Employment Protection, Investment in Job-Specific Skills, and Inequality Trends in the United States and Europe*

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February 2016

Abstract

Since the 1980s, the United States economy has experienced a sharp rise in education premia in the labor market, with the college premium going up by more than 30 percent. In contrast, most European economies witnessed a much smaller rise in the return to education, and in Germany, Italy, and Spain the college premium actually fell. In this paper, we argue that differences in employment protection can account for a substantial part of these diverging trends. We consider an environment where firms can invest in technologies that are complementary to experienced workers with long tenure, and workers can make corresponding investments in firm-specific skills. The incentive to undertake such investments interact with employment protection. Incentives are particularly strong if employment protection favors older workers and workers with long tenure, as is the case in the European countries where the college premium fell. We study these incentives in a dynamic model that allows for different education levels, labor-market search, and investment in relationship-specific capital and skills. In a calm economic environment, labor protection imposes non-binding constraints on firms' adjustment decisions: as a result, different legislations induce similar incentives for technological investment. As "turbulence" emerges in the early 1980's (Ljungqvist and Sargent 1998) differences in labor market legislation are reflected in firms' and workers' incentives. In a calibration exercise, we quantify the ability of this effect to account for diverging inequality trends in the United States and Europe.

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*Financial support from the National Science Foundation (grant SES-1260961) is gratefully acknowledged. Department of Economics, Northwestern University, 2001 Sheridan Road, Evanston, IL 60208 (e-mail: doepke@northwestern.edu).