" institutions may be able to counteract the negative effects provoked by the financial windfall. This works for the three effects considered in the literature: (1) the fiscal effect, the (2) rent-seeking effect and the (3) signalling effect.

H3: The reason of such deterioration is the political effect of the windfall. In countries with poorer institutions the likelihood that the windfall will be politically appropriated by the coalition that resists reforms is higher.

1.4 Empirical Analysis

In this section, I explore more in depth the theories presented in the previous sections and give empirical support to my three hypotheses. In what follows I present a description of the data I use and descriptive statistics, a section showing correlations between the EMU windfall, on the one hand, and structural reforms and institutional deterioration, on the other; and in the last part of this section I show correlations between initial quality of governance and institutional deterioration caused by the EMU windfall. Finally, I show simple linear regressions of institutional deterioration against windfall shocks, controlling for initial institutions, and contrast these to regressions including the interaction between the two variables. All the results give support to the hypotheses presented above: while windfalls represent an important test for institutions, their effect is heterogeneous and depends, crucially, on the initial quality of institutions.

1.4.1 Description of the Data

Financial Windfalls Data: The Bank for International Settlements (BIS) has constructed long series on credit to the private non-financial sector for 40 economies, both advanced and emerging. Credit is provided by domestic banks, all other sectors of the economy and non-residents. The "private non-financial sector" includes non-financial corporations (both private-owned and public-owned), households and non-profit institutions serving households as defined in the System of National Accounts 2008. In terms of financial instruments, credit covers loans and debt securities. The series have quarterly frequency but I used the data on the last quarter of the year only to match data available on reforms and governance quality. The data for each country include i) credit to private non-financial sectors by domestic banks and ii) total credit to private non-financial sectors. Moreover, for most countries, total credit is broken down into iii) credit to non-financial corporations and iv) credit to households and non-profit institutions serving households. For the purposes of this paper I have chosen the total credit to non-financial sector for the construction of the windfall variable. The way I constructed this variable is by looking at the percent increase of total credit in the economy between the average before the introduction of the Euro (1980-1998) and the average post introduction of the Euro (1999-2009). While the database covers 40 countries since 1945 I have adapted my selection to the data available on number of structural reforms, which includes 12 EMU countries since 1980.

Reforms data: The FRDB Social Reforms Database provided by Fondazione Rodolfo De Bendetti (http://www.frdb.org) is a database that collects information about social reforms in the EU-15 member states (except Luxembourg) over the period 1980-2007. The database contains qualitative features of social reforms, which are classified along two main dimensions: direction (increasing/ decreasing flexibility of the system) and scope (marginal/ radical reforms). The following four areas of labour market reforms are included: Employment Protection Legislation, Non-Employment Benefits, Public Pension Systems and Migration Policy. For each policy area, the following information is provided: (1) Cumulative number of reforms implemented in a country or region since 1980; (2) Direction: e.g. increasing or decreasing the flexibility of the systems due to reforms; (3) Index of coherence among all the measures within the same reform; (4) Number of measures/interventions related to each reform (5) Number of reforms implemented in a country during the same year; (6) Scope: structural or marginal reform. For the purposes of this analysis I use only those reforms that are defined as *structural* and *increasing*, that is, high impact reforms that increased market flexibility and rewards from labor market participation.[4]

[4]Countries covered are: Austria, Belgium, Denmark, Finland, Germany, Greece, Ireland,

Institutional Deterioration - Quality of Governance data: As discussed above I use 5 indicators of governance provided by the World Bank, World Governance Indicators. These are the broad definitions of each indicator. *Control of Corruption* captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. *Rule of Law* captures perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. *Government Effectiveness* captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. *Voice & and Accountability* captures perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media. *Regulatory Quality* captures perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development.

It needs to be noted that the available data on institutions used in this work has obvious shortcomings that limit the explanatory power of this empirical analysis. Firstly, both the Transparency International data and the World Bank data are based on subjective perceptions. These perceptions can be biased by a variety of factors, including the economic cycle. Secondly, the initial quality of institutions is difficult to disentangle from the institutional deterioration that came after, as a result of the financial windfall, so there might also be problems with endogeneity.

Table 1.2 shows the descriptive statistics of the final dataset used for the analysis. In this sample we can observe some important variations in the size of the windfall experienced by the different countries after 1998, with some countries experiencing an increase of only 39.8% in total credit to the private sector (Germany), and others experiencing an increase of as much as 398% (Greece). On average, the countries in the sample undertook around 5 structural

Italy, The Netherlands, Portugal, Spain, Sweden, United Kingdom. I exclude France due to the lack of available data.

reforms in the period since the introduction of the Euro. The most reformist countries implemented as much as 11 such reforms (Finland and Germany), while there were also countries that did not implement any structural reforms (Ireland, Italy, Netherlands and Belgium). In terms of initial institutional quality in 1998, with indices measured over a range from -2.5 to +2.5, we observe a relatively high quality overall with mean values of the governance variables ranging between 1.305 for Regulatory Quality and 1.729 for Control of Corruption, and again, high cross-country variations, with some countries exhibiting indices as low as 0.52 in the Control of Corruption category (Italy), or as high as 2.37 in the same category (Finland).

Table 1.2: Summary statistics

Variable	Mean	Std. Dev.	Min.	Max.	N
Change CPI Rank	-9.833	18.838	-58	13	12
Change in Credit (Windfall)	1.267	0.854	0.398	3.379	12
Number of (+) Structural Reforms	4.833	4.783	0	11	12
Governance Variables					
Control of Corruption	1.729	0.614	0.52	2.37	12
Regulatory Quality in 1998	1.305	0.404	0.66	1.89	12
Voice & Accountability in 1998	1.377	0.182	1.04	1.63	12
Government Effectiveness in 1998	1.666	0.475	0.75	2.07	12
Rule of Law in 1998	1.461	0.422	0.72	1.97	12

Notes: *Change in Credit*: Percentage increase in the average total adjusted credit to the private sector from 1980-1998 versus 1999-2008, Source: Bank for International Settlements, Long series on credit to private non-financial sectors. *Number of (+) Structural Reforms*: Total number of structural reforms undertaken since 1999, (+) means that the reforms were increasing the flexibility of the system, or increasing the rewards from labour market participation. *Change in CPI Rank*: Difference between the Transparency International Corruption Perception Index ranking in 1999 versus the ranking in 2012, Source: Transparency International. *Governance Variables*: Estimate of governance range from approximately -2.5 (weak) to 2.5 (strong) governance performance, Source: The Worldwide Governance Indicators, 2012 Update, www.govindicators.org

1.4.2 Exploring Correlations for the Case of 12 EU Countries

This section is divided into two parts corresponding to the first two hypothesis presented in this paper. In the first part of this section I will show some initial supporting evidence for the hypothesis that the EMU windfall is associated with institutional deterioration. The second part first looks at some simple correlations between initial institutions and institutional deterioration. I give some graphical support to the hypothesis as regards to the importance of existing institutions at the beginning of the Euro to explain institutional deterioration with the windfall. The evidence shows that indeed countries with initially better institutions have experienced smaller institutional deterioration during and after the crisis, and some have actually improved. I later explore whether institutions existing prior to the arrival of the windfall matter for the impact of the windfall on institutional deterioration. I show some simple linear regression results that indicate that when I control for initial institutional quality, the effect of a strong windfall can be mitigated. At the same level of windfall shock, countries with worse original institutions deteriorated relatively more than those with good "defensive" original institutional structures that worked against the detrimental windfall effects.

Institutional Deterioration and Financial Windfalls

Here I present two graphs in which I measure Institutional Deterioration in two different ways: one refers to the relationship between the increase in total credit and the increase in corruption and the other refers to the increase in total credit and number of structural reforms.

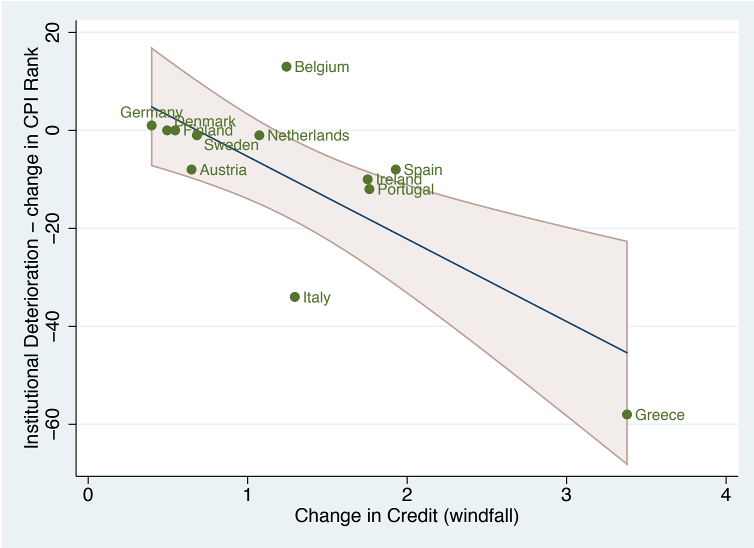
Corruption and Financial Windfalls

As predicted by the theory we can observe a clear negative correlation between the corruption performance of the EMU countries (measured by their variation in the CPI ranking) and the percentage increase in total credit in the economy after 1999, our proxy for financial windfall. Larger windfalls are clearly associated with more severe institutional deterioration. This result goes hand in hand with what is predicted in the literature on financial windfalls and institutions (Vamvakidis, 2007; Fernandez-Villaverde et al., 2013).

Reforms and Financial Windfalls

In line with what we can observe in figure 1.3 and as predicted by the literature, there is a negative correlation between the increase in average credit to the economy and the number of structural reforms undertaken since the start of the windfall. Countries that had available more credit also made less structural reforms. While this association cannot be interpreted as causal, the data nevertheless supports the hypothesis that financial windfalls may cause a pain-reliever effect, that is, they reduce the incentives for reforms as the economy performs

Figure 1.2: Corruption and Financial Windfalls



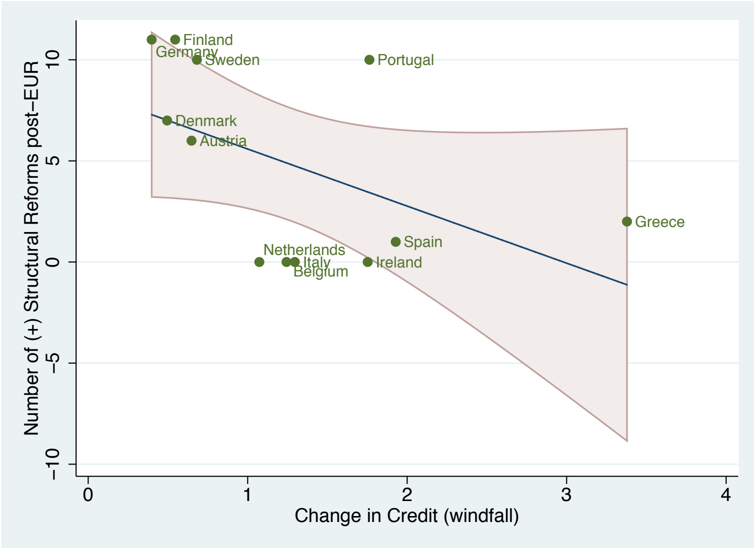
Notes: Plot of *Institutional deterioration* - the change in the Transparency International Corruption Index Rank position from 1999 to 2012 (a negative number represents a decrease in the rank in 2012 as compared to 1999) against *Change in Credit* - the percentage increase in the average total adjusted credit to the private sector from 1980-1998 versus 1999-2008 (1 represents a 100% increase). The blue line represents predicted values from the linear regression. The shaded area represents the 95% confidence interval.

well.

Pre-windfall Institutions and the Effect of Windfalls

I now move on to looking at the relationship between institutions existing prior to the arrival of the windfall and the institutional deterioration during the windfall. Institutional deterioration is again measured as the variation in position of the CPI index from the time when the parities were fixed to the Euro in 1999 to 2012. While some of the selected countries have seen almost no variation, others have seen corruption increase substantially since the EMU was created (particularly in the crisis period, see table 1.1 for details). The number of reforms are measured by the total number of *increasing structural* reforms, taken from the Database by FRDB as explained above. Specifically, reforms will have a positive sign if they: (1) "increase the rewards from labor market participation -reduce the amount or the duration of non employment benefits or makes eligibility conditions stricter - and (2) that increase the increases the flexibility of the system (in particular making it easier for a companies to dismiss workers). Initial institutions are measured by the World Governance Indicators (see Section 1.4.1 for the description of the variables) in the year 1998.

Figure 1.3: Reforms and Financial Windfalls



Notes: Plot of the *Number of (+) reforms* measures the total number of (+) structural reforms since 1999 against the *Change in Credit* - percentage increase in the average total adjusted credit to the private sector from 1980-1998 versus 1999-2008 (1 represents a 100% increase). The blue line represents predicted values from the linear regression. The shaded area represents the 95% confidence interval.

The evidence shown in Figures 1.4 and 1.5 support what I predicted in the hypothesis that original institutions are a key driver of the institutional deterioration associated with windfalls. Following the governance categories used by the World Governance Indicators explored above (Government Effectiveness, Regulatory Quality, Control of Corruption and Voice & Accountability) I see always the expected sign of the correlation. That is: the worse the countries performed in each of the governance indicators at the beginning of the windfall in 1999, the more have their institutions deteriorated in the period 1999-2012.

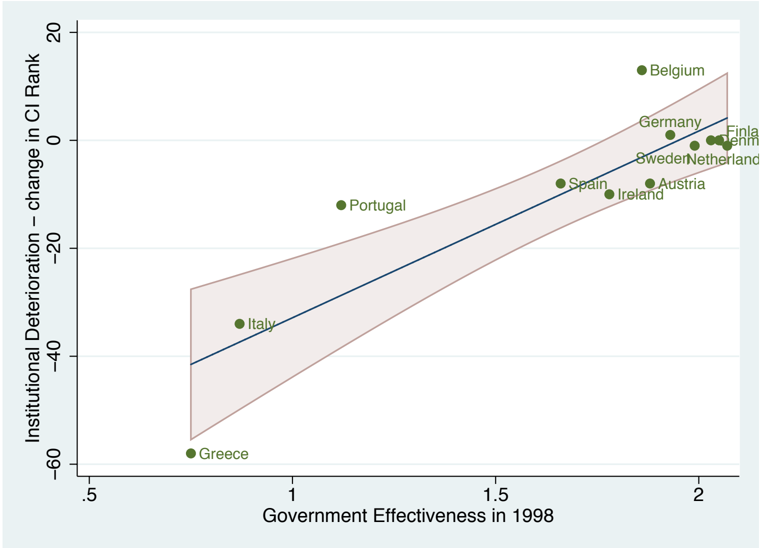
As argued in the theoretical model, countries with initially better institutions are better able to mitigate the negative effects of a windfall, or may even turn them into something positive.

Below we estimate the following two specifications of a model of institutional deterioration and windfalls.

