

REVIEW of Stephen Sacht: "On the efficiency of labor market reforms: how to solve the Spanish Puzzle"

Piero Ferri  
Emeritus Professor of Economics  
Department of Management, Economics , and  
Quantitative Methods, University of Bergamo (Italy), via dei Caniana 2, 24127  
Bergamo (Italy). E-mail: [pietro-enrico.ferri @unibg.it](mailto:pietro-enrico.ferri@unibg.it)

#### 1. The aim of the paper.

The aim of the paper is fundamentally that of explaining the so called "Spanish Puzzle", i.e. the increase in (youth) unemployment in spite of a structural reform of the labor market that occurred in 2010 and that tries increase flexibility. This reform is contrasted with a successive one, carried out in 2013, and named the Entrepreneur's act. While the former has been disappointing, the latter would seem to be more encouraging. Both empirical support and theoretical justifications have been put forward in order to support the thesis.

#### 2. Post hoc propter hoc

Let us start from the data. After the labor market law (2010), the rate of overall unemployment rose from 20,1% in the same year to 25% in 2012, when the maximum of the oveal period considered (2003-2014) has been reached. As far as the youth unemployment is concerned, it rose from 41,6 to

53,2 in 2013, i.e. it reached the maximum a year later. Since unemployment rate, in both versions, decreased from 2013 onward, when the Entrepreneur' Act became law, this should be a prove, according to the author, of the success of this measure.

As is well known, reforms take time in order to develop their effects. It follows that such short intervals of time are inadequate in order to draw clear cut conclusion on the relative merits of the two reforms. Post hoc does not necessarily imply propter hoc.

### 3. The Okun's law

In order to cast some doubts on this conclusion, let us consider an alternative empirical measure referred to medium-run periods. The so called Okun's law implies that the difference in the rate of unemployment is a fixed function of the difference in the rates of growth:

$$u_t = u_{t-1} - \gamma(g_t - g_{t-1})$$

The coefficient  $\gamma$  measures the reactivity of unemployment to changes in the rate of growth. Let us compute this coefficient for the various sub-period, as appears from Table 1.

Table 1:  $\gamma$  in the various sub-periods\*

2003-2007	4.02
2008-2010	1.8075
2010-2014	6.51

\*(The final year is the average of the period, excluding the initial term).

Two observations are worth making. The first is that  $\gamma$  has fallen during the Lehman brothers crisis period (2008-2010) and this has prevented unemployment from rising even further. The second element is that in the last period, i.e. after the Labor market law, the elasticity has increased and this is exactly what a labor market reform based upon flexibility should do.

The problem is that growth has been negative (except in 2014) and this has created the perverse effect of increasing unemployment even faster.

#### 4. The AD-AS Model

The effects of the two reforms have been examined by means of the AD-AS model. There are two general problems. The first is that since one is dealing with unemployment, the product market should be supplemented by an explicit the labor market representation, where fundamental variables such as real wages and labor supply should be present. The second is that the interrelationships between the various aspects can be better understood in

dynamic terms. Take for instance into consideration the second picture of Figure 1, when the virtuous circle of the so called AS reform is considered. In this picture is fundamental to understand why also aggregate demand move. The suggested answer is expectation. My impression is that the story is more complex.

#### 5. The "zeitgeist" of the period

The span of time considered has been dominated by the presence of the financial bubble and its aftermath. This is the "zeitgeist" of the period. The problem is to understand the complexity of the situation that involves, demand, supply and credit aspects. The author does recognize this aspect, but it should be developed in a deeper way.

In Spain the bubble has mainly concerned the construction sector. Even though this phenomenon implies relative price misalignment as suggested by Hayek, it is undoubtedly true that it has implied a huge drop in aggregate demand and episodes of credit crunch and liquidity trap. In this case one has to have a strategic view.

## 6. The deus ex-machina

Aggregate demand has been the market mover not just in a short period of time but also in a medium perspective. While demand decreased in the aftermath of the Lehman brothers episode, it underwent another negative round because of the sovereign debts crisis in the European Monetary Union. The successive change of policy by the ECB has stimulated demand also in countries such as Spain. Within this context, expectations have improved and this has certainly contributed to a better implementation of the Entrepreneur's Act. However, when aggregate demand is falling, it is very difficult to improve unemployment by acting on the labor market alone.

## 7. The real puzzle

In this context, therefore, the real puzzle is not that unemployment increased in spite of a labor market reform, as the fact that it has increased by 300% in 7 years, while the youth rate of unemployment has been the double of the general level. Labor market reforms tend to have impacts on the structure than on the level of employment that depends very much on the evolution of aggregate demand, at least in the medium-run.

For these reasons, a comparison with what happened in Europe should be a priority.

## 8. The challenges

The paper could be improved not only by strengthening the econometrics, as suggested by the author, but also by deepening the following aspects:

- a) A more accurate story telling of the period should be put forward, where dynamics must have a fundamental role.
- b) This is particularly true for the rate of unemployment, where the analysis should be enriched by the study of the dynamics of flows into and from unemployment. These can account part of the differences with respect to other countries.
- c) Finally, one might investigate if the nature of these flows depends on that of the contracts. This could be a particularly interesting perspective in order to judge the relative advantage of one reform with respect to the other.

