THE IMPACTS OF STRUCTURAL CHANGES IN THE LABOR MARKET:  
A COMPARATIVE STATICS ANALYSIS USING  
HETEROGENEOUS-AGENT FRAMEWORK

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Abstract

In this paper we aim at analyzing the impacts on welfare and wealth and consumption distribution across different labor market structural features. In particular, we assess the steady state impacts of changes in unit vacancy costs, unemployment replacement ratio and in the job destruction rate, for a given reduction in the unemployment rate.

We combine the standard labor market search and matching model based on Mortensen and Pissarides (1994) with a heterogeneous-agent framework close to Imrohoroglu (1989). Such approach enables the joint assessment of welfare and inequality implications derived from institutional changes in labor market. Moreover, the transition matrix between worker's states is endogenous, fully derived from labor market conditions.

The model, calibrated as to match Euro Area data, is solved in two stages. First, firms and a trade union negotiate over real wages and, then, given the wage, each worker makes labor supply and savings decisions; firms decide, instead, on optimal stock of capital and labor demand. Endogenous real interest and wage rates are found such that capital and labor markets equilibrium hold.

We conclude that labor market institutions have non-neutral effects on welfare and inequality measures. Accordingly, we can rank unit vacancy costs and job destruction strategies, but changes in the unemployment benefit replacement ratio involves a trade-off between welfare and consumption/income distribution.

JEL Classification: E21, E24, E27, 130, J64.

Keywords: Labor market institutions, search and matching models, heterogeneous-agent models, welfare and inequality.

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1 Introduction

In this paper we aim at analyzing the impacts on welfare and on wealth and consumption/income distribution across different labor market structural features. We use a standard labor market search and matching model of Mortensen and Pissarides (1994) combined with worker savings choices as defined in Imrohoroglu (1989). By combining an heterogeneous-agent model with a search and matching framework, we want to analyze not only welfare, but also inequality steady state implications of labor market institutional changes. The workers’ ex-ante homogeneity in preferences results in a non-degenerated asset holdings distribution (individuals with the same employment status choose different levels of savings); the implications on welfare and on wealth and consumption/income distribution are then deduced. From the modeling in here expressed, we want to ascertain the reasonableness of the direction and dimension of changes of the endogenous variables due to changes on labor market institutional variables.

Deliberately choosing a parsimonious approach of both frameworks, we assume that there is no search-on-the-job, no endogenous job destruction nor any job-search effort. As for the heterogeneous-agent framework, we consider that utility is driven only by consumption and that no borrowing is allowed. The purpose of this particular formulation is to establish a baseline from which to depart in future work. The timing of model-solving consists of two stages. First, firms, posting vacancies, and a trade union engage in a real wage bargaining process. After the real wage is set, firms choose the amount of capital to use in their productive activity. As a result, labor market adjusts to meet aggregate demand and aggregate supply of labor and the demand for capital is determined. Second, given the real wage and aggregate labor market conditions, workers decide on the amount of assets to hold; aggregate capital supply is found. An endogenous real interest rate is determined in the capital market to meet aggregate capital demand and supply. The result is, thus, a general equilibrium model where workers and firms optimize their actions and, through endogenous real interest rate and real wage, capital and labor markets equilibria hold.

There are only few works that combine these two frameworks. One is Krusell et al. (2010) that uses a search and matching model of the labor market where savings work as an insurance against unemployment (following the works of Merz (1995); Andolfatto (1996) and den Haan et al. (2000)). The paper focuses, following the debate in the search and matching literature that began with Shimer (2005), on the inability of matching models to replicate the observed volatility on unemployment and vacancy rates. The model incorporates the worker savings behavior in the wage bargaining and takes interest rate as exogenous. In both these aspects our work is distinct. The closest framework to ours is that of Nakajima (2010). As in Krusell et al. (2010), this work also addresses the volatility problematic in the search and matching model by introducing self-insurance. As in our work, an income tax is introduced to finance unemployment insurance but it additionally includes leisure in the utility function of the worker; interest rate is also endogenous. Shao and Silos (2007) also use a framework very close to this one. Also with the aim at analyzing the volatility properties of unemployment, vacancies, wages and labor market tightness,
interest rate and the transition matrix are are exogenous and borrowing is allowed. In contrast, Bayer and Walde (2010) focus on the dynamic and equilibrium properties of the matching model with savings. They use a continuous time model where the behavior of risk averse individuals is analyzed in steady state equilibrium; they also introduce the dynamics of transition. Interest rate is exogenous and no comparative statics is performed; in here too, our work makes a difference.

In none of the mentioned works the equilibrium is found by allowing the interest rate to be endogenously determined through the interaction between the optimizing behaviors of both the firms and the workers. More, the use of a transition probability matrix is, in our work, truly endogenously determined and derives from the labor market conditions. We leave aside the volatility puzzle that dominates most of the related literature; instead we intend to perform steady state comparative statics across different unemployment replacement ratios, vacancy unit costs and the job separation rates, in order to get insights of their implications on welfare and wealth and consumption/income inequality.

This work is organized as follows: section 2 describes the theoretical model; section 3 describes the computational solution adopted to solve the model and steady state and comparative statics results; section 4 concludes.

2 Model description

In order to assess welfare, and in particular, inequality effects on wealth and consumption/income distribution associated with labor market institutions, we have chosen to combine a search and matching model based on Mortensen and Pissarides (1994) with as heterogeneous-agent model close to the framework in Imrohoroglu (1989) (for more comprehensive understanding of these subjects we recommend the textbooks of Pissarides (2000), Ljungqvist and Sargent (2004) or Cahuc and Zylberberg (2004)).

There exists two moments for the household optimal outcome: first, the trade union negotiates a real wage with the firms given the corresponding bargaining powers and overall labor market conditions. Because of this centralized negotiation, assets holdings of the worker are assumed not to influence the real wage outcome. The outside option consists only of the current income when unemployed irrespective of asset accumulation; second, taken the bargained wage, each worker will make his labor supply and savings decisions according to his profile. Labor and capital supply are defined. Firms, instead decide on optimal stock of capital and labor demand. Real interest and wage rates ensure labor and capital markets equilibrium.