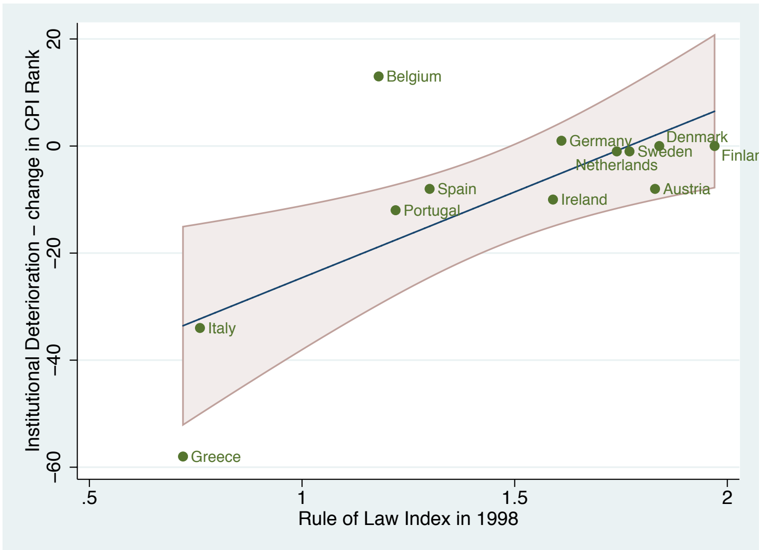
$$\Delta INST_i = \alpha + \beta Windfall_i + \gamma INST_i^{pre} + \epsilon \quad (1.1)$$

$$\Delta INST_i = \alpha + \beta Windfall_i + \gamma INST_i^{pre} + \delta Windfall * INST^{pre} + \epsilon \quad (1.2)$$

Figure 1.4: Initial Quality of Governance and Institutional Deterioration - A



(a) Government Effectiveness in 1998



(b) Rule of Law in 1998

Notes: Plot of the change in the CPI ranking from 1999 to 2012 against Quality of Governance variables from The Worldwide Governance Indicators, 2012 Update. The blue line represents predicted values from the linear regression. The shaded area represents the 95% confidence interval.

$\Delta INST_i$ represents institutional deterioration, $Windfall_i$ represents the size of the windfall experienced by the economy indexed i, $INST^{pre}$ represents pre-existing institutions, and ϵ is a random error term. The second specification includes an interaction term. The theory predicts a positive sign for δ, meaning that windfalls are not necessarily bad, or at least have a less negative effect when met with initially strong institutions.

Regression (1) of table 1.3 presents results of a linear regression of the first specification. The regression suggests a negative association between the change in the CPI rank and the size of the windfall: An increase in the available credit post-EUR by 100% is associated with a decline in the rank by about 14 positions. On the other hand, the coefficient on initial institutions is non-significant, suggesting that initial institutions have no significant correlation with institutional deterioration.[5]

Table 1.3: Institutional Deterioration and Initial Control of Corruption

	(1)		(2)	
	Change CPI Rank		Change CPI Rank	
Change in Credit	-13.8*	(6.32)	-55***	(14.9)
Control of Corruption	6.3	(8.8)	-21.4*	(11.5)
CoC * Change in Credit			31.7**	(10.8)
Constant	-3.3	(21.8)	37.7	(21.4)
Observations	12		12	
R^2	0.605		0.809	

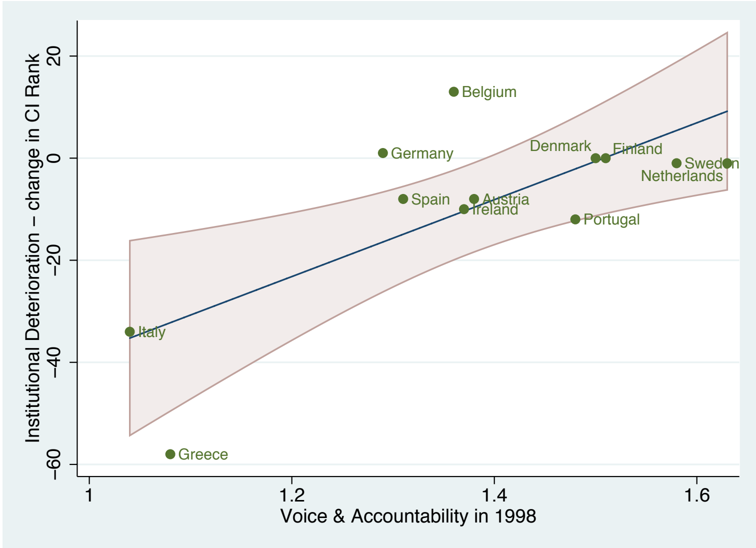
Standard errors in parentheses
* $p<0.1$, ** $p<0.05$, *** $p<0.01$

Notes: Linear regression of change in Transparency International Corruption Perception Index ranking from 1999 to 2012 on the percentage change in adjusted average credit to the private sector before and after introduction of the EURO and the value of World Governance Indicator "Control of Corruption" in 1998. The second regression includes the interaction term.

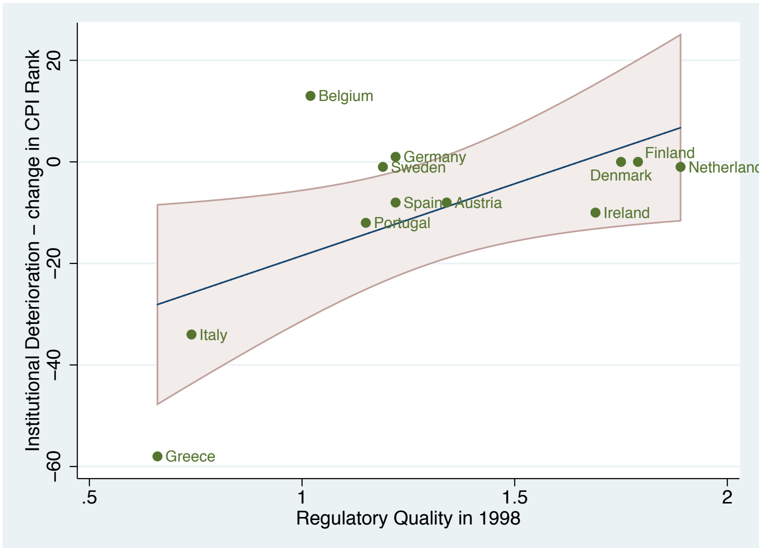
The right panel of table 1.3 shows the regression including the interaction between the previous two independent variables. The coefficient on the interaction term is large, significant and positive, suggesting that while countries with larger windfalls experienced stronger deterioration in their institutions (the coefficient on change in credit is -55), if initial institutions were strong, the effect of the windfall is mitigated. In fact countries with strong institutions at the beginning of a windfall are able to increase their institutional quality with the presence of a windfall.

[5]In Appendix 1.A.1 I also present the results of similar regressions using the other indicator of quality of government.

Figure 1.5: Initial Quality of Governance and Institutional Deterioration - B



(a) Voice & Accountability in 1998



(b) Regulatory Quality in 1998

Notes: Plot of the change in the CPI ranking from 1999 to 2012 against Quality of Governance variables from The Worldwide Governance Indicators, 2012 Update. The blue line represents predicted values from the linear regression. The shaded area represents the 95% confidence interval.

1.5 Political Process of Institutional Deterioration - A Case Study for the Spanish Construction Bubble

In this section, I use the case of the Spanish construction bubble to support the third hypothesis made in this paper, that is, that the mechanism through which windfalls negatively affect the economy and institutions is political rather than solely economic.

Between 1999 and 2007, two thirds of the houses built in the European Union were built in Spain. Growth in investment doubled real GDP growth in the same period to finance an average of more than 500.000 new residential houses per year. By 2006, the share of real estate loans in the books of some Spanish Saving Banks, or *Cajas*, was of almost 50% (Montalvo (2007), Juan et al. (2011)). It was the largest real-state bubble in the EU and the largest Spain has ever had. Why was it not stopped earlier?

By March 2003 the Research Service of the Banco de España, the Spanish Central Bank, published a comprehensive study on the Spanish construction bubble (Montalvo, 2007). The conclusion was that housing was overvalued by 20%. In the following years until the bubble burst in 2008, the IMF, The Economist, the BBVA bank and many others documented on the systemic risks of a credit-driven real estate boom, dangerously accompanied by unsustainable current account deficits and loss of competitiveness. But, as Arellano and Bentolila (22Feb 2009) have pointed out, nothing was done.

Looking back it seems clear that some of the socio-psychological dynamics, similar to those self-fulfilling waves of optimism famously described by Shiller (2007) for the US housing bubble, were at play in Spain. But in order to understand the surprising inaction by the government during the boom years, animal spirits are not sufficient. I argue here that domestic political dynamics and institutions contributed to fuel the real-estate boom in the first place and, secondly, increased Spain's vulnerability to financial crises by re-shifting internal power. At the origin of these dynamics was what Fernandez-Villaverde et al. (2013) call the "Incestuous relation between Regions, Cajas and Developers". Here is one interpretation of what happened:

An exogenous rise in housing demand gave real estate developers a renewed relative economic power. Naturally, the initial "winners of the bubble" augmented their pressures on municipal and regional governments to support their building agendas. But these governments were not ready to counteract the windfall pressures, and economic interests quickly intertwined with political interests. The reason is that local administrations were too permeable to the influence of private interests. Lapuente (27 March 2009) has argued that part of the explanation is that Spain has a "Strong Mayor"-type of system (as opposed to the American more professionalized "City Manager") in which the Mayor has very limited constraints on power and few institutional watchdogs operate. This facilitates higher levels of politisation and increases the risks of corruption. Instead of promoting a good quality bureaucracy, Strong Mayor systems give the Mayor very much freedom as regards to hiring policies. For this reason this type of system is associated with patronage, understood as "the way in which party politicians distribute public jobs or special favours in exchange of electoral support" (Robinson et al., 2006, p. 379). When a large number of public employees owe their job to a political appointment, "clientelistic networks" are more likely to appear and reproduce (see Robinson et al. (2006) and Robinson and Verdier (2002)) when the bubble starts developing. Windfalls reinforce the process because "booms lead politicians to increase the extent of patronage in order to stay in power" (Robinson et al., 2006, p. 450). As a result, most managerial positions in the regional and local administrations ended up being colonized by the members of the clan with a clear objective in mind: winning the election (Lapuente, 2011).

Large windfall rents and the high discretion to manage them are also highly correlated to the regional fiscal profligacy experienced in Spain (particularly problematic when the bubble busted). Gelb (1988) argues that there is a tendency for ill-prepared small administrations to spend the windfall revenues in large, economically unsustainable projects. The case of the numerous pharaonic public projects built in the region of Valencia is very illustrative of this. Airports with no planes, ruinous Formula One circuits and theme parks without visitors where built with public money leaving behind a massive pile of regional debt.

Overall, small municipalities enjoyed new earnings (great windfalls in some areas) and the system favored the creation of a very powerful emerging coalition that governed following particularistic interests in the detriment of the many.

Meanwhile some crucial urban regulations as regards to the control over zoning and planning by regions were relaxed from 1994 on at different pace among regions. These new regulations gave local governments almost complete power over zoning and land qualification (Fernandez-Villaverde et al., 2013) and municipalities became monopolists selling a very precious good - land for construction. Townships had a new "manna from heaven": they could produce virtually as many new construction licenses as they wanted (or at least as many as geographic limitations would allow) and become immensely rich through real estate speculation.

The literature on corruption and rent-seeking has explored the large risks involved when politicians or government officials enjoy high discretion in the provision of scarce permits that are needed to carry certain lucrative economic activities (see Krueger (1974) for a classic example of the same problem in relation to import licenses in India). In Spain happened what (Shleifer and Vishny, 1993, p. 10) call a "free entry in the collection of bribes" as politicians could alter property rights to generate new rents to extract. These dynamics "were the perfect deal for politicians: money for their private pockets and money to keep voters happy" (Fernandez-Villaverde et al., 2013, p. 15).

All this could only happen because crucial financial intermediaries, the *Cajas* (Spanish Saving Banks) were ready to finance it. The *Cajas* are a genuinely Spanish invention, with long historical roots as regional institutions that go back to the 19th Century. They have traditionally captured the savings of small local investors and used them to lend to small businesses. After a series of liberalizing reforms in the 1980's and 1990's the *Cajas* were allowed to engage in all the functions in which the commercial banks engaged (Sagarra et.al 2011). They grew in size and expanded massively over the Spanish territory - by 2009 one branch for every 1000 inhabitants, almost twice the density of the euro-area average, according to the International Monetary Fund (IMF, 2012). As a result of this expansion the *Cajas* gained market quota against commercial banks (from 40% in 1991 to the 54.5% in 2007). Yet, they preserved their original legal-institutional characteristics as non-for-profit public commercial institutions that do not have shareholders and can neither be acquired, nor merged with normal commercial banks (only among them). Since they are not quoted in the stock market, share price and other mechanisms that play an important role in banks do not act as automatic disciplining channels (Cuñat and Garicano, 2010).

Cajas have a general assembly and a board made up of representatives from different stakeholder groups: founding entities, depositors, employees and public authorities. The latter group is formed by party appointed politicians by both local and/or regional authorities. Already quite large evidence suggests the *Caja's* risk and investment decisions were strongly influenced by their weak and politicised governance systems (see Illueca et al. (2009) and Cuñat and Garicano (2010)). They had an implicit government guarantee (a moral hazard problem that played also a central in the Asian crisis, see Krugman) that allowed them to borrow excessively and invest in highly risky real estate investments. The *Cajas* were also "winners of the bubble". And as long as the bubble continued they could continue growing and financing the dreams of local politicians (to win elections) and of real estate developers (to become richer and richer).

These institutions were crucial in defining the way in which the phenomenal credit inflow that Spain enjoyed after the Euro entry translated into a self-destructive construction boom. Existing institutions in Spain allowed economic power to translate into political power. Understanding and preventing such destructive political economy dynamics is of most relevance to prevent crisis in the future.

1.6 Conclusion

Theories on the effects of financial windfalls have been normally presented in the literature in isolation, rather than as a product of the interaction with existing domestic institutions. In this paper I have argued that initial institutions matter to determine the way financial windfalls turn into economic outcomes. I have provided some preliminary empirical evidence that the effect of windfalls is statistically correlated with the quality of original institutions. In this way, I provide support to the view that windfalls can be detrimental for the economy as argued in the literature, but not in a homogenous way. I conclude that the detrimental effects of financial windfalls in the economy are not inevitable: As the evidence on the effect of the EMU windfall shows, initial windfalls, when met by strong initial institutions, do not necessarily have a negative effect.

Moreover, I have argued for a politisation of the theory on financial windfalls, escaping the rigid conventional demarcations of the economics literature.

I have proposed a mechanism by which financial windfalls can be detrimental. I have argued that the political permeability of the established institutional framework, the capacity with which economic interests translate into *de facto* political power is crucial to understand the impact of any financial windfall. Finally, I have presented a case study on the Political Economy of the Spanish Boom that provides further evidence of the theories presented.

Surely in terms of research design, the first chapter has some limitations as the initial quality of institutions is difficult to disentangle from the institutional deterioration that came after, as a result of the financial windfall. Also the measurements for the quality of institutions and corruption are far from optimal, as they are often based on perceptions, which might also be biased by the cycle.

Further research will be required to test the hypotheses laid out in this paper. In particular, it would be important to extend the analysis to a larger sample.

