

Optimal Taxation with Permanent Employment Contracts

Paweł Doligalski*

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Abstract

New Dynamic Public Finance describes the optimal income tax in an environment where private insurance is absent. I extend this framework by introducing permanent employment contracts which facilitate insurance provision within firms. The optimal tax system becomes remarkably simple, as the government outsources most of the insurance provision to employers and focuses mainly on redistribution. When the government wants to redistribute to the poor, a dual labor market could be optimal. Less productive workers are hired on a fixed-term basis and are partially insured by the government, while the more productive ones enjoy the full insurance provided by permanent employment. I provide empirical evidence consistent with the theory and characterize the constrained efficient allocations for Italy.

1 Introduction

Lifetime incomes differ due to initial heterogeneity in earning potential of workers and luck experienced during the working life.¹ The standard welfare criteria call for the elimination of both types of inequality. New Dynamic Public Finance (NDPF) answers this call by designing a tax system that both redistributes income between initially different people and insures them against differential luck realizations.² This approach has been criticized for two reasons. First, it neglects private insurance possibilities. Second, the optimal tax system is far more complicated than any tax system observed in reality. In this paper I address these two problems of NDPF by introducing permanent employment contracts.

The individual productivity of each worker evolves as a random process. Insuring a worker essentially means keeping his consumption constant through times of both high and low productivity.

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¹ Huggett, Ventura, and Yaron (2011) estimate that out of the two, initial differences account for more than 60% of the inequality in lifetime earnings.

²Golosov, Tsyvinski, and Werning (2007) and Kocherlakota (2010) survey the NDPF literature.

Insurance via income tax is difficult because the government does not observe individual productivity.³ I assume that firms have better information than government, yet face a different friction: neither they nor workers are able to commit to maintain the employment relationship. Permanent contracts with a high firing cost discourage employers from laying off their employees, thus allowing firms to act as insurers. The government optimally outsources most of the insurance to the better informed firms and, depending on social objectives, can focus on redistribution. As a result, the optimal tax system is simple: in the model calibrated to Italy any constrained efficient allocation can be implemented with a tax schedule that depends exclusively on current consumption expenditure. Such tax was proposed by various public finance economists in US.⁴ It contrasts with the standard implementation of NDPF which involves time-varying taxation of labor income and capital income that depends on the whole history of past earnings.

The insurance within firms comes at a price. Permanent contracts reduce the random variation of income over the life-cycle, but they also allow firms to shift workers' compensation across time in order to minimize the workers' tax burden. Such a behavior reduces the government's ability to redistribute. A redistributive government sometimes prefers to strip the least productive workers of the private insurance by equipping them with fixed-term contracts, since in this way they either receive higher transfers or face lower labor distortions. Hence, I provide a novel rationale for the coexistence of permanent and fixed-term contracts.

There is strong empirical evidence of income shifting within firm, both for insurance and tax avoidance reasons. [Guiso, Pistaferri, and Schivardi \(2005\)](#) document that Italian firms insure workers by reducing variability of their income. [Lagakos and Ordóñez \(2011\)](#) conduct a similar study for US and find that high-skilled workers obtain more insurance than low-skilled ones.⁵ [Kreiner, Leth-Petersen, and Skov \(2015\)](#) describe the shifting of salaries within firms in response to the announced decrease of the top income tax rate in Denmark. Individuals affected by the reform shifted on average 10% of their labor income, although the effect is concentrated in a relatively small group of taxpayers that shift most of their salaries. In a companion paper, [Kreiner, Leth-Petersen, and Skov \(2014\)](#) focus on top management. Managers are most likely to shift income by retiming bonus payments, but delaying the regular wage income is also evident.

In my model economy risk averse workers face risk due to stochastic idiosyncratic productivity and can trade only a risk-free asset. Risk neutral firms observe workers' productivity and compete for them in the labor market. The labor market is frictional, as both parties are unable to commit to maintain the employment relationship in the future. Workers are free by law to change employers. Firms can, at a specified cost, fire employees. I consider two different types of labor contract: permanent and fixed-term. Fixed-term contracts allow firms to dismiss workers in every period without any cost. Permanent contracts have high firing cost which discourages firms from laying off their workforce.

When all workers have fixed-term contracts, the taxation problem is equivalent to NDPF. If a

³Financial markets are also unlikely to observe individual productivity of every worker.

⁴The progressive consumption tax was advocated by [Hall and Rabushka \(1995\)](#) and [Bradford \(2000\)](#).