The capital used by the firms and the asset holdings by the households are, in substance, the same; therefore, we will use the expressions capital, savings and asset holdings interchangeably throughout this work. The period model is one year and the interest rate and wage are referred in real terms henceforth.
2.1 Labor market search and matching model building blocks

As in Pissarides (2000) we consider an economy composed of $L$ individuals in the labor force. A fraction $u$ of $L$ are unemployed while the remaining $(1-u)L$ are employed. Taking the unit interval for $L$, we can decompose the labor force as $1 = u + (1-u)$, and thus $u$ is the unemployment rate. The level of employment is measured in terms of jobs offered. These jobs can be either occupied with a worker and producing or remain vacant. The vacancy rate is measured as the fraction of vacant jobs over the overall job offers, that is, $v = \frac{\text{vacant jobs}}{\text{jobs}}$. The aggregate labor market conditions are measured by the relation between the rate of vacancies, $v$, and the rate of unemployment, $u$. For this purpose, $\frac{v}{u} = \theta$ represents labor market tightness. The process through which unemployed and vacancies meet is described by the matching function $M = \chi M(u, v)$, with $\chi \geq 0$ representing an efficiency parameter. As proposed by Blanchard and Diamond (1989) and Pissarides et al. (1986), the function $M$ is assumed to be homogeneous of degree one, concave, continuous and increasing in both arguments. In each period an amount $M$ of matches are produced; of course, we impose that $M = \min\{M(u, v), \text{vacancies, unemployed}\}$, $M(u, 0) = 0$ and $M(0, v) = 0$. On the vacancy side, firms post job vacancies that are filled at rate $q(\theta) \equiv \frac{\chi M(u, v)}{v} = \chi M\left(\frac{1}{\theta}, 1\right)$, i.e., the vacancy matching rate. On the unemployment side, the unemployed worker finds a job at rate $p(\theta) \equiv \frac{\chi M(u, v)}{u} = \chi M\left(1, \frac{1}{\theta}\right)$, i.e., the unemployment matching rate. More, the dynamics of unemployment exiting and of vacancy matching follow Poisson processes, that is, the instantaneous endogenous probability of unemployment exiting and of any vacancy being occupied are, respectively, $p(\theta)$ and $q(\theta)$. We also consider a Poisson process for job separation, with an instantaneous separation rate $\lambda$, exogenous.

In particular, and following the literature, we assume the following Cobb-Douglas type matching function:

$$M(v, u) = \chi^\eta v^{\eta} u^{1-\eta}, \eta \in ]0, 1[$$ \hspace{1cm} (1)

which implies that

$$p \equiv p(\theta) = \chi^{\theta\eta} \hspace{1cm} (2)$$

$$q \equiv q(\theta) = \chi^{\theta\eta-1} \hspace{1cm} (3)$$

Notice that, the instantaneous probability of an unemployed worker finding a job, $p$, increases when labor market conditions improve, that is, for a given number of vacancies, a decrease in the number of the unemployed increases the probability of finding a job. Obviously, the reverse applies for the instantaneous probability of filling a vacant job, $q$.

Since we restrict the analysis to the equilibrium situation, labor market balances when the flows to and out from unemployment are equal, that is, when

$$\lambda (1-u) = pu \hspace{1cm} (4)$$

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yielding the following endogenous unemployment and vacancy rates in equilibrium:

\[ u \equiv u(\theta) = \frac{\lambda}{\lambda + \chi \theta^n} \]  

\[ v \equiv v(\theta) = \frac{\lambda \theta}{\lambda + \chi \theta^n} \]  

2.2 Trade union

In the labor market, households are represented by trade unions that bargain over wages with firms. At any given moment, a worker can be at one of two states (s): employed (e) or unemployed (d), s = \{e, d\}. Following Imrohoroglu (1989), labor market flows are determined by transition probabilities between states defined in the following matrix, \( \Pi \):

\[ \Pi \equiv \Pi(\theta) = \begin{bmatrix} p_{ee} & p_{de} \\ p_{ed} & p_{dd} \end{bmatrix} = \begin{bmatrix} 1 - \lambda & \lambda \\ \chi \theta^n & 1 - \chi \theta^n \end{bmatrix} \]  

where \( p_{ij} \) represents the instantaneous probability that a worker is state \( i \) becomes a worker in state \( j \).

If employed, the worker is paid a wage net of income tax, \( w \), otherwise he earns an unemployment benefit, \( bw \). The unemployment benefit replacement ratio is an institutional labor market variable, therefore, exogenous, and is computed as a share \( b \in [0, 1] \) of the net wage, \( w \), earned by the employed workers. The amount of unemployment benefit if fully financed by taxes levied on the labor income of employed workers, such that government budget is always balanced:

\[ \tau (1 - u) w^{\text{gross}} = ubw \]  

where \( \tau \) is the income tax rate and \( w^{\text{gross}} \) is the gross wage. Since \( w = (1 - \tau) w^{\text{gross}} \) and using (4), we can express the endogenous equilibrium income tax rate as a function of labor market conditions alone:

\[ \tau \equiv \tau(\theta) = \frac{b\lambda}{b\lambda + \chi \theta^n} \]  

Notice that the equilibrium income tax rate depends negatively on the labor market tightness, that is, as labor market conditions worsen (as \( \theta \) decreases) the income tax rate increases.

In negotiating over wages, the trade union tries to maximize the rent of being employed, \( W \equiv W(w, U) \), over the fallback option of being unemployed, \( U \equiv U(w, p, W) \), where:

\[ rW = w - \lambda [W - U] \]
The employed worker receives a wage and faces an instantaneous probability $\lambda$ of job separation and, therefore, of losing the surplus of being employed over being unemployed. If unemployed, the worker receives an unemployment benefit and faces an instantaneous probability $p$ of job matching and, therefore, of gaining a surplus over being unemployed.

### 2.3 Firms

There is a large number of firms, each one owning a job. If occupied, the job-worker pair uses capital to produce a capital-equivalent good with homogeneous technology described as:

$$ y \equiv y(k) = \gamma k^\alpha $$

where $k$ and $y$ represent the per capita stock of capital and output, and $\gamma$ is a total factor productivity parameter. Additionally, firms rent capital from workers at interest rate $r$.