1.A Appendix

1.A.1 Institutional Deterioration and Initial Institutions

Table 1.A.1: Institutional Deterioration and Initial Voice & Accountability

	(1)		(2)	
	Change CPI Rank		Change CPI Rank	
Change in Credit	-11.6**	(4.6)	-62.4*	(27.1)
Voice & Accountability in 1998	46*	(21.6)	-5.79	(33.3)
V&A 1998 * Change in Credit			41.4*	(21.8)
Constant	-58.6	(33.4)	8.19	(45.9)
Observations	12		12	
R^2	0.722		0.808	

Standard errors in parentheses

* p<0.1, ** p<0.05, *** p<0.01

Notes: Linear regression of change in Transparency International Corruption Perception Index ranking from 1999 to 2012 on the percentage change in adjusted average credit to the private sector before and after introduction of the EURO and the value of World Governance Indicator "Voice & Accountability" in 1998. The second regression includes the interaction term.

Table 1.A.2: Institutional Deterioration and Initial Rule of Law

	(1)		(2)	
	Change CPI Rank		Change CPI Rank	
Change in Credit	-11.4	(6.86)	-34**	(11.7)
Rule of Law in 1998	14.6	(13.9)	-7.45	(15.3)
RoL * Change in Credit			21.4*	(9.68)
Constant	-16.7	(27.7)	9.85	(26.1)
Observations	12		12	
R^2	0.628		0.769	

Standard errors in parentheses

* p<0.1, ** p<0.05, *** p<0.01

Notes: Linear regression of change in Transparency International Corruption Perception Index ranking from 1999 to 2012 on the percentage change in adjusted average credit to the private sector before and after introduction of the EURO and the value of World Governance Indicator "Rule of Law" in 1998. The second regression includes the interaction term.

Table 1.A.3: Institutional Deterioration and Initial Government Effectiveness

	(1)		(2)	
	Change CPI Rank		Change CPI Rank	
Change in Credit	-5.35	(5.17)	-23**	(9.09)
Government Effectiveness in 1998	27.3**	(9.29)	8.45	(11.6)
GE 1998 * Change in Credit			13.6*	(6.15)
Constant	-48.6**	(21.1)	-19.6	(22)
Observations	12		12	
R^2	0.787		0.868	

Standard errors in parentheses

* p<0.1, ** p<0.05, *** p<0.01

Notes: Linear regression of change in Transparency International Corruption Perception Index ranking from 1999 to 2012 on the percentage change in adjusted average credit to the private sector before and after introduction of the EURO and the value of World Governance Indicator "Government Effectiveness" in 1998. The second regression includes the interaction term.

Table 1.A.4: Institutional Deterioration and Initial Regulatory Quality

	(1)		(2)	
	Change CPI Rank		Change CPI Rank	
Change in Credit	-13.6**	(5.2)	-31.2**	(11.9)
Regulatory Quality in 1998	13.2	(11)	-8.85	(17)
RQ 1998 * Change in Credit			17.7	(11)
Constant	-9.83	(19)	15	(23.3)
Observations	12		12	
R^2	0.640		0.728	

Standard errors in parentheses

* p<0.1, ** p<0.05, *** p<0.01

Notes: Linear regression of change in Transparency International Corruption Perception Index ranking from 1999 to 2012 on the percentage change in adjusted average credit to the private sector before and after introduction of the EURO and the value of World Governance Indicator "Regulatory Quality" in 1998. The second regression includes the interaction term.

Chapter 2

The Political Economy of Dual Labour Markets in Europe: A Review

Abstract: Despite the overwhelming consensus on the negative effects of dual labour markets on the economy, governments strongly resist reforming these institutions. This paper provides a review of the existing literature on the political economy of reform of dual labour markets. I address two questions in this review. First, why are dual labour markets so persistent over time and, second, what are the drivers of dual labour market reforms. I find three insights that should help develop further research in the area. First, despite the falling social support of trade unions, collective bargaining structures continue to be a key element for insiders to preserve their influence. Second, I don't find conclusive evidence that the political preferences of insiders actually diverge from those of outsiders. This gap in the theory might explain, in turn, why duality is so persistent. Third, I find that economic hardship does lead to reforms. However, I show that it is the interaction between crisis and EMU surveillance that seems to lead to duality reducing reforms in Europe.

2.1 Introduction

The dramatic increase in unemployment towards the end of the 1970s and the beginning of the 1980s led to a reformist push in Europe and the US. European governments reacted in two different ways. The first consisted in strengthening the already stringent Employment Protection Legislation (EPL, hereafter), with the objective of reducing job destruction. The second was to introduce more labour market flexibility at the margin, through the implementation of flexible, fixed-term (or temporary, used interchangeably from now on) contracts, with the aim of boosting job creation. The result was a spectacular rise in temporary work in some countries, particularly in southern European economies.

Duality is characterized by the existence of two types of workers: insiders, with permanent contracts that enjoy strong employment protection and job stability, and the rest of the labour force, the outsiders, including the unemployed, involuntarily underemployed, those on fixed-term contracts that enjoy very limited employment protection as well as those working in the shadow economy. The two types of workers, the insider-outsider theory assumes, have different interests, with insiders interested in preserving a high level of employment protection, and outsiders concerned about reducing rigidities so to have an easier access to employment and job stability.

Today, according to Eurostat, dual labour markets are a widespread phenomenon in the EU. In 2016, the proportion of employees' aged 15-74 in the EU-28 with a contract of limited duration (fixed-term employment) was 14.2%. More than one in five employees in Poland (27.5%), Spain (26.3%), Croatia, Portugal (both at 22.3%) and the Netherlands (20.8%) had a temporary contract. Fixed-term contracts typically offer small severance payments, few administrative steps, and limited judicial costs, so they are much less costly for firms to use than permanent (or open-ended, used interchangeably from now on) contracts. But temporary jobs are also associated with low-skilled activities, low pay, precarious conditions and minimal rights and benefits. Some segments of the labour market, such as young workers, women and low-skilled workers, are significantly more likely to hold temporary contracts than the rest of the labour force.

Most part of the literature on dual labour markets has focused on the negative effects of duality in labour market outcomes and the overall economy. As I will show, two-tier labour markets are associated with high turnover levels and lower investment in training and human capital, which translates in lower productivity levels and higher unemployment. However, despite the overwhelming consensus on the negative effects of duality, little attention has been paid to the reasons behind the strong persistence of labour market duality in EMU. In fact, as I will show, over the years, European governments have passed a substantial number of labour market reforms. However, these reforms have rarely contributed to reducing the insider-outsider divide (or wedge).

The goal of this paper is to provide an overview of the literature on the political economy of reform of dual labour markets, with a focus on the causes of duality and the drivers of reform. More specifically, two central questions are addressed: (1) what are the power configurations that allow the duality equilibrium to be so persistent over time and; (2) under what conditions such equilibrium might change to facilitate reforms to reduce the wedge between insiders and outsiders.

The main findings of this review regarding the first question are as follows. First, dual labour markets are strongly persistent because the political influence of insiders in designing the policy agenda continues to outweigh that of the outsiders, despite the latter group having grown in size persistently over time across the continent. Insiders are better organized and workers on permanent contracts continue to exercise a strong influence through trade unions. This is despite the deep transformations that have occurred in the labour markets over the last decades. Trade unions have not managed to internalize in any meaningful way the interests of outsiders, and continue to represent the preferences if insider workers across different European welfare regimes.

While trade unions have lost a significant amount of social support and affiliation, they have managed to preserve a strong influence, mainly, through informal institutions. Most importantly, collective bargaining structures emerge as a crucial factor, to explain why the power of insiders remains so prominent today. It is through these bargaining tables that trade unions manage to, de facto, influence fundamental policy decisions such as the way wage levels are settled or the degree of flexibility firms have to adapt working times to changing economic conditions. This finding is particularly relevant because the focus in the literature is, essentially, on the political economy of formal institutions such as EPL. A first straightforward conclusion from this finding is that in order to understand the reasons for the stickiness of two-tier labour markets, further research should focus on the varieties of collective bargaining structures across European welfare regimes – a good recent example of this research is Palier and Thelen (2010).

Secondly, a significant amount of the literature has focused on the influence of insiders in defining the policy agenda through social-democratic parties. While this theory (first proposed by Rueda (2005)) might still explain part of the divide – ie trade unions continue to have a strong political influence on social-democratic parties – the increasing fragmentation of the electorate and the rise of a large amount of new political parties and platforms would require, perhaps, a revision of the theory. This review concentrates, however, on another, equally relevant, issue that remains puzzling in the literature: do outsiders actually show political preferences that are systematically different than those of insiders?

The classic theory on the insider-outsider divide assumes that insiders and outsiders have fundamentally opposing preferences (see Lindbeck and Snower (1988), Saint-Paul and Rueda (2005)). While the former will actively defend stronger employment protection, the latter will want to increase flexibility in order to have easier access to employment. In this review, however, I don't find conclusive evidence that supports this central assumption in the literature. If that assumption does not hold, and the political preferences of insiders do not actually diverge from those of outsiders, it would be absurd to expect outsiders to organize themselves to fight duality, thus becoming also agents of the status-quo.

Here, the contribution of Emmenegger (2012) opens new avenues of research that remain largely unexplored, particularly as regards to the bounded-rationality argument in his critique to the classic insider-outsider theory. Just by opening any newspaper one can easily see his point. Journalists will probably blame globalization, technological change, or capitalism for the increasing precariousness of the labour market, but it is very unlikely you will find any journalist pointing at the stringency of EPL of permanent workers as a cause of the precariousness of the rest. Probably as a result of the immense complexity of labour market regulations the insider-outsider divide has not been politicized. And this, in turn, makes it more difficult to reform.

As regards to the drivers of reforms that reduce the duality wedge, this paper also adds two relevant contributions. First, I point to the economic cycle as a key driver of reforms in EMU. While most of the existing literature focuses on the politics of reform in the bad part of the cycle, I provide some evidence on what happens to labour market reforms in periods of bonanza. What the data shows is that over expansionary periods in EMU the rhythm of labour market reforms drops abruptly and the insider-outsider wedge does not change. This has a direct relevant implication for policy: in order to reduce social suffering, a lot more focus should be posed on how to drive governments to reform during the expansionary part of the cycle, when there is fiscal space to compensate the losers of reform.

I identify four periods of reform intensity in EMU. Over the decade that preceded the Euro, the EMU convergence criteria seem to have provided a strong incentive for reforms. However, after entering the monetary union, the relaxation of credit constraints made it easier for countries to get indebted, so necessary labour market reforms were delayed and, in fact, in terms of reform activity the wedge between insiders and outsiders did not change meaningfully. The third period starts with the Great Recession whereby reform activity increases abruptly. The key finding here is that the employment protection of insiders decreased, while the protection of outsiders increased, meaning that the EMU crisis contributed to reduce duality. Finally, with the beginning of the recovery and the intervention of the ECB to ease credit constraints, the rhythm of reforms diminishes considerably again.

The second finding might open a relevant nuance for the study of the political economy of reforms of dual labour markets in Europe: while there is no conclusive evidence in the literature that crisis lead to duality reducing reforms, this paper finds that the interaction between economic hardship and EMU surveillance seems to be more effective at reducing the insider-outsider divide. Further research in this area would help to better understand how specific political economy dynamics in EMU are associated with reform activity across welfare regimes. Finally, domestic political factors also influence reform; case studies show that effective consultation and communication, preserving insiders rights or compensation of losers of the reform help for successful duality-reducing reforms.

The paper is structured as follows: In the Section 2.2, I study the negative effects of duality on labour market outcomes and other economic variables, as well as the existing policies proposed in the literature to reduce duality. In Section 2.3, I provide a review of labour market institutions and how they interact with the insider-outsider divide. In Section 2.4 I exploit data on labour market reforms to study reforms in EMU over the last three decades and how these reforms have affected duality. In Section 2.5 I analyse the politics of the insider-outsider divide, I review the classic insider-outsider theory and the criticisms to the theory. In Section 2.6 I explore the drivers of duality reducing reforms. And in Section 2.7 summarizes the main findings and Section 2.8 concludes.

2.2 The negative effects of duality

The economics literature on duality has focused on the effects of two-tier systems on labour market outcomes and other economic variables. A significant amount of evidence shows that dual systems have strong negative effects on labour market outcomes. They show lower human capital formation by workers, unequal opportunities for workers (particularly young workers), social exclusion, excessive job rotation and higher unemployment.

Two-tier systems isolate permanent workers from the economic cycle, increasing their bargaining power and decreasing the response of wages to unemployment (Bentolila and Dolado, 1994). While insiders have become shielded from economic shocks, outsiders act as a buffer, bearing the costs of economic fluctuations. In Spain, for instance, which stands out as an extreme case of labour market duality, temporary contracts accounted for more than 90% of new hires and above 25% of the total in 2016, while unemployment levels were still above 20%. The new boom of temporary jobs in Spain is just the mirror of the huge destruction of temporary jobs over crisis that preceded it: between the first quarter of 2008 and the second quarter of 2011, 60% of temporary jobs were lost in net terms (650.000) Bentolila et al. (2012a).

Second, dual systems provide strong incentives for companies to dismiss workers at the end of their temporary contract, leading to higher turnover levels (Blanchard and Tirole, 2008). This is because firms prefer to substitute one temporary worker by another, avoiding offering much costlier permanent jobs. This penalizes new entrants to the labour market, making it very difficult for young workers to access job stability. In this process, because of the "invisible wall" that protects certain workers over others, potentially better-prepared workers are left out of the labour market. Cahuc et al. (2016), for instance, show that strong legal constraints on the termination of permanent jobs have a strong positive impact on the turnover of temporary jobs: the more stringent the regulation for permanent jobs is, the lower the job stability faced by temporary workers.

Third, because of the high turnover, companies tend to invest less in training temporary workers and this has a negative effect on their human capital accumulation and productivity. For instance, Cabrales et al. (2014), using micro data from the Programme for the International Assessment of Adult Competencies (PIAAC), document cross-country evidence on how the wedge in employment protection between permanent and temporary workers is associated with a large differential in on-the-job training, with the latter receiving considerably less training. Boeri and Garibaldi (2007), based on firm-level data on Italy for the period 1995-2000, find evidence that firms with a higher share of temporary workers experienced lower growth in productivity.

Another way at looking at the abuse of temporary work (for non-temporary activities, for instance) by certain firms is that they are taking advantage of social security systems and taxpayers to finance a business strategy that should not be supported by the public sector. When a worker loses his job, social benefits are automatically activated. When companies abuse temporary contracts as part of their business strategy, they are taking advantage of social security systems without having to internalize such cost.

Fourth, there are a number of other socio-economic consequences associated with having a regulation that penalizes young workers in the labour market. Job instability and precariousness are associated with postponing important life decisions such as emancipating from the parents house or having children. According to Juan J. Dolado and Jimeno (2002), higher uncertainty with regards to the duration of the contract is associated with lower mobility rates as well as lower fertility rates. Spain, which in 2018 was the country with a higher temporality rate in EMU, was also the country with the lowest fertility rate.

