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Dual Labor Markets and Labor Protection in an Estimated Search and Matching Model

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Abstract

Temporary contracts, as well as labor protection, have been used to reduce unemployment with the latter leading to fewer job destructions. This paper estimates a search and matching model with labor protection and dual labor markets in which the relative availability of temporary versus permanent contracts in the market is endogenous. Chilean data is used to evaluate the role of labor protection legislation and the use of temporary contracts in unemployment, welfare, and inequality. Results show that the share of temporary contracts in the labor market becomes more important as firing costs increase. Simultaneously, temporary contracts negatively affect the frequency with which regular jobs arrive and offset any positive effect of firing costs on unemployment. Finally, temporary contracts increase flexibility and generate increasing welfare gains as labor protection becomes more stringent.

Keywords: Temporary jobs, labor protection, search models, maximum likelihood estimation, structural estimation.

1. Introduction

Temporary contracts are widely used in European countries and, in the last twenty years, have proliferated in developing nations, particularly in Latin American countries (Harrison and Leamer, 1997; Heckman and Pages, 2000). They have been used to introduce flexibility in the labor market in order to reduce unemployment. However, the literature has found an ambiguous effect of temporary contracts on unemployment because these contracts do not only affect the flows out of unemployment but also the flows out of employment for

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