The present value of an occupied vacancy, $J \equiv J(y, \tau, w, V)$, corresponds to the expected output less rent costs, depreciation of capital, $\delta$, and the gross wage paid to the worker. In addition, there is an instantaneous probability $\lambda$ of match separation and, consequently, of losing the value of the occupied vacancy. On the other hand, the vacant job, $V \equiv V(q, J)$, supports a fix cost, $c$, and has an instant probability, $q$, of becoming occupied. Thus, we can define the present values of the occupied vacancy and vacant job as:

$$ rJ = y - \gamma (r + \delta) k - \frac{w}{1 - \tau} - \lambda J $$

$$ rV = -\gamma c + qJ $$

Additionally, in equilibrium, all profit opportunities for the vacant job are exhausted, that is, $V = 0$, then in (14):

$$ J(\theta) = \frac{\gamma c}{\chi \theta^{q-1}} $$

Given that $q^{-1}$ is the average waiting time of a vacant post, the previous expression states that, in equilibrium, the expected value for the occupied vacancy must equal the cost of holding a vacant job. More, we can decompose output in its respective components by rearranging (13) and using (15):
\[ \frac{y}{r + \lambda} = \frac{w}{(1 - \tau)(r + \lambda)} + \left( \frac{\gamma r}{r + \lambda} k + J \right) + \frac{\gamma \delta}{r + \lambda} k \]  \tag{16} \]

where the left-hand side of (16) refers to the normalized output. In the right-hand side of (16), the first term represents labor factor payments, the second the capital factor payments (in brackets: rents on capital and the expected cost of a vacant job) and, finally, the last term represents the capital depreciation.

In this context, the firms can only choose the amount of capital to use when a vacancy-unemployed worker match is formed and, negotiate a wage with the trade union. The problem of the firm is then one of maximizing the present value of a filled vacancy, \( J \), by choosing the optimum amount of capital and labor, that is:

\[ \max_{k,w} \{ J \} \]  \tag{17} \]

The solution to the optimization problem (17) is expressed in the following proposition:

**Proposition 1.** At the optimum, the firm chooses the amount of wage and capital as to verify:

\[ w \equiv w(y, \tau, q) = (1 - \tau) \left[ y - \gamma (\delta + r) k - \frac{\gamma (r + \lambda) c}{q} \right] \]  \tag{18} \]

\[ k = \left( \frac{\gamma \alpha}{\delta + r} \right)^{\frac{1}{1-\alpha}} \]  \tag{19} \]

Expression (19) states that the marginal product of capital must cover for the depreciation and the rent of capital. As for expression (18), the optimum wage for the firm, which follows from the optimum choice of capital, depends positively on output and on the probability of job matching; negatively on depreciation and rent costs of capital, on unit vacancy cost (which are direct costs to production) and on the probability of match separation (which acts as an indirect cost to production). In fact, any increase in direct or indirect costs of production have negative impacts on wages. The wage expression, \( w \), is the inverse of the demand for labor function of the firm.

Since firms are homogeneous and own a single vacancy each, the individual demand for capital corresponds to the average aggregate demand for capital of the whole economy. Therefore,

\[ D_k = k \]  \tag{20} \]
2.4 Wage negotiation

The wage is determined by a negotiation between the firms and the trade union with a view to share the total surplus of the match, where the total surplus is \( S = (W - U) + (J - V) \) as the surpluses of the trade union (first term in the right-hand side) and the firm (second term in the right-hand side). In this framework, that consists of workers centralized bargaining, the negotiation does not take into account the asset holdings of the workers; the rent of workers is pulled over the \( U \) value given the union negotiation strength, which we denote by \( \mu \in [0, 1] \). In equilibrium, \( V = 0 \), therefore, the problem at hand is one of finding the wage that maximizes the total surplus of a successful match making use of the Nash product \((W - U)^\mu J^{1-\mu} \):

\[
\max_{(W-U),J} \{(W - U)^\mu J^{1-\mu}\}
\]

s.t. : \( S = (W - U) + J \)

the respective solution to the maximization problem yields:

\[
\mu J = (1 - \mu)(W - U)
\]  

(22)

The wage will have to be such that the surplus of the job and the surplus of the worker are divided in terms of bargaining power between firms and trade union. The explicit solution to the wage negotiation problem is expressed in the following proposition:

**Proposition 2.** The wage that maximizes the total surplus of a successful match is:

\[
w \equiv \bar{w}(y, \tau, k, \theta) = \frac{(1 - \tau) \mu}{\mu + (1 - \tau)(1 - \mu)(1 - b)} \left( y - \gamma (\delta + r) k + c \gamma \theta \right)
\]

(23)

The wage agreed between the firm and the worker decreases with depreciation and rent cost of capital and increases with output and labor market tightness. Higher output increases the firm resources to better reward labor; the inverse occurs when depreciation and capital rent costs increase. Expression (23) is the effective labor supply.

2.5 Households

Following Imrohoroglu (1989), we will use the transition probabilities between states of the worker as a constraint to the maximization of the utility of the household. From solving the households' optimization problem we can compute the average aggregate amount of savings, i.e., the capital supply-side of the model.

A household maximizes utility taking bargained wage, labor market conditions and interest rate as given. Being so, let \( a_t, c_t \geq 0 \) be, respectively, the amount of asset holdings
and consumption level in period $t$, $\beta = (1 + r)^{-1}$ the discount factor and $\Upsilon$ the following utility function that verifies the usual neoclassical properties:

$$\Upsilon_t \equiv \Upsilon(c_t) = \frac{c_1^{1-\sigma} - 1}{1 - \sigma}$$  \hspace{1cm} (24)

where $\sigma$ is a risk aversion parameter.