Fifth, a higher duality is also associated with higher unemployment levels. Blanchard and Landier (2002), looking at the experience of France since the early 1980s, argue that allowing firms to hire workers on fixed-term contracts leads to a higher turnover in entry-level jobs, resulting in higher, rather than lower, unemployment. In a comparative study of France and Spain over the Great Recession, Bentolila et al. (2012b) find that unemployment grew much more rapidly in Spain than in France over the crisis as a result of the gap (or wedge) between the dismissal costs of workers with permanent and temporary contracts, and the laxer rules on the use of temporary contracts in Spain than in France. This is because the higher the gap, the lower the proportion of temporary jobs that are converted into permanent jobs, especially if restrictions of the use of temporary jobs are de facto very limited, like in Spain. The authors conclude that "Spain could have avoided about 45% of its unemployment surge had it adopted the French employment protection legislation" (Bentolila et al., 2012b, p. 155).

2.2.1 Varieties of insider-outsider regimes

The literature on Varieties of Capitalism introduces other interesting dimensions to the debate on the negative effects of the insider-outsider divide. Labour markets have gone through a deep transformation over the last three decades. The general trend has been to substitute traditional forms of work associated with the industrial world (for-life jobs with high protection and high stability) for an increasing segmentation of the labour market. The reasons for this structural change in labour markets are many; the increasing relevance of the service sector, the increased labour force participation of women, technological transformations, among others.

These developments have led to a boom in atypical work, increasing temporality, with a growing proportion of workers becoming outsiders. However, the actual impact of this segmentation has not been homogenous across countries and welfare regimes: while public policies in certain places have tended to mitigate the negative effects of segmentation, in others they have contributed to perpetuate the insider-outsider divides.

Häusermann (2012) study how these structural changes in labour markets have actually translated into social divides and structural disadvantages for outsiders in social, economic or political outcomes. The authors conclude that for countries belonging to the Liberal regime type, segmentation is associated with large income inequality, particularly affecting low-skilled workers, and poor access to training. However, these inequalities are reduced by the intervention of the state. Regarding political access and participation, outsiders typically are less active in elections than insiders.

Conversely, in Nordic countries, women are the most affected by labour market segmentation and, while there are significant ex-ante income inequalities between insiders and outsiders, these inequalities are largely corrected through taxes and transfers. Moreover, better policies regarding access to training and promotion policies for outsiders reduce considerably the *de facto* penalization of atypical workers. Remarkably, in terms of political participation (in elections and trade unions), no difference is observed between outsiders and insiders.

In Continental European countries, gross income gaps between insiders and outsiders are significantly larger than in all other regimes - reaching a difference of up to 30-40 percent - and access to training is also poorer for outsiders than it is for insiders. Worryingly, the intervention of the welfare state in these economies, according to the authors, tends to reinforce rather than reduce the insider-outsider divide, for instance through the Pension systems in France and Germany.

Finally, inequalities between insiders and outsiders in Southern European countries tend to be smaller than in Continental European countries, although the welfare state seems to be also inefficient in correcting these inequalities. Rather than decreasing, the divide between insiders and outsiders increases after taxes and transfers. This pro-insider institutional bias, according to the authors, reflects the poor political integration of outsiders, who are much less active in trade unions and participate less in elections than outsiders in other welfare regimes.

For the purposes of this paper, the distributional effects associated with the insider-outsider divide in different welfare regimes are very relevant. This is because they might affect the political behaviour of insiders and outsiders. In the words of (Häusermann, 2012, p. 3):

> "if unemployment or atypical unemployment is not linked to concrete disadvantage in terms of labour market power, welfare rights, or political integration, the insider-outsider divide may well remain as a purely sociological distinction without further political relevance"

As we will see in 2.4, one of the main gaps identified in the classic insider-outsider theory of employment and unemployment (Lindbeck and Snower (1988), Saint-Paul (2000) and Rueda (2005)) is that the predicted rational preferences and political behaviour of outsiders (i.e. that they will have divergent preferences as regards to insiders on employment protection legislation and that these preferences will translate into different political behaviour) are not observed in the data in any systematic way. This might be one of the reasons why dual labour markets are so hard to reform. For purposes of future research, it would be of interest to strengthen the empirical evidence proposed by Häusermann (2012) to evaluate whether the political preferences of outsiders do indeed vary systematically across welfare regimes, and whether this is associated with the effective of the welfare state in correcting the insider-outsider divide.

2.2.2 Tackling duality

Reducing the firing cost gap between temporary and permanent workers has been on the European academic and policy agenda for a long time. The OECD and the IMF have alerted on multiple occasions of the costs of rising duality. Influential economic newspapers such as The Economist have denounced the existence of the insider-outsider divide in the labour market as a "two class society" ("Insiders and Outsiders", 2006, October 26). The IMF, in their evaluation of labour market policies over the Great Recession in Europe, argue that "dual employment protection, where high employment protection on permanent contracts coexists with lighter regulation on temporary contracts, should be avoided" (Blanchard et al., 2014, p. 6).

The literature has proposed a number of different ways to reduce the insider-outsider divide. These include (1) reducing employment protection and the costs for terminating open-ended contracts; (2) increasing the costs for terminating fix-term contracts; (3) the implementation of bonus-malus systems to promote (or penalize) job stability (volatility) through lower (higher) social-security contributions; (4) facilitating the conversion of fix-term to permanent jobs through different types of subsides and (5) introducing a single open ended contract with severance pay that is increasing with seniority (see Bertola (2014)).

So far, the success of most of these policies has proven to be very limited and in some cases very costly. In Spain a number of measures have been implemented to incentivize the conversion of temporary contracts into permanent contracts, with very poor results. Given that these incentives were paid for all conversions, companies that were anyway going to offer a permanent position received the subsidy. For instance, Garcia Perez and Rebollo Sanz (2009) evaluate the effectiveness of regional wage subsidies to foster permanent employment and they find that the outflow into permanent employment of eligible workers improves only minimally.

The so-called "single contract" has been in the policy agenda of a number of European countries for years. Such a contract would imply the effective elimination of all alternative contract types (with some exceptions) and as a result would eliminate completely the wedge between temporary and permanent workers, ending duality. Examples of proposals of a "single contract" for all workers include Blanchard and Tirole (2004) for France, Boeri and Garibaldi (2007) for Italy or FEDEA (2009) for Spain.

While there is still discrepancy as regards to the optimal design of the single contract, existing proposals tend to agree on a model with increasing layoff costs over time. Such a design would provide the necessary flexibility for all workers at the beginning of their contracts, while eliminating, at the same time, the wedge of protection at a certain threshold. This would eradicate the incentives of firms to disregard workers driven by arbitrary regulatory reasons, thus improving the efficiency of the system.

In terms of reforms, the implementation of the "single contract" has encountered strong legal and political difficulties. Renzi's Jobs Act has so far been the most ambitious attempt of reducing duality through changes in the contract system, with the introduction of a new open-ended contract with increasing protection over time, aimed at substituting the large variety of existing contracts (see Sestito and Viviano (2016) for an in-depth analysis Renzi's Jobs Act and its initial effects on labour market outcomes).

In this section we have reviewed the negative effects of dual labour markets on a number of variables, as well as the policies to address them. We have also seen that the political implications of the insider-outsider divide might be mitigated by effective welfare distribution, which, in turn, might vary across welfare regimes. In the following section we study European labour market institutions and how these relate to duality.

2.3 Labour Market Institutions in Europe

According to (Boeri, 2011, p. 1182) a "labor market institution is a system of laws, norms or conventions resulting from a collective choice, and providing constraints or incentives which alter individual choices over labor and pay". These institutions include formal and informal regulations that determine a variety of rules and rights for workers and firms, such as different contractual formulas, minimum wages, or the benefits mothers are entitled to while on maternity leave. But labour market institutions also include more informal norms and arrangements such as collective bargaining structures, which are often not written down in laws. All these institutions end up affecting in one way or another almost everything in the economy: employment and unemployment levels, the wages that workers take home, firms' revenues, the temporality rate, as well as the opportunities young workers have to progress in their job.

For research purposes, the OECD (Tompson, 2009) classifies labour market institutions according to four categories: (1) Employment Protection Legislation (EPL), which refers to the regulations and costs associated with hiring and dismissing workers (rules for the use of fixed-term or part-time contracts, firing compensations, procedures for collective dismissals of workers, judicial costs, etc); (2) Unemployment Benefits (UB), which include cash transfers to compensate for unemployment, redundancy payments and various measures to support specific groups of workers; Active Labour Market Policies (ALMP), which include training programmes, hiring subsidies for disadvantaged workers, activation schemes, support and orientation in transition periods, etc. and (4) the Tax Wedge which the OECD defines as "the ratio between the amount of taxes paid by an average single worker without children and the corresponding total labour cost for the employer".

Naturally, different combinations of these institutions, translate into very different labour market results. Political scientists - in particular the literature on Varieties of Capitalism - have identified four types of labour market regimes in Europe: (1) the Liberal or "Anglo-Saxon" model, which is associated with low unemployment, short employment duration, low EPL and low UB; (2) the "Nordic" model, which is also associated with low unemployment, medium EPL and high UB, combined with conditionality and strong active labour market policies, (3) the "continental" model, with medium unemployment, high EPL, generous UB and poor ALMP that limit reallocation and (4) the "Southern" model with high unemployment, generous UB and poor ALMP (see Thelen (2001), for instance, for a good summary of the literature on Varieties of Capitalism and labour markets as well as for different typologies).

2.3.1 Collective Bargaining Structures and duality

Besides the existing formal institutions analysed in the previous section, there are other relevant informal institutions that matter for the study of the political economy of dual labour markets, most importantly bargaining structures. It is through collective bargaining negotiations that wages are determined and hence, the outcomes of these negotiations directly affect the insider-outsider divide. Furthermore, depending at the level at which these negotiations take place, the agreements achieved also determine the internal flexibility that firms enjoy to adapt to the cycle, for instance, by adjusting the working time of their workers. This, in turn, might have a strong effect on the insider-outsider wedge: if the agreements on flexibility are very stringent, outsiders will pay the consequences by losing their jobs. Moreover, social partners (trade unions and business associations) also play a key role in labour market reform consultations and in many cases they are crucial partners for a reform to succeed (see for instance Sestito and Viviano (2016)).

Collective bargaining structures vary across countries. Some countries have nationally centralized systems and others determine wages at industry or plant-level negotiations. Other countries have two-tier systems in which multi-employer wage agreements (at regional, industry or country level) coexist with firm-level negotiations over many issues, including pay levels or work-time flexibility (see for instance Boeri (2015)).

Given that trade unions and employer organizations are responsible for establishing the way these bargaining structures work as well as in defining wage-setting negotiations, the interests they represent are crucial to understand the outcomes of these negotiations. Data shows that workers with permanent jobs (insiders) are strongly over-represented and, although collective bargaining structures vary across countries, the same patterns of representation are reproduced in most European countries (see for instance Checchi and Lucifora (2002)).

In a study on the insider-outsider divides in Spain (Dolado et al., 2010) find that 85% of the workers affiliated to unions are on permanent contracts. They also observe that affiliation is strongly biased in age and gender. Women and young workers are underrepresented. Moreover, public sector workers are much more likely to be affiliated to a trade union than workers in the private sector. Also, workers in large-companies and workers that have been a long time in the firm tend to be over-represented. Remarkably, the authors also find that in the first two years of the Spanish economic recession (between 2007-2009), 99.3% of the employment destroyed was among workers that had no trade union affiliation, a large majority of them on temporary contracts (with significantly lower dismissal costs) (Dolado et al., 2010).

It is precisely in periods of crisis, when collective bargaining institutions matter the most, because firms need to be able to adapt quickly to the economic cycle. In strongly dualized economies with low protection for temporary workers, insiders tend to be shielded from macro-economic shocks and outsiders work as a buffer for the adjustment. Existing legal limitations to adjust wages in some European countries and resistance by permanent workers - the workers sitting at the bargaining tables - to adapt their conditions normally means that firms have to adjust the quantity of work (rather than the price of it). Since it takes time until insiders feel threatened (see Section 2.5 on the drivers of duality reducing refoms) pay-levels do not adjust quickly to economic and productivity variations, and outsiders pay the consequences.

The role of employer organizations in collective bargaining structures also matters for the insider-outsider divide. Given that large companies usually control these organizations, wage-setting negotiations are used instrumentally to reduce wage competition from smaller companies (Boeri, 2015). Small companies (SMEs) are largely absent from collective bargaining structures (they are underrepresented both in terms of workers in unions and as firms in employment organizations) and this hinder their competitiveness vis-à-vis big companies while limiting their capacity to grow.

According to Palier and Thelen (2010), collective bargaining structures are the most important institution driving the persistence of duality. The authors analyse the evolution of collective bargaining and industrial relations over recent decades, and conclude that "in both countries the structures put in place in the 1970s and early 1980s to enhance labour's voice at the plant level ironically provided ideal vehicles for fuelling trends toward dualism when economic hard times hit" (Palier and Thelen, 2010, p. 126). This is because, they argue, it is through collective bargaining structures that trade unions have managed to successfully preserve protection for core workers, while accepting increased flexibility for other types of jobs. This, as we will see in Section 2.4 on the theory of the insider-outsider divide, goes against one of the central arguments put forward in the literature: Rueda (2005)'s view that social-democratic parties, and not collective bargaining structures, are the main responsible for the rise of dual labour market structures.

One of the key collective bargaining mechanisms that has allowed trade unions to preserve their influence is the automatic extension to all workers in the economy of agreements achieved at country (industry or regional) level. In France this is called the *procedure d'extension* – a legal device by which sectorial or national agreements are extended to all companies in the industry or the country, even if only a minority of unions and business associations has supported them.

These automatic extensions function in the same way as they did 30 years ago, despite the fact that affiliation to trade unions has fallen, persistently, in recent decades. Germany's affiliation rate today has gone below 25 percent, while in the 70s it peaked at 35 percent. In Spain, while only about 13 percent of workers are affiliated to a trade union, these still determine working conditions for more than 90 percent of workers. In France, organization rates have fallen below 10 percent in recent years, although in the 60s they were close to 20 percent. It is important to note that norms like the *procedure d'extension* have allowed trade unions to preserve a large amount of power, consolidating insiders' interests in detriment of outsiders, despite loosing huge social support.

It goes beyond the scope of this paper to try to understand why different combinations of these institutions exist in the first place in different countries. But the fact that these institutions have deep historical roots and are culturally and socially embedded in societies, might be one of the reasons why well-designed formal institutional reforms are not easy to implement or transplant from one place to another (Blanchard et al., 2014).

Informal institutions and civic attitudes, such as the level of trust between firms and workers have a large explanatory power in cross-country evidence on levels of absenteeism and the extent to which workers abuse the unemployment benefit system. Conversely, higher trust might help to improve dialogue between social partners and to reach shared commitments (Blanchard et al., 2014, p. 5). Moreover, civic attitudes tend to be very sticky, meaning that they might be an invisible constraint for successful reforms in certain European countries. For instance, as Agell (1999) argues, "persistent social norms are an independent and important cause of wage rigidity (. . .) and "when these norms are a binding constraint on behaviour, legal reform may accomplish very little". All in all, the relevance of other informal labour market institutions and their impact on labour market outcomes deserves further exploration.