⁵Although there is no mandatory firing cost in US, [Bishow and Parsons \(2004\)](#) shows that between 1980 and 2000 on average 30% of employees in private establishments were covered by a voluntary severance pay provided by the employer. White collar workers are more likely to be covered, which can explain the gap in insurance between skill groups.

firm and a worker can terminate their relationship at no cost and start a new one with a clean slate, no private insurance is possible. Worker's income is equal to his output in each period and the labor market collapses to a sequence of spot labor markets. Optimally, the government steps in with taxation that both redistributes and insures. Since the government is constrained by available information, it has to set up a complicated, history dependent income tax system to screen evolving productivities of workers. [Golosov, Kocherlakota, and Tsyvinski \(2003\)](#) show that the optimal insurance provision with private information requires levying a tax on labor income and on savings, although agents are heterogenous only in labor productivity.

When all workers are employed on a permanent basis, firms are not tempted to fire workers, but workers are unable to commit to stay in their firms. I show that this market imperfection can be remedied by backloading labor compensation. By shifting labor income to the future, employers effectively lock workers in the company. As workers no longer have incentives to quit, firms can offer them full consumption insurance. In such cases the taxation problem can be expressed as a static [Mirrlees \(1971\)](#) model.⁶ The tax schedule depends on the average lifetime elasticity of labor supply and only the initial distribution of types. Intuitively, if all people entered the labor market with an identical initial productivity and the same distribution of future shocks, any inequality in income would be a matter of insurance, not redistribution.

I show that the government should always assign permanent contracts to some workers. Specifically, efficiency requires that workers who pay the highest taxes should be fully insured and permanently employed. The intuition is simple: with permanent contract, paying high taxes becomes more attractive. It could, nevertheless, be suboptimal to equip all workers with permanent contracts. When the government cares most about the initially least productive, these workers could optimally end up with fixed-term contracts and no private insurance. The reason behind this finding is as follows. Under permanent contracts firms can shift workers' income to the future. On the one hand, this allows firms to insure workers; on the other, firms have incentives to structure income payments in a way that minimizes their employees' tax burden. The currently productive workers would benefit from shifting income to the future and claiming transfers due to low current earnings. Since such income shifting is possible only under permanent contract, the government can prevent this by assigning fixed-term contracts at low levels of income. This argument provides a novel perspective on dual labor markets where the two types of contracts coexist, a prevalent labor market arrangement in Europe. There is the extensive literature documenting the negative impact of dual labor markets on the unemployment risk, the human capital accumulation and the volatility of business cycles.⁷ I complement this literature by highlighting the additional redistributive channel of fixed-term contracts.

How to implement the optimal allocation with taxes? When all workers have permanent contracts, they should face only the redistributive tax based on consumption expenditures. The usual base for redistributive tax, such as labor income or total income, exhibits time variation due to backloading of compensation. Since the consumption expenditures remain stable through a worker's lifetime,

⁶However, it is not the case that the optimum with only permanent contracts always involves full consumption insurance - see discussion in [Section 4](#).

⁷See references in the related literature section. For information on dual labor markets in Europe, see [Eichhorst \(2014\)](#).

it allows the tax schedule to be time-invariant. When tax payments increase progressively with consumption expenditures, the tax schedule can depend only on current consumption expenditures - no history dependence is required. There is no need to tax the savings of permanent workers. When the dual labor market is optimal, fixed-term workers are covered by an extensive public insurance program. As in NDPF, it involves a tax on savings that can be interpreted as means tested income support.

This paper focuses on the relation between the type of contract and the volatility of workers' income. I show that this effect is present in the data by analyzing the administrative records of employment histories from Italy. The residual income variance of a median worker is higher by 78% under fixed-term rather than permanent contract. This estimate is conditional on continuous employment at one firm, so it is not affected by income changes due to losing or switching jobs. I am the first to document the impact of fixed-term contracts on income volatility, conditional on staying employed. A proper causal analysis of the link between firing costs and income risk is an interesting topic for future research.

I calibrate a simple life-cycle model to Italy. All constrained efficient allocations involve assigning permanent contracts to all workers. As a result, any allocation at the Pareto frontier can be implemented with a simple consumption expenditure tax. The welfare gains are substantial: when the planner is utilitarian, permanent contracts increase welfare gains from optimal taxation by 50%.⁸ Then I investigate under which parameter values the dual labor market would be optimal. If the productivity of the initially least productive type was lower by at least 4%, the Rawlsian planner would assign fixed-term contract to these workers.

