

# Referee report on “Skill-biased labor market reforms and international competitiveness”

August 3, 2012

## 1 Summary and evaluation of the paper

The paper investigates the effect of skill-specific labor market reforms on capital flows, wages, and unemployment in a variation of the Feenstra and Hanson (1996, 1997) model. A unilateral decrease in unemployment benefits decreases unemployment in the reforming country but also increases wages and leads to an inflow of capital. To the contrary, the non-reforming country experiences an outflow of capital and an increase in its unemployment rate.

I think the paper addresses a very relevant topic for both academics and politicians as the international spillover effects of unilateral labor market reforms are hotly debated, especially in the European Union. That the paper also incorporates FDI strengthens its relevancy even further given the recent events in the European government debt crisis as this is still an underresearched area in the literature.

The model advances the literature by modeling FDI, capital flows, and skill-specific labor markets at the same time. In the revised version, the author motivates the empirical relevancy of skill-specific labor market reforms, and hence has strengthened the paper considerably.

Overall, the paper definitely has a contribution and merits publication. Also, the revision has considerably improved the paper. Still, there remain some issues on which I will comment below.

## 2 Major comments

1. I really like the revised version of the introduction which now really motivates the paper and considerably increases its potential audience. Now, skill-specific labor market reforms are way better motivated, also by the allusion to the “Euro crisis”. However, I think the introduction now has lost its focus a bit as it includes too many issues and references to other papers which are not directly linked to the issues discussed in the main body of the paper. Accordingly, the introduction is now nearly twice as long as before. Therefore, I would shorten the introduction. For example, there are several paragraphs alluding to the effects of trade liberalization on labor markets, an issue not discussed in the paper. The current paper looks at the spillover effects of skill-biased labor market reforms. Hence, these references are not really related to the paper. The author might therefore consider e.g. simply dropping the following paragraphs:  
“Moreover, under floating exchange rates... due to its size.” (p. 3) (This sentence is confusing anyway, as the relationship between (wage) inequality and the floating exchange rate remains unclear, and the main body of the text or the model does not allude to exchange rates.)  
“The predictions about the foreign... , and foreign direct investment.” (p. 5)  
“Boulhol (2009)... UNCDAT.” (p. 6)  
“Moreover, globalization... using matched employer-employee data for Germany.” (p. 6)  
“Two empirical papers that... find the same negative relationship.” (p. 7)
2. p. 12: The proof for part b) of Proposition 1 got lost during the revision, so this copy and paste error has to be corrected. Relatedly, the following paragraph on pages 12 and 13 seems repetitive in its explanation of the unit in which vacancy posting costs are paid. This may also simply be a result of the copy and paste error from Proposition 1.

3. In your revision, you introduce a preference parameter  $\iota_k$  which models the preference for unemployment benefits. This seems a bit awkward. As unemployment benefits normally are paid in cash, not in kind, differences in  $\iota_k$  across skill-groups imply a different utility of money for high- and low-skilled workers. This, however, would have to show up in the utility function as well. However, there is a simple solution to this problem. Assume that the flow value of being unemployed is given by

$$b_k = \tau_k + B_k \quad (1)$$

Assume for simplicity that unskilled workers do not own any other assets which generate income if they are unemployed, hence  $\tau_l = 0$ . High-skilled people possess such assets, hence  $\tau_h > 0$ . According to German unemployment benefits legislation, an unemployed worker is only entitled to unemployment benefits if she does not own any considerable assets. Hence, in our model, only low-skilled workers will receive  $B$ , the replacement rate, if they are unemployed. Hence, any comparative static in  $B$  will only affect low-skilled workers without having to resort to contradictory assumptions about money preferences. With this minor modification of your model, all your results will be exactly the same, it will be closer to the German institutional setting you talk about in the introduction, and it will not require any assumptions about heterogeneous money preferences.

4. In my first referee report, I asked the author to clarify the difference between his paper and Beissinger (2001). This has not been done. I would still like the author to write just one sentence as Beissinger studies the very same topic.
5. In my first referee report, I asked the author to “polish the paper considerably”. However, the paper is still full of typos and grammatical errors, see below.

### 3 Minor comments, typos

1. p. 2: “For **the** low-skilled the effect is ambiguous.”
2. p. 3: “extremely” seems very extreme.
3. p. 4: “More stringent labor market institutions are lower unemployment benefits or **less** employment protection for instance.
4. p. 5: “foreign” vs. “Foreign” (p. 25).
5. p. 7: extent.
6. p. 10: I do not understand “Moreover, industries are ranked according to unit costs, which implies that  $\gamma_{ki} > 0$ .”
7. p. 11 “There are two different **types** of firms”
8. p. 11: “economy **equally** endowments” ?!
9. p. 12: “standard Bellman equations”: Please refer to equations (14) and (15) as it is not clear what the author is referring to.
10. p. 15: “both actors’ bargaining power,  $\beta$ ”. Is it the bargaining power of the worker or the employer?
11. p. 15: “the existence of recruitment costs increases **wages**”
12. p. 15: “pendant” is an earring, you probably mean “equivalent”.
13. p. 17: “where they have **a** comparative advantage”
14. p. 20: “bound of the **integral. Also**”
15. p. 22: “improve a **country’s** competitiveness”
16. p. 22: “has an effect on **the** domestic labor market”
17. p. 22: “into **its** skill-specific effects” is wrong.
18. p. 22: “The **worker’s** bargaining power”

19. p. 23: Proposition 2: “leads to **a** decrease”
20. p. 25: Proposition 2: “leads to **a** decrease”
21. p. 27: “Suppose that both governments reduce[...] **in way** [...] schedules”
22. p. 27: “analysis of different types”
23. p. 28: “**it** also indirectly **affect**”
24. p. 28: “on **its** partner countries” ?!