Regarding the political and historical origins of duality specifically, the literature is not very extensive either. Rueda et al. (2015) provides perhaps the most ambitious explanation, by linking the economic policy decisions in the aftermath of World War II, to the emergence of labour market regulations, and the extent of labour market dualism today. He argues that "policies developed with an eye toward internally-oriented industrialization (ISI) left a powerful imprint on labour market regulations aimed at protecting labour market insiders" (Rueda et al., 2015, p. 3). On the other hand, Rueda et al. (2015) argue that, consistent with the need to respond to dynamic market signals, the most open and externally oriented economies in the 1960s, like the Scandinavian countries, promoted rather low levels of employment protection combined with high levels of social compensation.

2.4 Labour market reforms in Europe

An analysis of the number and characteristics of labour market reforms in Europe points to some interesting facts. As regards to the number of reforms between 1980 and 2014, European countries implemented an average of almost two reforms per year per country (460 for seven selected countries of the Eurozone, according to Boeri (2011)).

Since the 1990s, four different periods can be identified. The first is the decade that goes from 1990 to 1999 whereby reform activity increases in most Continental and Southern countries in all policy areas, presumably to meet the core EMU convergence criteria. Over this period the economies that had committed to enter the Euro went into the Exchange Rate Mechanism, which forced them to stabilize their nominal exchange rates. Moreover, the Maastricht Treaty, signed in 1991, established ambitious targets on debt, deficits and inflation. These factors left little space, particularly for the more backward Southern

European economies, to avoid necessary reform (see Hancké and Rhodes (2005)).

The second period goes from 1999 to 2007 in which most countries reduce reform activity, probably as a result of the relaxation of constraints, particularly in the South, presumably as a result from the massive flow of cheap credit (see Fernandez-Villaverde et al. (2013)). The third period goes from 2007 to 2012, the harshest years of the financial and debt crisis. Over these years reform activity increases abruptly, and it concentrates in the Southern economies. The fourth period, which goes from 2012 until today, shows again a moderation in the number of reforms. One possible explanation for that could be the return to growth and, generally lower external constraints, with bailout programmes ending and the ECB intervening as a lender of last resort for these economies, relaxing monetary conditions.

In what follows I will be analysing the Labour Market Reforms Database (LABREF) compiled by the European Commission, which covers all labour market reforms and relevant collective agreements and tripartite agreements enacted and implemented in Europe from 2000 to 2016. Reforms and agreements are classified into nine different policy domains, covering labour taxation, unemployment benefits, other welfare-related benefits, active labour market policies, job protection legislation, disability and early retirement schemes, wage bargaining, working time organisation, immigration and mobility. For each measure, it also identifies the policy field. For instance, in the domain of unemployment benefits, it identifies whether the measure affected coverage and eligibility conditions, duration, the net replacement rate or search and job availability requirements. It also identifies the direction (increasing or decreasing) of the policy measure, which differs depending on the policy area. For instance, an "increasing" reform in unemployment benefits would be interpreted as increasing the generosity of unemployment benefits and relaxing the job search and availability requirements. In job protection legislation, an increasing reform measure would mean that it increases the level of protection against job dismissals or severance pay. Interestingly, the database also identifies the population that is affected by the reform, i.e. whether it just concerns new entrants, incumbents, or both, and whether it affects temporary workers or permanent workers. The number of reforms recorded in this database is very large, because one single legistative initiative might affect several policy domains, and/or different types of individuals, and will therefore be recorded more than once.[1] The aim of this analysis is to see trends over time in reform activity that affects labour market duality.

Figure 2.1 below shows the average number of labour market reforms per country in the South of Europe (Cyprus, Greece, Italy, Portugal and Spain) and in what I denote the Core countries (Austria, Belgium, Finland, France, Germany, Luxembourg, Netherlands) between 2000 and 2016. The rhythm of reforms is almost flat until the start of the Great Recession in 2007, when reform activity increases across the board, and especially for those countries more severely affected by the financial and sovereign debt crisis (South). The average number of reforms in Southern countries rises from around 11 in 2007 to 33 reforms in 2012, while Core countries introduced on average about 9 reforms in 2007, and 14 in 2012. After the announcement of the European Central Bank (ECB) to do "whatever it takes" to stabilize financial markets, reform activity drops sharply in the South, while it remains at a level higher than that prior to the crisis for Core countries.

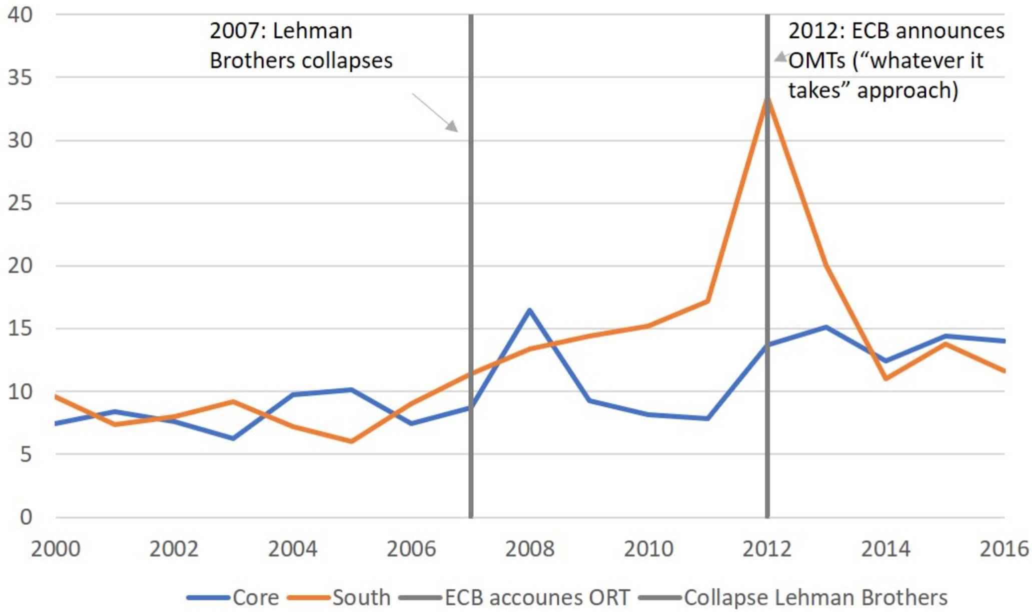
Naturally, the rhythm of reforms has varied over time, among countries as well as policy areas. According to the analysis of Alessandro Turrini (2014) using the LABREF database, reforms have been more frequent in active labour market policies (ALMP) and labour taxation than in employment protection legislation (EPL). However, the reform patterns have not been homogenous across country groups. While core countries have focused more on reforming ALMPs, Southern countries show a higher frequency of reform activity in EPL, particularly towards the end of the decade.

Countries have, indeed, carried out reforms, although not always in a direction that increased efficiency or improved equity. For the purposes of this paper what matters is whether reforms contributed or not to reduce duality (ie the insider-outsider wedge). One way at looking at this is by analysing the direction of reforms. That is, for instance, whether reforms decrease (increase) EPL protection or reduce (augment) the generosity of unemployment benefits and so on.

Over the whole period analysed, the LABREF data indicates that European countries follow a common trend towards strengthening ALMPs. As regards to

[1] For a more detailed description of the database, see Alessandro Turrini (2014).

Figure 2.1: Average Number of Labour Market Reforms undertaken by countries in Core and South of Europe



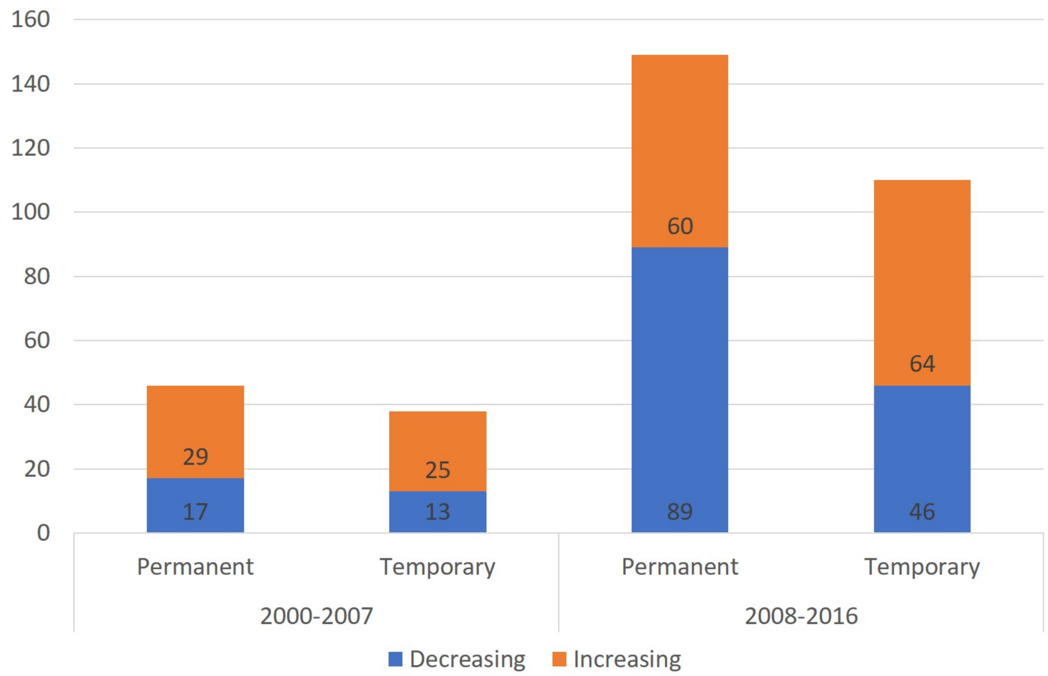
Source: Based on LABREF data. Notes: The graph shows the average number of labour market reforms undertaken per country per year, for different country groups. The numbers are derived by summing up the total number of all labour market reforms undertaken in each country of each group and dividing by the number of countries in the group. Core countries include Austria, Belgium, Finland, France, Germany, Luxembourg, Netherlands. South includes Cyprus, Greece, Italy, Portugal and Spain.

EPL, which is the most relevant area affecting the insider-outsider divide, an increased frequency of reforms addressing the EPL regime for permanent workers is observed after 2006. Two periods can be easily identified. Over the short decade that preceded the crisis the data does not show a clear direction towards increasing or decreasing EPL protection (or reducing the wedge) between permanent and temporary workers. In fact, EMU countries implemented a similar amount of reforms in both directions: increasing and decreasing the protection of permanent and temporary workers (taken here as a proxy for insiders and outsiders).

Figure 2.2 shows the total number of reforms undertaken in EPL, divided by whether they were targeted at temporary or permanent workers, and whether they increased or decreased EPL for these workers. We see the following pattern: in the period prior to the crisis (2000-2007), about the same overall number of reforms were targeted at temporary workers (38) and permanent workers (46), and the proportion of reforms that increased EPL and those that decreased EPL was very similar for both temporary (66% vs 33%) and permanent workers (63% vs 37%).

Since the onset of the crisis, the number of EPL reforms has increased substantially for both permanent and temporary workers, but much more so for the former (to 149 for the former and 110 for the latter). Moreover, permanent workers were much more frequently the target of EPL-decreasing reforms (60%) than EPL-increasing reforms (40%) in the period since the crisis, while temporary workers faced a much larger number and proportion of EPL-increasing reforms (60%) than EPL-decreasing reforms (40%). This means that in the period after the crisis, the pattern of reforms can be regarded as decreasing duality, driven by a relatively stronger reduction in the protection of permanent workers, and a relatively faster increase in protection of temporary workers.

Figure 2.2: Total Number of Employment Protection Legislation Reforms undertaken by countries in Europe targeted at temporary and permanent workers in the pre- and post-crisis period



Source: Based on LABREF data. Notes: EPL decreasing reforms are reforms that resulted in a reduction of employment protection, while those that are defined as increasing made employment protection more stringent.

As shown in the following Section, this data coincides with the predictions in the literature on the political economy of reforms in dual systems: it is only when insiders feel threatened by high and rising unemployment, that reforms to reduce EPL protection for permanent workers (and hence reduce duality) are possible (see for instance Saint-Paul (2000) and Juan J. Dolado and Jimeno (2002)). The fact that EPL for temporary workers does increase over the crisis period, as can be observed in the graph, might reflect a gradual adjustment from previous reforms reducing their protection and increasing segmentation.

A similar pattern is observed when looking at the FRdB database. According to Boeri (2011): a majority of reforms of employment protection from 1980 to 2007 focus only in the flexible tier of the labour market and, hence, increase dualism in European labour markets. This reinforces one important argument predicted by the theory: it is during periods of crisis, when unemployment is high and growing, that reforms altering the protection of insiders, are more likely.

In relation to the crisis, Alessandro Turrini (2014) identify two different periods of reform activity. At the beginning of the crisis (the 2008-2009) European countries implemented reforms focused on cushioning the impact of an economic recession that was perceived to be temporary. These reforms were focused on expanding the social safety net and, broadly, increasing protection for all workers: mainly through more generous unemployment benefits and more investment in active labour market policies. However, this pattern changed in the period 2010-11. As the crisis continued, debt increased, demand contracted and credit conditions tightened, the composition of reforms changed in order to improve the adjustment capacity of labour markets. In this period, reforms were primarily targeted at employment protection, wage setting and working time. Moreover, as the fiscal space became tighter, the initial measures aimed at mitigating the impact of the recession, started to fade away.

Overall, these stylized facts point to two conclusions. The first is that in periods of bonanza, countries in Europe do not seem to implement duality-reducing reforms, but rather prefer to focus on the (politically more viable) reforms in the margin, affecting only a segment of the labour market or temporary workers. However, this pattern changes in periods of crisis, whereby insiders do seem to lose some degree of protection vis-à-vis outsiders. In Section 2.6 we explore in more depth the interaction between crisis and reforms as well as the importance of specific EMU political economy dynamics that might facilitate the reduction of duality.

To conclude, most of the literature on labour market institutions and reforms in Europe focuses on the effects of labour market reforms on other economic variables, based on cross-country comparisons or using difference-in-difference techniques to exploit regulatory variations. Both these literatures are well reviewed in Boeri (2011). However, much less attention has been paid, to the drivers of labour market reform, or lack thereof, which is the focus of the following section.

2.5 The politics of labour market institutions

As we have seen in previous sections, there is a large variety of labour market institutions and different institutional regimes in Europe. However we have not addressed crucial questions for the purposes of this paper: what are the power configurations that lead to these different institutions in the first place? What are the political reasons behind the persistence of duality? In this section, I review the literature on the political economy of the insider-outsider divide, the classic economist view, as well as the main criticisms to the theory.

State interventions in labour markets are necessary, as markets often lead to socially undesirable results. For instance, market forces do a poor job in protecting workers against unemployment risks, requiring the public provision of unemployment protection. Similarly, the equilibrium wages determined by supply and demand of work in the economy might be too low to guarantee minimum living conditions for workers, thus requiring the implementation of minimum wage regulations. In the same way, given technological change, governments might decide that investment in skills, through active labour market policies, is needed to keep up with those changes.