In each period, the household must decide on the amount of assets to hold in the following period, $a_{t+1}$, subject to the following budget constraint:

$$a_t \equiv a_t(a_t, a_{t+1}, s_t) = \omega_t + (1 + r) a_t - a_{t+1}, \omega_t = \{w_t, bw_t\}$$  \hspace{1cm} (25)

The household must choose a plan $\{a_{t+1}\}_{t=0}^{\infty}$ for a given $(a_t, s_t)$ as to maximize the discounted utility, $H_t \equiv H(\Upsilon_t, \Pi_t, H_{t+1})$. Formally, we are faced with the following dynamic programming problem:

$$H_t = \max_{a_{t+1}} \left\{ \Upsilon_t + \beta \sum_s \Pi_t H_{t+1} \right\}$$  \hspace{1cm} (26)

The solution to (26) yields the decision rule for next period’s asset holdings, i.e., the asset supply function that depends on the pair $\{current\ employment\ state,\ current\ amount\ of\ asset\ holdings\}$:

$$a_{t+1} = \Gamma(s_t, a_t)$$  \hspace{1cm} (27)

Since we define a probabilistic framework for the transitions between worker states, more precisely, a discrete Markov process with a finite number of states with the ergodic property (7), then an invariant distribution can be determined. Being so, let

$$\rho \equiv \rho(s)$$  \hspace{1cm} (28)

be the density function for the invariant distribution of asset holdings across households depending on the worker state. Once determined, it is immediate to calculate the average aggregate equilibrium asset holding - the capital supply:

$$S_k \equiv a = E\{\rho\}$$  \hspace{1cm} (29)

### 2.6 Steady state equilibrium

The model is closed through a two stage computation. On a first stage, labor market equilibrium is determined. This is obtained by putting together the demand (23) and the supply (18) for labor. Implying an implicit equilibrium value for $\theta$ obtained by verifying:
\[ \tilde{w}(y, \tau, k, \theta) = w(y, \tau, q) \] (30)

On a second stage, the demand and supply for capital is determined. We determine the equilibrium in the capital market through finding the endogenous interest rate, \( r \), which satisfies both average supply (29) and demand (19) for capital. Since we are faced with a recursive solution for the supply side of the capital market, the interest rate that balances the capital market has to be found by trial and error, such that:

\[ r = \{ \tilde{r} : D_k = S_k, \tilde{r} \in \mathbb{R}_0^+ \} \] (31)

As we aim at assess the impacts of changing structural features of the labor market, we compute the steady state value function (26) to measure welfare. Moreover, and to assess potential inequality impacts of the measures, we complement welfare analysis with consumption/income dispersion, using the Gini coefficient\(^1\).

**Definition 1.** Stationary Equilibrium. The recursive stationary equilibrium of the economy is the set of functions \( S = \{ u, \tau, w, D_k, S_k, \theta, r \} \) which are the solution to

1. Labor market equilibrium: entries equal exits from unemployment (4), where \( u \) is the equilibrium unemployment rate;

2. Optimization problem of the firm: the amount of capital used by the firm maximizes the value of the occupied vacancy (17), where \( k \) is the optimum per capita stock of capital and \( w \) is the inverse of the labor demand function;

3. Wage determination problem: the wage agreed between the firms and the trade union maximizes the match surplus (21), where \( w \) is the labor supply function;

4. Government’s budget equilibrium: the income tax rate fully finances unemployment benefits (9);

5. Labor market tightness: the level of labor market tightness must be such that the labor demand (18) and the labor supply (23) are equal;

6. Optimization problem of the household: the amount of asset holdings, given the wage and labor market conditions, maximizes inter-temporal utility (26) of the household; and

\(^{1}\)The technique used for solving the model requires a discrete asset space, therefore, the calculation of Gini coefficient will be:

\[ Gini = 1 - \sum_{i=0}^{n} (\hat{\rho}_i - \hat{\rho}_{i-1}) (\hat{a}_i + \hat{a}_{i-1}) \]

where \( \hat{\rho} \) and \( \hat{a} \) corresponds to the cumulative value for the population and asset holdings at the \( i^{th} \) quantile, respectively. This index of inequality measures the distance of the variable cumulative distribution from absolute equality dispersion. It ranges from \( Gini = 0 \) (absolute equality) to \( Gini = 1 \) (absolute inequality).
7. Capital markets’ equilibrium: the interest rate of the economy is such that balances average capital demand with average capital supply (31).

2.7 Calibration

When available we use Euro area data, as collected in Tables C.1-C.3 in appendix and in Figure 2.1, which also serve as reference to model’s output. We define $EA(12)$ as the Euro area first 12 member countries: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal and Spain.

![Figure 2.1: Unemployment rate and long term real interest rate (monthly)](image)

For parameter calibration purposes, data show that the average job duration is 11.15 years, hence, $\lambda$ is calibrated as $0.082^2$. Unemployment rate registers an average of 9.17%, while annualized real interest rate has an average of 3.06%. Given that data on the unit vacancy costs, $c$, for the $EA(12)$ countries are, to our knowledge, nonexistent, we choose, residually, the value for $c$ as well as the maximum asset level a worker can hold, $a_{max}$, in order to obtain steady state equilibrium interest and unemployment rates as close as possible to the data. As for the minimum asset level a worker can hold, $a_{min}$, the no-borrowing model imposition implies that this parameter is set to zero.

Data for the calibration of the production function and matching function are also incomplete, that is, we could not find data for a significant number of countries and the series were also small preventing any relevant estimation of the parameters. Given this we have set these parameters according to the related literature. Of course, in connection with the production technology, we have also calibrated the depreciation rate of capital accordingly. For this purpose, we chose the calibration used in Ljungqvist and Sargent (2007) of the related parameters. As for the utility function, we used the calibration of $\sigma$ as in Imrohoroglu (1989), that is, 6.2. Finally, for the unemployment replacement ratio, $b$, we rely on Campolmi and Faia (2010), this rate varies between 0.39 for Spain and 0.89 for Ireland. We chose the intermediate value of 0.65. Also, taken the data (see Table C.3 in appendix) the compensation of employees averages at 48.75% of GDP.

Table 2.1 summarizes the parameter calibration of the model.

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$^2$Given the assumption of a Poisson process for job separation rate, if a job is expected to end once every 11.15 years, the probability that it will end within a single year is of $\lambda = \frac{1}{11.15} \cdot \frac{1}{\lambda} = 0.08199266$.

$^3$Source: ECB. The long term real interest rate is computed as the difference between the 10 year government bonds interest rate and the HICP changes relative to the homologous period.
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Table 2.1: Parameter calibration

3 Model implementation and output analysis

In what follows we briefly expose the computational approach and explore in detail the model’s outcome.

3.1 Computational approach\footnote{for an extensive description on the computational implementation see da Silva (2010)}

As depicted in Figure 3.1, this model builds on two block linked by an interest rate, the demand and supply blocks. The demand block determines the asset demand level, which results from the maximizing behavior of the firm in terms of capital stock used, given wages (and correspondent $\theta$ and $u$). The labor costs are the result of wage negotiation between firms and the trade union. From the solution to the wage negotiation and the problem of the firm we get the optimal capital stock, wages and labor market conditions for different interest rates. The second block determines the aggregate savings level, which is supplied by households to firms. The solution to the worker utility maximization problem, given interest rate, wage and labor market conditions yields an optimal asset holdings level. The interest rate will make the link between the two blocks and will be such that, in equilibrium, the capital demanded by the firms equals the asset holdings by households and it will be
found by trial and error.