Decisions by governments to intervene in the labour market have strong distributional implications that need to be taken into account, as they lead to very different labour market outcomes. Standard economic theory holds that a stringent employment protection legislation, which limits the employers' ability to adapt the work force to changing economic conditions, is associated with higher unemployment levels and longer unemployment spells. Similarly, high unemployment benefits, because they increase the reservation wage, might provide disincentives to work. Also, low investment in active labour market policies (ALMP) is associated with longer unemployment duration and inefficient spending (Bertola, 2014). The same idea applies to dual labour markets: segmented labour markets and high temporality rates translate into lower human-capital formation, less opportunities for the young and even higher unemployment, as we have seen in Section 2.2. However, if we know that some of these institutions are inefficient and lead to inequitable outcomes, why are these seemingly bad institutions so persistent over time?

Different institutional settings are not (only) the result of automatic public interventions to correct microeconomic frictions and market imperfections. They are the reflection of a political process; whereby different interest groups determine a specific political economy setting that favours some more powerful groups over others (Saint-Paul, 1993). From a political economy perspective, institutional equilibriums must be beneficial to, at least, some powerful groups in the labour market, so that they can be politically sustained over time. In other words, there may be some distributional dimensions of the rents that result from different institutional arrangements, which create enough winners that work in favour of reinforcing the status quo.

The concept of rent applied to the labour market is a central concept in the work of Saint-Paul (1993, 2000), who is one of the most relevant contributors to the political economy of labour market institutions. Rents, according to Saint-Paul, are the welfare difference between being employed and unemployed, and thus they reflect an equilibrium between insiders and outsiders. Reducing the wedge of employment protection between insiders and outsiders might be good for employment and improve the fairness of the system, but it is not easy to achieve, precisely because it reflects a specific power relationship (see Saint-Paul (2000)).

2.5.1 The classic insider-outsider theory

Lindbeck and Snower (1988) were the first economists to formalize a theory of employment and unemployment based on the insider-outsider divide. Their initial goal was to address a puzzle that became evident after the first oil shocks in the seventies: the rapid de-industrialization in most advanced economies translated into lower productivity growth and unemployment rose spectacularly. However, wage setters did not seem to adjust to the new reality of lower productivity growth (Blanchard, 2005, p. 19). Salaries were not responding to market signals, as the theory would predict, so other forces, beyond the pure market incentives, had to be playing a role.

Lindbeck and Snower (1988) analysed the way wages were settled in collective bargaining institutions and were the first to argue that in wage negotiations carried out by trade unions and employer organizations (see Section 2.3), the interests of outsiders were not being represented. On the contrary, the authors argued, employed workers (i.e. the insiders) defended their own strategic interests, which involved setting higher wages for themselves or implementing more stringent employment regulation to avoid being fired. Employers on permanent contracts were legitimately defending their interests, but at the same time they were hurting the interests of temporary workers and the unemployed. If wages did not adjust in the bargaining tables in periods of high unemployment, employers would have no other option but to stop hiring unemployed workers and start dismissing (cheaper) temporary workers. By maximizing their interest in wage negotiations, insiders were raising the entry barriers for outsiders (Saint-Paul, 2004). The result was that unemployment remained above the theoretical natural rate, and this was a direct result of a purely political equilibrium reflected in the imbalance of representation of insiders and outsiders in the wage bargaining process.

According to "the economist view", insiders and outsiders have opposing interests and are, naturally, assumed to behave rationally. While outsiders should fight to reduce rigidities so to have an easier access to employment and job stability, insiders should insure labour-turnover remains low by increasing employment protection for workers with a permanent contract. Naturally, this will reduce the chances of the unemployed and temporary workers to access job security. Also, given that insiders are much less vulnerable than outsiders to unemployment, they will be less inclined to support spending in employment promotion or higher benefits for the unemployed.

The power of insiders, according to Lindbeck and Snower (2001) is a function of labour turnover costs. Turnover costs are, mainly, the costs of hiring, firing and training. The higher these are, the higher will be the entry barrier for outsiders and the lower the incentives for the firm to replace insiders with outsiders.

2.5.2 The political economy of employment protection legislation

As we have seen in Section 2.2, EPL includes severance payments to workers, direct payments to the state, and administrative and judicial costs. Typically, these regulations have the goal of protecting existing jobs because they are aimed at reducing job destruction. So, EPL has, naturally, a strong political support and has an easy sell: nobody likes unemployment.

The actual implications for the labour market are, however, often perverse. By increasing dismissal costs, EPL reduces job creation as it becomes less profitable for businesses to hire and for entrepreneurs to create new firms. The effect of EPL on unemployment in theory as in practice is ambiguous: while by decreasing job destruction it lowers unemployment, by reducing job creation it increases unemployment. One clear effect of EPL is its negative impact on productivity: by altering the process of job creation and job destruction, it changes the nature of unemployment, increasing, for instance, the average duration of unemployment (Blanchard and Tirole, 2004).

In the words of (Saint-Paul, 1993, p. 152), "EPL is difficult to reform: while jobs destroyed are very visible for society, jobs not created are not. Organizing political coalitions to defend the rights of those that already have a job is much easier than defending those that could potentially have a job (or a better one) if the regulation were to be changed". Moreover, "given that the unemployed are a minority, political decisions are likely to reflect the interests of the employed rather than the unemployed".

The insider-outsider distinction also provides insights on a number of other divides, most importantly, skilled versus non-skilled workers. According to the economist view, political support for labour market rigidities such as EPL comes mainly from employed workers on permanent contracts. However, unskilled employed workers are likely to be the most active in defence of duality, given that they enjoy a higher wage than they would in equilibrium (they are benefitting from an artificial rent). Conversely, the unskilled unemployed would be the strongest coalition against EPL, given that EPL increases the fraction of time they expect to be in unemploymentLindbeck and Snower (2001). In addition, the labour market for high-skill workers is (assumed to be) in equilibrium with wages that adjust to offset demand and supply imbalances. High-skilled workers (both insiders and outsiders) are, generally, assumed to be in favour of lower EPL because they are likely to have to, indirectly, assume the burden (in terms of higher taxes) of higher unemployment levels induced by stringent EPL. Saint-Paul (2000) predicts that as long as the unskilled employed are more numerous, more cohesive and have a stronger political influence than the coalition of the skilled and the unskilled unemployed, support for high levels of EPL will persist.

Similarly to Saint-Paul (2000), Boeri et al. (2012) characterise EPL and Unemployment Benefits as schemes not only redistributing between insiders and outsiders, but also across skill groups. They suggest that "flexicurity" configurations characterized by less segmentation, lower job protection, more training and more support to the unemployed should emerge in countries with a larger fraction of the population being skilled. Given the two arguments above, a plausible explanation for the persistence of duality is low investment in education.

It is precisely because of the difficulty of reforming EPL of permanent workers that governments started engineering two-tier reforms as a device to overcome political resistance. The introduction of temporary contracts is a way of reducing employment protection without running into the opposition of workers already protected. Fixed-term contracts do not reduce in any way the rights or bargaining power of the already employed, while they, theoretically, provide an improvement in labour market participation for the unemployed.

2.5.3 The problems with the "economist view": outsiders, unions and parties

A central assumption in what we have called the economists view is that the interests of insiders and outsiders are fundamentally opposed. While the former care mainly about preserving their job security, the latter care about job precariousness and unemployment, hence standing always for lower employment protection. According to the economist view these opposing interests translate, almost mechanically, into political preferences and party behaviour. That is, (low-skilled) insiders and outsiders will organize themselves to defend their interests and vote accordingly, as two homogenous and clearly separated political blocks.

Almost by definition, the political influence of insiders in designing the policy agenda will outweigh that of the outsiders. This influence will work through two theoretical mechanisms. The first assumption is that insiders control trade-union strategies. And, given that trade unions are instrumental in determining labour market relations (through collective bargaining structures, political parties and participation in reform processes), they will ensure their strategic interests are defended (against those of the outsiders). The second assumption is that the insider/outsider division will determine voting behaviour and party strategies. As we will see in the following section, according to the economist view, insiders will naturally support social-democratic parties (Rueda, 2005). And social-democratic parties will choose to defend insiders' interests (against those of outsiders) because the former represent a majority of the voting base and are politically more engaged.

While the first assumption is broadly accepted in the literature – insiders do control trade unions, as we have seen -, the political preferences and "rational behaviour" that the classic insider-outsider theory attributes to outsiders are contested in the political science literature. In fact, there is no conclusive evidence that outsiders vote systematically differently than insiders. Which leads to another, more structural, criticism to the classic economic theory on the insider/outsider divide, first pointed out by Emmenegger (2009): there is no conclusive evidence that outsiders are even aware of their condition as outsiders. As a result, it is unlikely they will organize themselves to defend their interests. If this argument is true, and outsiders' political preferences do not diverge from those of insiders, for the purposes of this paper, it would be absurd to expect them to be actively defending reforms to reduce duality, thus becoming also agents of the status quo. Clearly, the most important gap in the literature I have identified is as regards to empirical support for the assumptions taken on the political behaviour of outsiders. In fact, according to the existing evidence, there is no reason to believe that outsiders will have any different interest than, actually, becoming insiders.

One would expect that further research should focus on how bounded rationality might play a key role here. Even when looking at newspapers, one becomes easily aware of the limited understanding (even among economic journalists) of how the basic functioning of the labour market works. Expecting outsiders to understand the tremendous complexities of labour market regulations and their impact on their job situation is probably, simply, to ambitious. For instance, the very understanding that the employment protection of some workers (insiders) might be associated to job precariousness of other workers (outsiders) is far from trivial.

In the following section I address the first (correct) assumption of the economist view on the insider-outsider divide: the role of the unions.

2.5.4 Unions as the vanguard of duality

Market liberalisation and the decline of manufacturing and heavy industry not only undermined the traditional base of trade unionism. They went also accompanied by a fast increase in temporary work that did not feel represented by the unions. The expansion of the services sector and the appearance of new professions (goods delivery, elderly care and so on) also translated into new forms of "non-standard" work, new types of contracts and more precarious working conditions for a large number of workers.

However, these changes did not alter the composition, or the behaviour of trade unions. It is widely accepted among economists, political scientists and sociologists that unions have not been able to integrate the interests of outsiders (see for instance Kalleberg (2009)). Hall (1987), for example (already in the 80s!) notes how increasing flexibility intensified "the cross-cutting pressures that unions already feel between the demands of their core constituency, who are employed, and the broader penumbra of the working class that is under or unemployed" (Hall (1987), cited in (Richards and Polavieja, 1997, p. 10)). Although trade unions have managed to isolate effectively their core workers throughout the on-going changes in the labour market, pressures to accept increasing flexibility for other types of jobs have intensified.

Moreover, the spaces of work socialisation have changed dramatically with the new forms of work. This makes it more difficult for workers to organise, like they used to, around factories or industrial centres. The lack of work socialisation (and organisation) is particularly acute for temporary workers. Using data for Spain, Richards and Polavieja (1997) argue that workers on temporary contracts or unemployed do not get involved in pro-union behaviour.

Writing about the Spanish case, Dolado et al. (2010) argue that trade unions (through collective bargaining structures and their influence in social-democratic parties) have been the first line of defence of the Spanish extreme dual system.

In fact, by analysing reforms in the Spanish labour market over the last 20 years, they show that the evolution of the relative strength of insiders is closely associated with the probability of labour market reforms, with the latter falling when the former rises.

This is mainly because the typical worker represented in a Spanish union is not representative of the working population. In fact, the median voter of a Spanish trade union - needed to insure internal re-election in the union - coincides with the typical worker (with a permanent contract, typically working at a large firm, low-skilled and strongly protected) that would lose the most from a reform that reduces employment protection legislation. As we saw in Section 2.3, given that trade unions (despite having lost a large amount of social support) still preserve a strong influence across Europe in designing labour market reforms and in determining nation-wide wage levels and working conditions, their power in preserving large insider-outsider divides remains very strong.

In their study of the developments of industrial and collective bargaining structures over the last decades in France and Germany, Palier and Thelen (2010) see a similar on-going trend in these continental economies. They conclude that:

> "Labor market reforms have generally promoted developments in which the status and privileges of labor market insiders remain relatively well protected, with the flexibility necessary to stabilize the core being achieved at the expense of a growing number of workers in "atypical" or "nonstandard" employment relationships." (Palier and Thelen, 2010, p. 139)

The authors also point to another relevant issue: the trend towards dualization is also affecting welfare reforms and protection. Increasingly, a stronger divide exists between traditional contributory benefits for workers on permanent contracts and new forms of limited assistance through in work non-contributory benefits for outsiders (Palier and Thelen, 2010).

In their analysis of the latest Italian labour market reforms, Sestito and Viviano (2016) also see trade unions as playing a central role in preserving duality. Nonetheless, they also see the Great Recession as playing a central role in driving duality-reducing reforms. They argue that the two attempts to reduce dismissal costs for permanent workers by the D'Alema and Berlusconi administrations were frustrated by the opposition from the largest union, the CGIL. However, the “Fornero reform” (2012), named after Elena Fornero, the Employment Minister under Monti’s government, did reduce severance costs of permanent workers (mainly by reducing judicial uncertainty). The unwillingness of trade unions to reduce the stringency of EPL for permanent workers was overcome, the authors argue, by a combination of a technocratic government (by definition, less responsive to insiders’ pressures) and strong external constraints at the peak of Italy’s vulnerability in the Eurozone crisis (Sestito and Viviano, 2016).

The Jobs Act, introduced in 2014 by Renzi’s government, has so far been the most ambitious attempt to fight duality in Europe. The reform introduced measures to reduce firing costs and uncertainty for firms above 15 employees by limiting the influence of judges in firing decisions, and the risks of reinstatement, as well as a very generous non-conditional hiring subsidy for companies hiring permanent workers, among other measures. Sestito and Viviano (2016) argue that the government gave up ’the idea of obtaining union’s consent and that this was the key factor facilitating reform.

Given the above, the fact that temporary workers barely participate in unions, should be an important factor explaining the persistence of duality. However, why are outsiders not building alternative forms of influence and representation to defend their interests? In the following section we explore the relationship between dualization and party strategies.

2.5.5 Dualization and Party Strategies

One of the central arguments in the political science literature on insider-outsider politics refers to the relationship between party strategies and the insider-outsider divide. This is particularly important for the purposes of this paper, given that political parties – after all, the suppliers of policy and reforms- are likely to play a key role in explaining why duality is so persistent.

The seminal work by (Rueda, 2005) provides the classic political framework of the economist view, explaining how insider-outsider politics might map into voting and party behaviour. The theory argues that while traditional social-democratic parties used to defend the interests of the working class as a whole, this is not true anymore. Increasing labour market segmentation over the years, the rise of the so-called atypical employment, and the emergence of the insider-outsider divide have transformed party strategies over time and this has become a crucial factor explaining the stickiness of duality.

Looking at Eurobarometer data and annual macro data from 16 OECD countries from 1973 to 1995, Rueda (2005) shows that social-democratic parties "have abandoned the goal of providing equality and security to the most vulnerable sectors of the labour market (i.e. the outsiders)". Given that the working class is not anymore a homogenous block, social-democratic parties had to choose between serving the interests of those with stable jobs (the insiders) and those in precarious work or unemployed (the outsiders). Rueda concludes that Social-democratic parties are now "best served by pursuing policies that benefit insiders while ignoring the interests of outsiders" (Rueda, 2005, p. 61-62). Given that insiders are a majority of the work force and that outsiders are politically largely unengaged, social-democratic parties will have little choice but to defend their interests. Moreover, Rueda (2005) adds, conservative parties, by supposedly serving the interests of the well-off and skilled workers, may actually be more willing to tackle the insider-outsider divide than left-wing governments.