In order to solve the model, one has to address each block at a time. First, for a given \( r \), the demand block is solved by:

1. solving (12) to get the value of the demand for capital, \( D_k = k \);
2. solving (30) together with the previously obtained value for \( k \), and the value for \( \theta \) is found;
3. solving (23) together with \( k \) and \( \theta \): the equilibrium wage \( (w) \) is found together with the unemployment level \( (u) \) by using (4); and
4. using (4) into (7) to determine the transition probability matrix, \( \Pi \).

Once the key values from the demand block are calculated, which are \( w \) and \( \Pi \), we can solve the supply block, for the same value of \( r \), by:

1. solving the dynamic programming problem (26) through numerical methods to obtain the decision rule (27), \( a_{t+1} = \Gamma (s_t, a_t) \);
2. solving (27) in order to determine the invariant distribution (28), \( \rho \); and
3. using (28) to find the supply of capital (29), \( S_k \equiv a = E \{ \rho \} \).

At this point, we have determined the value for the demand and supply of capital for a given \( r \). The interest rate equilibrium value is achieved by guessing across different values until convergence, that is, until \( |D_k (r) - S_k (r)| \leq \epsilon \) verifies, with \( \epsilon \) being an arbitrarily small positive value.

### 3.2 Numerical simulations

#### Steady state results

Figure 3.2 shows the stationary distribution of assets depicting an accumulation point in the lower end of the asset domain; this is an idiosyncratic result of this type of modeling [see, for example, Imrohoroglu (1989) (Figure 1, page 1376) or Nakajima (2010) (Figure 1 (e), page 23) for a similar result in a discrete context or Krusell et al. (2010) (Figure 2, page 19) for the continuous time case]. The small dimension of the transition matrix \( \Pi \) and the choice of utility function, depending on consumption alone, are the reasons, we believe, for this behavior. Another consistent feature with similar works is that the employed worker holds much more assets than the unemployed (Imrohoroglu (1989); Nakajima (2010) and Krusell et al. (2010)). This is an expected result since, given the homogeneity of the household behavior, the lower income for the unemployed workers implies a smaller ability to accumulate wealth.

Table 3.1 summarizes the main results of the model in steady state equilibrium compared with the average data collected for the EA(12) countries.

The model is unable to match the vacancy rate and, consequently, the equilibrium labor market tightness. It is worth mentioning that, on the firm's side, the optimal behavior
Figure 3.2: Employed and unemployed asset holdings distribution (% of the population in the $y$ axis and the asset holdings level, normalized to $k$, in the $x$ axis).

<table>
<thead>
<tr>
<th>Variable</th>
<th>Data</th>
<th>Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>$\tau$ Interest rate</td>
<td>3.058</td>
<td>3.058</td>
</tr>
<tr>
<td>$\theta$ Labor market tightness</td>
<td>[3.130, 36.760]</td>
<td>66.492</td>
</tr>
<tr>
<td>$v$ Vacancy rate</td>
<td>[0.210, 1.890]</td>
<td>6.075</td>
</tr>
<tr>
<td>$u$ Unemployment rate</td>
<td>9.173</td>
<td>9.137</td>
</tr>
<tr>
<td>$1/p$ Average unemployment duration</td>
<td>1.396</td>
<td>1.226 periods</td>
</tr>
<tr>
<td>Compensation of employees</td>
<td>48.750</td>
<td>64.112 % GDP</td>
</tr>
<tr>
<td>Overall Gini coefficient</td>
<td>[26, 38]</td>
<td>43.877 %</td>
</tr>
</tbody>
</table>

Table 3.1: EA(12)data vs base case model output

takes into account the vacancy unit cost for which, lacking micro data, we have calibrated residually. But this calibration strategy may not be the cause of such a high model vacancy rate result since the value used is within the range used in related literature (see Pissarides (2009); Krusell et al. (2010) and Bartelsman et al. (2010)). It is our conviction that, once again, the dimension of the transition matrix $\Pi$ is the cause of such a high value for the vacancy rate and, consequently, of the high labor market tightness outcome. Therefore, increasing the range of states and, perhaps, endogenizing the in-here exogenous $\lambda$ could improve the prediction on the vacancy rate.

The share of the labor factor in GDP is higher than observed in 15.36pp. This is due, as discussed in the previous paragraph, to the abnormal result in the vacancy rate, that is, we believe the causes of the unbalance between labor and capital weights in output have the same origins as those from the vacancy rate. See that, one key expression of the model is the vacancy creation condition (15), which is crucial, not only to the labor market conditions outcome, but also to output decomposition (16).

Equilibrium unemployment deviates by a very small margin of 0.04pp. The average unemployment duration is lower than data shows: while the model predicts 14.7 months unemployment duration, data shows that it takes 2 months longer for the unemployed to
find a job.

The Gini coefficient for consumption/income is 5.877\(pp\), larger than the high end of the data interval.

### Comparative Statics

The aim of this work is to access how changes in some institutional labor market variables affect the equilibrium unemployment rate and analyze their implications on welfare and wealth and consumption/income inequality. In order to make analysis comparable across institutional changes, we have computed for the required change in the unit vacancy cost, \(c\), in the unemployment replacement ratio, \(b\), and on the job destruction rate, \(\lambda\), in order