The mechanism by which the insider / outsider divide translate into voting preferences and party strategies has been strongly contested in the literature. Most importantly Emmenegger (2009) challenges Rueda's theory and the economist view on both theoretical and empirical grounds.

The first theoretical critique is regarding the stark rationality assumptions of the insider-outsider theory. He argues that many outsiders (as well as insiders) might not be aware of the complex dynamics of labour market equilibriums, the reasons for their underemployment or have a clear understanding of the effects of regulations on their respective utility. Even Saint-Paul (1993), perhaps the most prominent representative of the economist view recognizes that "due to a lack of knowledge about the 'actual' working of the labour market, voters can be manipulated by rent-seeking groups to antagonize labour market reforms, although they would benefit from them" (Emmenegger, 2009, p. 134). There is no empirical support, he argues, to the argument that outsiders are in fact aware of their condition of outsiders and that they actually associate stringent labour market regulation with a barrier to entry to stable employment. In fact, he argues, such hypothesis is not even considered by those responsible of writing the Eurobaromether questionnaire:

> "The following question was included in the Eurobaromether (1996):
> 'What do you think should be the first priority for combating un-

> employment? Shoud we. . . ?' The respondents could choose among eleven suggested answers. The answer 'reducing job security regulations' was not even included. The authors of the questionnaire did not seem to consider it to be of particular importance. How can this issue then be expected to dominate voting decision?" (Emmenegger, 2009, p. 134)

Secondly, and building on the previous assumption, Emmenegger (2009) argues that there is no reason to believe that insiders and outsiders will have different preferences as regards to job security or employment protection legislation. In fact, he argues, outsiders might have a strong preference for job security because they expect to be able to enjoy it in the future. In other words, outsiders might behave against their short-term interest in the hope that they will become insiders in the future.

The third critique directly addresses voting behaviour. Emmenegger (2009) argues that a single policy issue does not determine voting preferences. In fact, voters in elections have to choose among different "policy packages" which surely include issues they might disagree with, but the menu of party options they can choose to vote is limited. As a result, it might be the case that even if outsiders don't like high EPL they choose to vote for social democratic parties because, for instance, they defend stronger unemployment benefits. Finally, Emmenegger (2009) supports these claims by showing empirical evidence (using limited survey data) that outsider workers can be expected to be equally supportive of job security regulations and social-democratic parties as labour market insiders.

Other authors, such as Marx and Picot (2013) for the case of Germany find, on the contrary, that "compared with standard employees, atypical workers have stronger preferences for small left-wing parties". They also find differences in voting behaviour compared to the unemployed: as atypical workers in Gemany do not participate in elections less than insiders do (Marx and Picot, 2013, p. 165). Unfortunately, the work of Marc and Picot only applies to one country.

Another element that might be affecting the voting behaviour of outsiders is household composition. Häusermann et al. (2016) find, with data for Western Europe, that women's social policy preferences are associated with their partner's labour market situation. That is, women (presumably in a vulnerable work situation) sharing a household with a male worker that holds a secure job, are likely to have similar policy preferences as their partner. This might be, according to the authors, part reason that explains the apparently irrational political behaviour of outsiders.

Häusermann (2012) find yet another reason that might be behind the apparently puzzling voting preferences of outsiders. By looking at the socio-political situation of outsiders after welfare transfers across welfare regimes, they find that in some cases the disadvantages that atypical workers encounter in the labour market are de facto corrected by public intervention. Importantly, they argue, looking at outcomes in terms of welfare rights, political integration or labour market power, is crucial to understand the actual political relevance of the insider-outsider divide. In different words, if outsiders do not suffer from concrete disadvantages, why would they show a different political behaviour than insiders?

Considerations by sociologists and political scientists on the voting behaviour of outsiders are relevant for the purposes of this paper. While the impact of the rise in atypical employment on party politics remains contested in the literature, one element seems clear. While insiders are effectively defending their interests through unions and do seem to vote coherently with their economic interests, outsiders cannot be assumed to be defending their interests in an organized or systematic way. Whether this is a consequence of their expectation to become insiders one day, a result of bounded rationality, household composition or the effect of welfare transfers remains an open question. In all cases, there is one important implication: a core assumption of the classic economist view on the insider-outsider divide (ie the expectation that outsiders will organize to defend their interests) does not seem to hold empirically. And this, somewhat paradoxically, helps explaining why the insider-outsider divides are actually still so persistent.

2.6 What triggers a reform to reduce duality?

The arguments explored in the previous section address the reasons why duality might be so persistent over time. But what are the drivers of change? According to Saint-Paul (2000), the duality equilibrium is instable and naturally leads to a change in the balance of power between insiders and outsiders that results in reform. As time passes, the stock of rigid, permanent contracts gradually erodes.

After some time, $t*$, those who hold rigid contracts will no longer be a majority in the labour force, at which point the coalition of unemployed and temporary workers (the outsiders) will have gained sufficient weight to politically support reforms toward lower flexibility.

This theory has been supported by evidence on the Spanish case. After the Spanish transition to democracy in the 70s, labour markets became more rigid as a result of the legalization of trade unions that had been persecuted for years. However, after the oil shocks a deep recession followed at the beginning of the 80s and the unemployment rate went up to 22%. Saint-Paul (1993) argues that while labour unions were in principle opposed to temporary contracts, the insiders started feeling threatened by unemployment, and the political conditions became more prone to reform. The introduction of flexible contracts by the socialist Government in 1984 was expected to lead to a large effect on the hiring rate. The result, however, was mixed. The recovery led to increasing employment, but also to a deep division between a world of protected insiders shielded from the economic cycle, and a new large group of precarious unprotected outsiders. That division is still the norm today.

When the reforms were introduced, unions were already aware of the political implications for them of opening-up the possibility of a segmented, dual labour market to arise in the economy. As Saint-Paul explains, unions knew "that these contracts would gradually undermine their support. Flexible workers had clearly different interests". With the years, when the coalition of unemployed and flexible workers became stronger, the government started pressuring the unions (Saint-Paul, 1993, p. 176) to introduce reforms to reduce the protection gap between insiders and outsiders.

Similarly, Juan J. Dolado and Jimeno (2002) argue that after the spectacular rise of temporary workers that followed the two-tier labour market reform of 1984, pressures reform increased, leading to the labour market reforms that reduced EPL for permanent workers in 1994 and 1997. According to their calculations, in the mid-90s, the sum of the unemployed and temporary workers outnumbered the insiders. The absence of any major labour market reform reducing the protection of insiders over the boom years (1997-2007)– when unemployment fell to historical lows and the ratio between insiders and outsiders well below 50% - would also sustain Sain-Paul's central hypothesis.

However, the “rule of thumb” of the 50% ratio does not always apply. Bentolila et al. (2012a), referring in this case to Spain during the Great Recession, do not find this indicator useful, given that a significant reform took place in 2010, while the total number of unemployed and temporary workers was still below 50% (42%). Instead, they focus on the exposure of insiders to the risk of job loss, another theoretical insight proposed by Saint-Paul (2000). They conclude that given that the unemployment toll of the crisis was overwhelmingly assumed by temporary workers - permanent employment did not fall below pre-crisis levels until the first quarter of 2011 – insiders might have not perceived their jobs to be threatened until well into the crisis.

Overall, the variation of the ratio between outsiders and insiders in the economy seems to be a variable that facilitates reforms in the labour market. However, given the problems with the theory analysed in previous sections, it remains unclear how the causal mechanism for these reforms actually works. In other words, while it might be relatively easy to generate a consensus for reform when unemployment levels are abnormally high and growing, it is far from obvious that reforms will effectively reduce the insider-outsider divide. In fact, in a number of cases, even in times of deep crisis, reforms have focused on the flexible tier of the labour market, thus increasing the wedge between insiders and outsiders (although this was not the case during the Great Recession, as analysed in Section 2.2).

Following with Saint-Pauls’ argument, the insider-outsider ratio normally evolves with the economic cycle, and as we have seen, a simple look at the stylized facts of reforms in Europe points to the idea that economic recessions play a crucial role in driving reform activity. Usually these crisis are associated with a tightening of external constraints, higher interest rates, rising external debt or sudden stops in financing.

Referring to the Great Recession Bentolila et al. (2012a) argue that “labour reform was triggered by external pressure coming from international financial markets”, although the kind of reform that was undertaken did not significantly reduce the insider-outsider divide in the Spanish labour market (Bentolila et al., 2012a, p. 20). A similar argument was proposed by Guillermo de la Dehesa (Williamson, 1994, p. 137) also referring to the Spanish case (although, in this case, to a crisis 20 years before): "only when the level of reserves was sufficiently low and the current account was in large deficit have necessary economic adjustment and structural reform measures been taken". Bertola (2010) also finds empirical evidence that countries with high public debt are likely to undertake more reform.

However, when looking at the EMU, specific international political economy dynamics that resulted from entering the Euro seem to have played a role well beyond crisis related considerations. As we have seen in Section 2.4, four periods of reforms have been identified in EMU. Over the decade that preceded the entrance in the Euro pressures to meet the core EMU convergence criteria pushed countries to increase reform activity (see for instance Hancké and Rhodes (2005)). The complement to the previous argument is the one proposed by Fernandez-Villaverde et al. (2013) and Roldán (2013) for EMU. The flow of cheap credit that followed the introduction of the Euro reduced the pressures for reform in peripheral countries (i.e. lower external pressures after meeting the core EMU convergence criteria to access the Euro) whereby "reforms were abandoned, institutions deteriorated, the response to the credit bubble was delayed, and the growth prospects of these countries declined" (Fernandez-Villaverde et al., 2013, p. 146). Roldán (2013) finds some preliminary evidence for the EMU to support that argument. Countries that received a larger financial windfall after the entrance in the Euro implemented less structural reforms. Duval and Elmeskov (2006) anticipated also provided some early empirical evidence that EMU could be leading to less reform pressure. Other papers have explored the impact of financial windfalls beyond the EMU experience. Looser credit conditions have been linked to a general relaxation of constraints, lower reform capacity and, ultimately poor growth performance (Vamvakidis, 2007).

Importantly, for the purposes of this paper, reform pressure coming from EMU has also been associated to labour market reforms openly intended to reduce duality. For the Italian case, referring to the Treu (1997) and Biagi (2002) reforms, the OECD argues that:

> "To a greater or lesser extent, both these reforms were driven by EU-related policy considerations. The drive to get Italy ready for Economic and Monetary Union (EMU) formed the background to the Treu reform,(...) The Biagi reform was based in part on the European Employment Strategy and also involved changes dictated by European law." (Tompson, 2009, p. 247)

While in previous labour market reforms the dominant concern had been to insure the protection of "insiders", according to the OECD, the rise of a large new class of precarious outsiders brought to a new political consensus (strongly influenced by the EU) around the idea that further transformations in the labour market needed to create greater opportunities for young workers, new entrants and, generally, labour market outsiders (Tompson, 2009). Both the Treu (1997) and Biagi (2002) reforms implemented measures to improve the protection of temporary workers as well as diminishing some of the stringent regulations for permanent workers.

In the literature that covers the Great Recession a number of papers explore the different reform paths followed by countries exposed to similar external constraints. For instance, Bentolila et al. (2012a) suggests that countries that signed a Memorandum of Understanding with the troika and had to be bailed-out (such as Greece or Portugal) followed a divergent path in relation to others. Given that Spain only received a banking sector bailout, with limited conditionality on the rest of the economy, this would explain why the two reforms carried out in 2010 and 2011 did very little to reduce duality. The author argues that, despite the crisis, neither the government, nor the social partners were interested in significantly altering dual EPL. Adding to this argument, and analysing a larger panel of countries, Saint-Paul (2000) does not find a robust relationship between the business cycle and the timing of labour market reforms, except for marginal ones such as two-tier reforms that only affect the flexible tier of the market.

In a comparative study of labour market reforms between Italy and Spain over the Great Recession, Picot and Tassinari (2014) point to another hypothesis to explain the divergent reform paths between the two countries. They argue that while both Italy and Spain shared severe labour market inefficiencies and suffered from virtually the same external constraints over the Great Recession, the labour reforms implemented by each country were fundamentally different. While Italy's reforms were much more encompassing (i.e. seriously and purposely addressing duality, active labour market policies, unemployment benefits and EPL), Spain's 2012 reform was only "liberalising" (i.e. firing costs for permanent employees were reduced, collective bargaining was decentralised), with no intention of approaching a "flexicurity" model.

Their core argument is that "where the parties supporting government are not ideologically inclined towards broad-brush liberalisation and where imbalances in social protection are widely recognised, as in Italy, a recalibration is possible that aims at improving protection for non-standard workers and the unemployed" (Picot and Tassinari, 2014, p. 16). Given that Rajoy's conservative government held an absolute majority and assuming that Renzi's government was more left-leaning, ideological preferences are assumed to be explanations for the different reform paths followed in the labour market. Other authors, in the political science field, have highlighted the need for understanding the interaction of external pressures with other domestic drivers such as electorally weak governments and/or an intermediate level of union centralization Avdagic (2010).

According to the OECD, a number of other specific domestic political factors matter to drive duality-reducing reforms. Regarding the Italian case, the transition to the second republic in the early 1990s brought several reform-prone actors (economists, labour lawyers) to politics that had a "shared understanding of Italy's labour market problems". The Treu (1997) and the Biagi (2002) reforms (both intended to reduce duality) involved long consultation processes, including the preparation of a white paper for the Biagi reform, which was an innovation in Italian policy making. Moreover, both reforms incorporated measures to compensate the losers of reform, such as subsidies to the *Mezzogiorno*[2], and legislative concessions on other issues, such as taxation and working time (Tompson, 2009).

Specific domestic political factors also were crucial in driving the Spanish reforms in the 90s. Spain adopted two reforms in 1994 and 1997 that aimed at reducing duality by reducing incentives to use temporary contracts and by lowering dismissal costs. Huge unemployment (25%), the persistent crisis and the resulting strain on public finances facilitated a strong consensus on the need for action on both reforms. The arrival of a new government in 1996 helped to build momentum for reform and the lowering unemployment made changes in EPL less threatening to workers. Shared objectives among the key protagonists also mattered, given that the share of temporary employment had reached levels seen nowhere else in the OECD, both trade unions and employers understood that the status-quo was unsustainable. The final result of the reform, however, left the rights of those already employed under permanent contracts largely unaffected (Tompson, 2009).

[2]The term *Mezzogiorno* refers to the poorer regions in the South of Italy.

The interaction between different reforms can also be a factor driving reforms. Partial labour market reforms, such as two-tier reforms, tend to affect the political economy of future reforms. For instance, the introduction of fixed-term contracts in Spain in 1984 contributed to increasing flexibility and reducing employment protection. But by massively increasing duality – temporary contracts became a third of all contracts – the reform created the conditions for future reforms in the 1990s, which reduced the protection of permanent employment contracts (Juan J. Dolado and Jimeno, 2002). Similar evidence has been found by Duval and Elmeskov (2006), referring to structural reforms in the EMU: reforming one area, for instance, product markets, induces reforms in other areas, for instance labour markets.