<table>
<thead>
<tr>
<th></th>
<th>(b)</th>
<th>(\lambda)</th>
<th>(c)</th>
</tr>
</thead>
<tbody>
<tr>
<td>(\Delta)</td>
<td>-6.5924</td>
<td>-5.4705</td>
<td>-10.3357 %</td>
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<tr>
<td>(\Delta)</td>
<td>1.20463</td>
<td>0.99963</td>
<td>1.88865</td>
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<tr>
<td>(r) Interest rate</td>
<td>0.0745</td>
<td>-0.0083</td>
<td>-0.0289 pp</td>
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<tr>
<td>(k \equiv a) Average per capita asset holdings</td>
<td>-0.9991</td>
<td>0.1021</td>
<td>0.3563 %</td>
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<tr>
<td>(a^n) Assets of the employed</td>
<td>-0.3424</td>
<td>0.6560</td>
<td>0.9343 %</td>
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<tr>
<td>(a^u) Assets of the unemployed</td>
<td>-5.5168</td>
<td>-5.3780</td>
<td>-5.3619 %</td>
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<td>(a^u/a^n) Unemployed assets to average assets ratio</td>
<td>-6.5066</td>
<td>-0.0547</td>
<td>-0.0570 pp</td>
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<td>(a^u/a^n) Unemployed assets to employed assets ratio</td>
<td>-6.2262</td>
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<tr>
<td>(\gamma) Output</td>
<td>-0.3040</td>
<td>0.0340</td>
<td>0.1186 %</td>
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<tr>
<td>(c) Overall Consumption</td>
<td>-3.6289</td>
<td>0.8483</td>
<td>0.9347 %</td>
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<td>(c^n) Consumption of the employed</td>
<td>0.1507</td>
<td>0.5455</td>
<td>0.6874 %</td>
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<tr>
<td>(w) Employed current income</td>
<td>-0.5168</td>
<td>-5.5348</td>
<td>-5.2565 %</td>
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<tr>
<td>(ra^n) Employed savings income</td>
<td>2.0866</td>
<td>0.3828</td>
<td>0.0198 %</td>
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<tr>
<td>(ra^u) Employed savings income</td>
<td>-0.1978</td>
<td>0.0161</td>
<td>0.0099 pp</td>
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<td>(\beta) Vacancy rate</td>
<td>-5.1955</td>
<td>-0.4504</td>
<td>-0.4195 %</td>
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<tr>
<td>(\lambda) Labour market tightness</td>
<td>0.1315</td>
<td>0.0111</td>
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<tr>
<td>(\mu) Probability of remaining unemployed</td>
<td>0.4292</td>
<td>-0.2688</td>
<td>0.4226 pp</td>
</tr>
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<td>(\tau) Income tax rate</td>
<td>-0.7071</td>
<td>-0.3462</td>
<td>-0.3462 pp</td>
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Table 3.2: Impacts of changes in labor market institutional variables in order to promote a 0.5pp reduction in equilibrium unemployment rate
to accomplish the same reduction (0.5pp) in the unemployment rate; given the baseline case solution, this comprises to a 5.47% reduction in the unemployment rate. The focus on these specific institutional variables derives from the fact that: (i) the unemployment replacement ratio is a direct labor market institutional variable as it captures the amount of income that an unemployed is entitled to as insurance for becoming unemployed; (ii) regarding the job separation rate, it captures, though indirectly, job destruction regulation (job protection legislation, firing costs or age retirement restrictions, for instance, are strong constraints on the job separation decision); (iii) although the unit vacancy cost is not a labor market institutional variable, vacancy costs are crucial in the job creation decision of the firm and, hence, they are meaningful as they impact strongly on unemployment and labor market functioning.

Accordingly, Table 3.2 presents the required changes in the labor market institutional features together with the corresponding steady state impacts on the most relevant endogenous variables and also on average welfare and wealth and consumption/income distribution by worker status.

We start by stating that the desired reduction on the unemployment rate can be achieved by reasonable changes in all the exogenous variables. It is by itself a positive outcome since it excludes extreme responses from these variables. For that matter, the model predicts that in order to decrease the unemployment rate in 0.5pp the replacement ratio needs to be reduced in 6.59%. Alternatively, the same result is achieved by reducing 5.47% in the job separation rate or by reducing the unit vacancy cost in 10.34%, ceteris paribus. While the effects are one-to-one of $\lambda$ in $u$, it requires 1.2% and 1.9% changes in $b$ and $c$ to achieve a decrease 1% change in the unemployment rate.

Average per capita capital, $k$, falls with $b$ and increases with $\lambda$ and $c$ which, by (12), pushes the average per capita output, $y$, in the same direction accompanied by opposite changes in the equilibrium interest rate. The greatest positive impact is obtained when we reduce the vacancy unit cost. For the same desired reduction in the unemployment rate, reducing a direct production cost results in an approximately 3.5 times greater increase in output than reducing the job separation rate. Moreover, the reduction in the unemployment replacement ratio achieves the desired reduction in unemployment but yields negative results on output. In all cases, the unemployed worker owns less assets, $a^u$ falls, and, moreover, he owns relatively less than the average employed worker (both $a^u/a$ and $a^u/a^e$ ratios decreases).

Average overall welfare decreases only when $b$ is used as a institutional tool towards unemployment reduction. This results from the large decline in the consumption level of the unemployed which is not sufficiently compensated by the rise in the employed consumption; hence, average welfare moves directly with $b$. More precisely, the sharp reduction on the unemployed consumption is the result of both a fall in current labor-related and savings income: the increase in wage is overcome by the fall in $b$ and the increase in the interest rate is overcome by a fall in asset holdings, resulting in a double downward effect for the consumption of the unemployed. In contrast, in the case of $\lambda$ and $c$, the fall in savings income is more than compensated by the rise in current labor-related income. As regards
consumption of the employed worker, it rises due to the increase in both current and savings income. Even when the increase in asset holdings is not enough to overcome the decrease in interest rate, resulting in a marginal reduction on the savings income (as in case of a downward shock in $c$), the increase in current labor-related income is enough to raise the consumption of the employed. Once again, a reduction in $c$ dominates, yielding the best results in overall (and group-specific) consumption and, consequently, in overall (and group-related welfare).