To conclude, there seems to be a number of factors that facilitate labour market reforms. First, the effect of recessions in increasing reform activity is uncontested. Normally throughout economic crisis the share of outsiders in the economy increases, presumably adding pressure for duality reducing reforms to take place. However even in deep periods of crisis, there is no conclusive evidence that reforms will reduce protection of insiders. A great number of these crises (and the reforms that followed) are prompted by external constraints such as sudden stops of financing. However, the international political economy dynamics that result from EMU - such as the EMU convergence criteria – matter also to understand reforms. Nonetheless, while a combination of the explanatory variables above might help to understand labour market reforms, the specific drivers of duality reducing reforms remain still elusive in the literature.

2.6.1 Other lessons from the literature on the political economy of structural reforms

This section explores the broader literature on the political economy of reform with the aim of identifying other relevant factors that might be affecting the reform process. A large theoretical and empirical literature has been dedicated to understanding the reasons why reforms are delayed as well as the drivers of policy reform more generally. Key works in economics include Alesina and Drazen (1991), who provide a model in which stabilizations are delayed because it is rational for different socioeconomic groups to try to shift the burden of stabilization onto other groups, in a process that mimics a "war of attrition" game and leads to the accumulation of debt. Other models, such as Tommasi and

Velasco (1996), provide a framework for understanding fiscal profligacy, where fiscal policy is modelled as the outcome of a political process in which spending is in the hands of several controllers who represent different interest and behave non-cooperatively.

These and other models are clearly relevant to understand the persistence of fiscal profligacy or the delay of stabilization, but to get a good understanding of the drivers of reform (or lack of thereof) of dual labour market systems, specific political economy dynamics seem to be more informative. In other words, there is no reason to believe that the political coalitions, for instance, against fiscal reforms are the same as those against two-tier systems. The literature on the political economy of reform would probably benefit from further specialization on different types of reforms (product markets, pensions, labour markets, etc.).

A similar argument applies to previous works trying to draw lessons from a wide variety of reforms in different sectors. For instance, Williamson (1994), drawing from experiences from a large number of structural reforms (product, financial, fiscal, pensions, etc.) of developing countries derive a number of hypotheses about what makes reform feasible and successful. These include (1) policy reforms emerge in response to crisis, (2) policy reforms are a right-wing program (3) reformers enjoy a "honeymoon period" of support before opposition builds up (4) reforms are more difficult to sustain unless government is strong (5) reforms are more likely if opposition is weak (6) strong leadership is important (7) rapid implementation is important for successful reform (8) reformers should make a good use of the media to build favorable coalitions and (9) reforms are easier if losers are compensated. However, Williamson (1994) himself recognizes that neither of these hypotheses is necessary or sufficient for successful reform.

Similarly to Williamson (1994), Tompson (2009)draws lessons from a number of reforms in different areas. While case studies might be more useful than, for instance, broad econometric correlations to capture and understand the causality mechanisms that lead to different reforms, further specialization is needed to get better theoretical insights and a more useful guidance for policy-makers.

Tompson (2009) concludes that successful reforms are associated with (1) a clear electoral mandate for reform; when reforms are crisis driven they may be easier to pass in the first place but difficult to sustain over time; (2) effective communication, through coordinated efforts to persuade voters and stakeholders of the need of reform, and in particular communicate the costs of non-reform. The study also points out the need for policy design to be underpinned by solid research and analysis, which, if (3) presented by an authoritative, non-partisan institution that commands trust across the political spectrum, appears to have a far greater impact. (4), they point out that reforms take time. As a rule of thumb, the OECD considers that two years are needed to prepare the right breeding ground for reform to succeed. (5) The strength and cohesiveness of a government is also critical, if governments send mixed messages, opponents will exploit them. (6) Strength of government matters more than the strength or unity of opposition parties. (7) Government leadership is more important than concentration or a broad agreement with social partners, unless the government is in a position to reward social partners somehow. (8) The study also argues that voters do not necessarily punish reforming governments. It remains a subject of future research to establish more systematically which of these potential drivers of successful reform are more relevant for dual labour market reforms.

2.7 Main findings: a summary

In what follows I summarize the most important lessons from the literature on the political economy of dual labour market reforms, trying to shed some light on the reasons for the persistence of duality in Europe and the drivers of duality-reducing labour market reforms:

Reasons for duality persistence and questions for further research

1. Almost by definition, the political influence of insiders in designing the policy agenda outweighs that of the outsiders. Organizing political coalitions to defend the rights of those that already have a job is much easier than defending those that could potentially have a job (or a more stable one) if the regulation were to be changed.

2. The employed are (almost always) a majority and are usually better organized to defend their interests. Trade unions defend the interests of the insiders. Typically, the workers represented in trade unions are unskilled, highly protected employees, those most interested in keeping two-tier systems.

3. Collective bargaining structures appear as the crucial mechanism through which trade unions and insiders manage to impose their strategic interests over those of the outsiders (not represented in those negotiations).

4. The most important unresolved question regarding the predictions of the classic insider-outsider theory relates to outsider's voting behaviour: there is no solid cross-country evidence that indicates that the political behaviour of outsiders is different than that of the insiders. This is a possible explanation for the strong persistence of dual labour markets: if outsiders are not organizing to fight duality, who will?

5. The insider-outsider divide has also changed party strategies: social-democratic parties, which traditionally defended the interests of the most vulnerable, tend to be best served now by defending the interests of the insiders.

6. However, the way the insider-outsider and party strategies divide are going to be affected by the emergence of new political parties across Europe is still an question that remains broadly unaddressed.

Drivers of duality-reducing reforms and questions for further research

1. The duality equilibrium is instable, and its own dynamics lead to a change in the balance of power between insiders and outsiders over time, as the stock of rigid contracts gradually erodes, that may lead to reform.

2. Economic recessions and crisis are the main drivers of reform activity, but there is no conclusive evidence that reforms in these periods actually go in the direction of reducing duality.

3. The EMU has its own specific reform dynamics. Meeting EMU convergence criteria forced countries to introduce labour market flexibility. Moreover, the rhythm of reforms relaxed in the years that preceded the Great Recession, and it increased, abruptly, throughout the crisis. The relationship between the economic cycle and reforms deserves further exploration.

4. Stronger external surveillance in EMU seems also associated with duality reducing reforms. The data on labour market reforms analysed in this paper shows that the wedge between insiders and outsiders was reduced since the onset of the financial crisis.

5. Case studies on "successful" reforms in Italy and Spain show that duality-reducing labour market reforms are more likely under the following domestic circumstances: an employment crisis, strong government leadership, shared objectives among the protagonists respect for acquired rights, effective consultation and communication process, and compensation of losers of the reform.

2.8 Concluding remarks

The objective of this paper was to try to understand why, despite the well-known negative effects of duality, dual labour markets are still so persistent in Europe. In order to address this puzzle I have reviewed the available data on labour market reforms and both the economics and political science literatures on the political economy of reform of labour markets. The main findings of this review can be divided in two parts.

In the first sections I provide an overview of the relevant institutions, both formal and informal, that matter to understand labour markets as well as a description of the reform activity of European countries over the last 30 years. When looking at the labour market institutions that matter to understand the persistence of duality, collective bargaining structures have emerged as a crucial, often overlooked, factor, to explain why the power of insiders remains so influential today, despite trade unions having lost a significant amount of social support.

In terms of reforms, I identify four periods of reform intensity in EMU. Over the decade that preceded the Euro, the EMU convergence criteria provided a strong incentive for reforms. However, after entering the monetary union, countries the relaxation of credit constraints made it easier for countries to get indebted, so necessary reform was avoided. The third period starts with the Great Recession: the data shows an unprecedented increase in reform activity. According to the LABREF database, in this period the employment protection of insiders decreased, while the protection of outsiders increased, meaning that the EMU crisis contributed to reduce duality. Finally, the recovery seems to be associated again with a sharp decrease in reform activity.

Overall the first part of this paper adds two relevant contributions. First, I provide a clear identification of the economic cycle as a key driver of reforms in EMU, both in periods of bonanza and crisis. While the correlation between crisis and reforms is very present in the literature, I have found that there is little evidence available explaining the relationship between expansionary periods and reforms. This is relevant, given that, for policy purposes, finding ways to improve reform performance in the good part of the cycle would contribute to reduce economic instability and social suffering.

Second, I point to the importance of some specific political economy dynamics associated with EMU (such as the convergence criteria, or EMU surveillance during the Great Recession) that have proven to be key in driving reforms. This is particularly relevant when looking at dual labour market systems: while there is no conclusive evidence in the literature that crisis lead to duality reducing reforms, this paper finds that the interaction between economic hardship and EMU surveillance seems to be more effective at reducing the insider-outsider divide.

In the second part of the paper I explore the politics of the insider-outsider divide to try to understand the persistence of duality. Besides the, already mentioned, importance of collective bargaining structures in explaining the persistence of duality, I identify some gaps in the literature that deserve further exploration. First, I find one central problem in the classic labour market theory of the insider-outsider divide (the economist view): empirical evidence does not support the assumption that outsiders behave systematically differently, politically, than insiders. If this is true, and outsiders' political preferences do not diverge from those of insiders, for the purposes of this paper, it would be absurd to expect them to be actively defending reforms to reduce duality, thus becoming also agents of the status quo. While some authors have already pointed to this problem, more research is needed to explore how bounded rationality might play a key role here. Even when looking at newspapers, one becomes immediately aware of the limited understanding (even among economic journalists!) of how the basic functioning of the labour market works. Expecting outsiders to understand the tremendous complexities of labour market regulations and their impact on their job situation is probably, simply, to ambitious.

Secondly, I find very little evidence exploring the complex relationship between the insider-outsider divide and party strategies. While in the past the association between insiders and social-democratic parties seemed to hold well, the appearance of a great number of new political parties in Europe might have changed this relationship. Moreover, changes in the supply side of the equation might lead to changes, as well, in the demand side. In other words, perhaps the increasing number of party options might contribute to offer new ways of political engagement to outsiders that would deserve further research.

On a more methodological note, more work needs to be done to integrate the increasing amount of evidence of different case studies into a new theoretical models of the political economy of labour market reforms that would, in turn, help to improve the rigor of case-study analysis.

One lesson learned from this paper is that in order to understand the causes of policy reform, inductive approaches on specific case studies might be as useful a method as cross-country comparison, and probably more useful than comparative econometric work based on broad macro correlations. A second lesson is that the literature hugely benefits from interdisciplinary work. A third lesson is that it would be probably more useful for policy makers to study the political economy of reforms separately, by field. The political economy dynamics of dual labour market reforms have little in common with reforms in other areas such as pensions or product markets. So far the existing literature on the political economy of reform, to my knowledge, has not done that effort.

Finally, it needs to be noted that the reforms that are studied are always the reforms that actually took place. The true political economy challenge probably resides in the previous phase, where many reforms die for reasons that are never studied.

Conclusion

This thesis on the political economy of reforms in Europe explores two related questions. The first refers to the persistence of bad institutions, which remains one central question both for academics and policy-makers in Europe today. The second refers to the interaction between credit booms and the quality of institutions, which has gained a lot of attention as a result of the Great Recession in Europe.

In the first chapter I study the effects of the boom of cheap credit, which followed the introduction of the Euro, on reforms and corruption in the EMU. I find that countries that received a larger windfall of credit reformed less and showed a larger increase in corruption. I also find that those countries with stronger initial institutions, at the beginning of the boom, managed to alleviate the negative institutional dynamics associated with credit booms.

These dynamics manifest themselves in two different ways. First, booms create a general relaxation of constraints in the economy because they alter the signalling that voters and governments receive from it. When the economy is growing and creating jobs, incentives for reform weaken. The second is related to the literature on the so-called resource curse and, to the best of my knowledge, new in its application to credit booms: financial windfalls (like a large oil discovery) in interaction with poor institutions may act as a catalyser for rent-seeking behaviour and corruption.

The results of my first chapter are preliminary and, both the empirical evidence and the causal mechanisms suggested here, should be further tested. Nonetheless, the results resonate with the existing evidence that periods of economic bonanza might be detrimental for reforms, and also provide an original hypothesis on the interaction between credit booms and institutions, which might open avenues for further research on the political economy of corruption.

The second chapter is a survey of the literature on the political economy of reform of dual labour market institutions. The abuse of temporality and youth precariousness are today central concerns for a number of European governments. Both are a direct consequence of two-tier labour market systems. The key question addressed in this paper is why duality is so persistent in Europe, given the overwhelming consensus on the negative effects of duality in the economy. The main contribution of the paper is that it is the first attempt to provide a comprehensive survey of the specific literature on the *reasons for the persistence* and the *drivers* of reform in dual labour markets, which I hope to be useful for both further research and policy guidance.

I draw a number of lessons. First, more research is needed to understand why temporary workers and the unemployed have not found better ways to defend their interests in the labour markets. Second, I point to collective bargaining structures as a key, often overlooked element, crucially contributing to the persistence of the insider-outsider divide. Third I find that research on the political economy of reform would benefit from more specialization in order to find more systematic theories that help understand the drivers of different reforms in different fields. Given that there is little connection between the drivers of, for instance, pension reform and reform of dual labour markets, studying them separately would likely lead to more useful policy insights. More specific case studies and comparative work are needed to help inform and build a more comprehensive theory on the political economy of reform of dual labour markets in Europe.

Overall, this thesis offers a broad picture of how reforms have developed in Europe over the last 30 years. What this picture shows is that the credit cycle plays a more important role than what was previously thought. On the one hand, the view that external constraints are key drivers of reform seems reinforced by the available evidence in EMU. Remarkably, more reforms were done in Southern European economies in the three years that followed the beginning of the Great Recession than in the whole previous decade. Contrary to the conventional wisdom held 20 years ago on the EMU effects on reforms, the monetary straightjacket of EMU did not lead to an increase in reform activity. In fact, over the years that preceded the Great Recession, those countries that needed more reform to catch up with international competitive pressures, were the ones that reformed less.

This has one straightforward lesson for the future. The EMU needs to be better equipped to deal with reforms in periods of bonanza. This is particularly relevant given the social suffering (and its political consequences) that resulted from the Great Recession. If countries implement harsh reforms, but they have fiscal space to compensate losers, social suffering will be diminished. Looking at the most recent reform developments, the picture does not look very bright either. With the return of growth and credit – particularly since the decisive intervention of the ECB to guarantee lending - many necessary reforms have been postponed. In Spain, for instance, there has not been a single ambitious structural reform since 2012, and key structural reforms such as pensions, the judiciary, active labour market policies, employment protection or education remain unaddressed.

Given that debt levels are still at record historical levels and that growth enhancing reforms are not being implemented, the next crisis is likely to be very difficult to handle. Moreover, in the coming years, new factors (that were not present in the first two decades of the EMU) will need to be taken into account for the political economy of reforms. Notably, increasing political fragmentation in national parliaments and the rise of populist and Eurosceptic forces all over the continent will probably translate in increasing difficulties to carry out reforms. Furthermore, in some cases, several the growth-enhancing reforms that had been implemented in previous years are likely to be undone. We are already observing this process in Italy and Spain.

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