Regarding the asset holdings, average overall inequality as well inequality within

**Figure 3.3:** Impacts on asset holdings distribution of the employed and unemployed due to changes in labor market institutional variables in order to promote a 0.5$pp$ reduction in equilibrium unemployment rate. For the employed in the left side and for the employed in the right side. (% of the population in the $y$ axis and the asset holdings level, normalized in order of the baseline case average asset holdings for each state, in the $x$ axis)

groups decreases only with unit vacancy costs (see Figure 3.3). On the contrary, using $b$ and $\lambda$ wealth inequality increases, with $b$ registering the worst outcome. Low values of $b$ enlarge asset distribution, distributing the individuals throughout a larger domain and, hence, increasing wealth inequality. As for the $\lambda$, though the distribution of asset choices shrinks, there exists a deviation to the extremes that counteracts the positive effects of a smaller distance between those who own lower and higher asset levels. From Figure 3.3, both these effects seem to work in favor of inequality reduction when $c$ falls. As for group-specific inequality, given a downward change in $b$, and a consequent fall in current income, the worker uses more of its savings income in order to minimize the effects on consumption; that does not happen with changes in $\lambda$ and $c$. A larger use of savings implies less ability to save and, hence, lower average asset holdings, represented by a shift to the left of the asset distributions, for both the employed and the unemployed (see that $w/c^e$ and $wb/c^e$ ratios fall). In line with the effects on asset distribution, downward shocks in $b$ and $\lambda$ increases inequality within groups in what regards consumption while a downward shock in $c$ decreases groups-specific inequality. The fact that all market
institutional variables reduce unemployed individuals, flowing into employed groups who achieve larger consumption levels, induces a positive effect on average overall consumption inequality, that is, all measures reduce asymmetries between employed and unemployed.

As for labor market tightness, $\theta$ improves in all cases, although with a clear smaller impact in the case of $\lambda$ due to the opposite effects of a decrease in both unemployment and vacancy rates (in the case of $b$ and $c$, a decrease in $u$ is leveraged by an increase in $v$). Labor market conditions are determined by the demand and supply for labor which, from (18), establish a positive relation between $\lambda$ demand for labor, that is, as jobs last longer, the average job turnover falls, implying that less job vacancies are available, this effect dims the positive one resulting from a fall of unemployment in $\theta$. Consequently, the reduction in the expected duration of unemployment is less sharp and the expected time for a job vacancy to be filled increases by less in this case when compared with the alternative structural changes ($b$ and $c$).

Reflecting the improvement in labor market conditions, the wage negotiated between firms and the trade union rises for all strategies. The smallest increase is registered when $b$ is reduced. Given that the opportunity cost of being unemployed ($bw$) decreases with $b$, *ceteris paribus*, the trade union obtains a smaller wage improvement when negotiating with firms. Apparently, the use of $c$ and $\lambda$ also results in higher wages, although for different reasons: on the one hand, low $c$ corresponds to low expected job vacancy costs (15) and, therefore, firms are more willing to open new vacancies, increasing labor demand. This effect is expressed in (18) where the optimum wage reflects the reduction on vacancy costs to compensate for higher wages resulting from a raise in competition between workers. On the other hand, a low $\lambda$ corresponds to a low uncertainty of firms on the asset value of the job; therefore, firms are willing to pay more to the worker in order to keep the vacancy filled (see also (18)); at the same time a low $\lambda$ increases workers fallback option.
and, consequently, their bargaining power.

As expected, the equilibrium income tax rate decreases in all cases. A reduction in the number of unemployed requires fewer resources to pay for unemployment assistance and, at the same time, there are more employed workers to tax. An additional effect works in the case of an intervention using $b$ because, obviously, the replacement ratio is reduced, hence implying an even lower tax rate.

In summary, according to our model, a reduction in unemployment rate is better achieved through a unit vacancy cost reduction than by reducing the job separation rate: average overall welfare increases by more while both consumption and wealth inequalities are reduced by more. The use of a reduction in $b$ has ambiguous effects: this strategy decreases welfare, specially for the unemployed, and increases wealth inequality. However, this strategy exhibits the best outcome in terms of consumption/income distribution.

4 Conclusions

In order to access the welfare and redistributive impacts of some institutional changes in the labor market, we use the standard labor market search and matching model with aggregate savings within a heterogeneous-agent framework. We have deliberately elected a simple formulation from the search and matching literature as well as from the heterogeneous-agent framework. One novelty is the structure of the model which relies in combining labor market equilibrium with capital market equilibrium. This specification allows interest rate to be determined endogenously. Second, the particular structure chosen for the labor market interactions, determines an equilibrium that is based on the behaviors of workers and firms. Third, the model enables to access, besides impacts on unemployment, welfare and wealth and consumption/income distribution impacts from structural changes in labor market functioning. Fourth, the transition matrix is endogenous; it is not produced according to exogenous shocks and derives from the equilibrium outcome.

We conclude that, for a reasonable parameter calibration - mostly based on the $EA(12)$ economy, the model is quite accurate in predicting the equilibrium unemployment rate, unemployment duration, interest rate, $Gini$ coefficient for overall consumption/income and output decomposition. Although, vacancy rate and, consequently labor market tightness, are higher than data shows. The results from the comparative statics analysis show that, to obtain a given reduction in the unemployment rate the reduction in the vacancy unit costs, induces both welfare improvement and inequality reduction when compared with a strategy relying on the reduction of the job separation rate. On the contrary, a reduction in the replacement ratio implies a trade-off between welfare and consumption/income distribution. The fact that a lower replacement ratio implies a worse welfare may be justified because the model ignores the effects that the replacement ratio has on the search intensity of the unemployed. It is commonly argued that there is a significant impact of unemployment insurance on the worker search intensity (see, for instance, Pissarides (2000)) and, therefore, on the probability of finding a job and thus, on welfare. Therefore, the immediate research agenda for this future work is the inclusion of search effort by the unemployed worker by allowing the probability of finding a job be a function of the replacement ratio.
level and/or by affecting unemployment duration. Furthermore, the worker utility function in the model should encompass a trade-off between consumption and leisure, namely to capture labor supply-side effects. Another caveat is the small dimension of the transition matrix; the inclusion of extended characteristics of the worker, such as education level, gender or tenure, would certainly produce higher dispersion across households.

Finally, recall that this is a static analysis and, therefore, any results are computed only by comparing the initial system steady state with the end system steady state. No transition dynamics is accounted for, thus, we cannot determine if, in fact, the best steady state results still correspond to the most beneficial when including the transition path.

References


Appendix

A Proof for Proposition 1

PROPPOSITION 1: At the optimum, the firm chooses the amount of capital and wage as to:

\[ w = w(y, \tau, q) = (1 - \tau) \left[ y - \gamma (\delta + r) k - \frac{\gamma (r + \lambda) c}{q} \right] \]

\[ k = \left( \frac{\gamma \alpha}{\delta + r} \right)^{\frac{1}{1-\alpha}} \]

PROOF: following Pissarides (2000) chap.1, the firm aims at maximizing the asset value of the occupied vacancy by choosing the optimum amount of capital and labor, therefore, the problem of the firm is:

\[ \max_{k,w} \{ J \} \]  \hspace{1cm} (32)

in steady state \( V = 0 \) and rearranging 13 as \( J = \frac{1}{r+\lambda} (y - \gamma (r + \delta) k) - \frac{w}{r+\lambda(1-\tau)} \), the first order condition is:
\[
\frac{dJ(k)}{dk} = 0 \iff f'_k = r + \delta
\] (33)

Our choice of production function implies that \( f'_k = \gamma \alpha k^{\alpha - 1} \), which from the optimizing choice of capital by the firm (19), the per capita equilibrium stock of capital is:

\[
k = \left( \frac{\gamma \alpha}{\delta + r} \right)^{\frac{1}{1-\alpha}}
\] (34)

In equilibrium all profit opportunities are exhausted, therefore, the vacant job cannot yield any positive value implying that for (13), with use of (15) and (19), the inverse of the demand for labor function of the firm yields:

\[
w = (1 - \tau) \left[ y - \gamma (\delta + r) k - \frac{\gamma (r + \lambda) c}{q} \right]
\] (35)

\[\diamondsuit\]

**B Proof for Proposition 2**

**Proposition 2:** The wage that maximizes the total surplus of a successful match is

\[
w \equiv \tilde{w}(y, \tau, k, \theta) = \frac{(1 - \tau) \mu}{\mu + (1 - \tau) (1 - \mu) (1 - b)} (y - \gamma (\delta + r) k + c \gamma \theta)
\]

**Proof:**

Again, following Pissarides (2000) chap.1, in equilibrium, all profit opportunities for the vacant vacancy are exhausted, therefore \( V = 0 \). Rearranging (13) and (10) as \( J = \frac{1}{r + \lambda} (y - \gamma (\delta + r) k) - \frac{w}{(r + \lambda)(1 - \tau)} \) and \( W = \frac{w + \lambda U}{r + \lambda} \), respectively, we can substitute in (22), to yield:

\[
\mu J = (1 - \mu) (W - U) \iff w = \frac{(1 - \tau)}{((1 - \mu) (1 - \tau) + \mu)} [(1 - \mu) r U + \mu (y - \gamma (\delta + r) k)]
\] (36)

On the other hand, we rearrange (11) as \( W - U = \frac{r U - bw \mu}{p \theta} \) and \( \frac{w m(u,v)}{u m(u,v)} = \frac{p}{q} = \theta \). Together with (15) we replace in (22) to achieve at:

\[
\mu J = (1 - \mu) (W - U) \iff \mu \frac{\gamma c}{q} = (1 - \mu) \frac{r U - bw}{p} \iff r U = \mu \frac{1 - \mu}{\gamma \theta} + bw
\] (37)

Finally, using (37) in (36) and making use of (19) yields the desired expression for the wage as a function of market conditions alone:
\[ w = \frac{(1 - \tau)}{((1 - \mu) (1 - \tau) + \mu)} \left[ (1 - \mu) rU + \mu (y - \gamma (\delta + r) k) \right] \]
\[ = \frac{(1 - \tau)}{\mu + (1 - \tau) (1 - \mu) (1 - b)} (y - \gamma (\delta + r) k + c \gamma \theta) \]

(38)

C Tables

<table>
<thead>
<tr>
<th>Country</th>
<th>Gini coefficient (^1)</th>
<th>Average Job tenure (^2)</th>
<th>Vacancy rate (^3)</th>
<th>Unemployment rate (^4)</th>
<th>(\theta)</th>
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\(^1\) OCDE data on income distribution for the mid 2000's
\(^2\) OCDE yearly data on average job tenure for the 1992-2009 period
\(^3\) OCDE yearly data on vacancy rate for the 1981-2009 period
\(^4\) OCDE yearly data on unemployment rate for the 1986-2009 period

Table C.1: Selected data on the EA(12) countries

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Source: OECD

Table C.2: Average unemployment duration in European countries

22
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<td>% GDP</td>
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<td>% GDP</td>
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f: Forecast. Source: Eurostat

Table C.3: Average compensation of employees on EA(12) countries (as a percentage of GDP)

<table>
<thead>
<tr>
<th>VARIABLE</th>
<th>VALUE</th>
<th>CONSUMPTION</th>
<th>VALUE</th>
</tr>
</thead>
<tbody>
<tr>
<td>$r$</td>
<td>Interest rate</td>
<td>3.058</td>
<td>%</td>
</tr>
<tr>
<td>$k = a$</td>
<td>Capital</td>
<td>4.514</td>
<td></td>
</tr>
<tr>
<td>$a^e$</td>
<td>Capital of the employed</td>
<td>4.099</td>
<td></td>
</tr>
<tr>
<td>$a^u$</td>
<td>Capital of the unemployed</td>
<td>0.414</td>
<td></td>
</tr>
<tr>
<td>$a^u/a$</td>
<td>-</td>
<td>9.179</td>
<td>%</td>
</tr>
<tr>
<td>$a^u/a^e$</td>
<td>-</td>
<td>10.107</td>
<td>%</td>
</tr>
<tr>
<td>$w$</td>
<td>Wage</td>
<td>0.995</td>
<td></td>
</tr>
<tr>
<td>$\theta$</td>
<td>Labor market tightness</td>
<td>0.665</td>
<td></td>
</tr>
<tr>
<td>$\nu$</td>
<td>Vacancy rate</td>
<td>6.075</td>
<td>%</td>
</tr>
<tr>
<td>$\nu$</td>
<td>Unemployment rate</td>
<td>9.137</td>
<td>%</td>
</tr>
<tr>
<td>$p_{un}$</td>
<td>Prob. remain unemployed</td>
<td>18.457</td>
<td>%</td>
</tr>
<tr>
<td>$\frac{1}{q}$</td>
<td>Vacant vacancy spell</td>
<td>0.815</td>
<td></td>
</tr>
<tr>
<td>$\frac{1}{p}$</td>
<td>Unemployment spell</td>
<td>1.226</td>
<td></td>
</tr>
<tr>
<td>$\tau$</td>
<td>Income tax rate</td>
<td>6.135</td>
<td>%</td>
</tr>
</tbody>
</table>

Table C.4: Baseline case model output