Related literature. This paper contributes to the literature on optimal taxation with private insurance markets. [Golosov and Tsyvinski \(2007\)](#) study this question under the assumption that the government and firms face the same friction: asymmetric information. I assume that frictions faced by firms and those faced by the government are different: the government lacks information, while firms and workers lack commitment. [Stantcheva \(2014\)](#) considers an environment in which firms face both limited information and limited commitment, but her model is static and hence concerned only with redistribution. [Chetty and Saez \(2010\)](#) model private insurance in the reduced form. Instead, my paper provides microfoundations of insurance on the labor market, which reveals the crucial role of the firing cost. [Attanasio and Rios-Rull \(2000\)](#) and [Krueger and Perri \(2011\)](#) study how the public insurance crowds out the private one. Although their private insurance is also constrained by the limited commitment friction, agents' endowments are random and exogenous. In my framework productivity is random, but income is endogenous. Shifting income across time turns out to be the key margin of response to taxes. In a different framework [Abraham, Koehne, and Pavoni \(2014\)](#) show that hidden asset trades, which are closely related to income shifting, reduce the optimal progressivity of labor income tax in line with my findings.

Another strand of the literature focuses on simple tax implementations. [Albanesi and Sleet \(2006\)](#) show that with iid productivity shocks the constrained efficient allocations in NDPF can be im-

⁸Suppose that utilitarian welfare of laissez-faire allocation is 100 in consumption equivalent terms. NDPF achieves 102.8, while optimal taxation with permanent contracts 104.3 (see Table 5). The permanent contracts regime improves NDPF relative to the laissez-faire by more than 50%.

plemented with potentially time-varying tax that depends jointly on current wealth and current labor income. [Farhi and Werning \(2013\)](#) and [Weinzierl \(2011\)](#) argue that age dependent taxation captures most of the welfare gains from the optimal non-linear taxes. [Findeisen and Sachs \(2015\)](#) optimize with respect to the history-independent, non-linear labor income tax and linear capital income tax rate. [Conesa, Kitao, and Krueger \(2009\)](#) is an example of a Ramsey approach, which restricts the tax function to some exogenously chosen class. My paper shows that the inclusion of private insurance leads to the fully optimal tax systems that are as simple as the tax functions assumed in the Ramsey approach.

Dual labor markets and fixed-term contracts are studied extensively. It was shown that temporary contracts are associated with higher unemployment risk ([García-Pérez, Marinescu, and Castello \(2014\)](#)) and lower on the job training ([Cabrales, Dolado, and Mora \(2014\)](#)) than permanent contracts. Furthermore, dual labor markets amplify macroeconomic fluctuations, as employers are less likely to hoard labor ([Bentolila, Cahuc, Dolado, and Le Barbanchon \(2012\)](#); [Kosior, Rubaszek, and Wierus \(2015\)](#)). I contribute to this literature by documenting that, conditional on continuous employment at one company, fixed-term workers have significantly more volatile income than permanent employees.

The labor market in my model is frictional, as both parties can terminate the contract at any time. There is a long tradition of modeling labor market without commitment, dating back at least [Harris and Holmstrom \(1982\)](#) and [Thomas and Worrall \(1988\)](#). [Thomas and Worrall \(2007\)](#) provide a recent review of the limited commitment models of labor market. This friction plays a key role also in other insurance markets: life insurance ([Hendel and Lizzeri \(2003\)](#)) and health exchanges ([Handel, Hendel, and Whinston \(2013\)](#)).

Structure of the paper. The next section introduces the environment and sets up the taxation problem. The benchmark case without frictions on the labor market is solved in [Section 3](#). [Section 4](#) characterizes the constrained efficient allocation with limited commitment. Implementation with the tax system is discussed in [Section 5](#). In [Section 6](#) I validate the predictions of the model with Italian data. The model is calibrated to Italy in [Section 7](#). The last section concludes. All proofs are available in the Appendix.

2 Framework

2.1 Firms and workers

There is a continuum of workers that live for $\bar{t} \in \mathbb{N}_+$ periods. In each period they draw a productivity, which I describe in detail below. A worker with productivity θ and labor supply n produces output θn . Workers sell their labor to firms in exchange for a labor income y . Workers have access to the risk-free asset, in which they can save and borrow up to the limit $b \geq 0$ at the gross interest rate R . I denote a worker's choice of assets by a and assume that workers have no wealth initially. A worker's contemporaneous utility depends on consumption and labor supply according to a twice differentiable function $U(c, n) = u(c) - v(n)$, where u is increasing and strictly concave, while v

is increasing and strictly convex. A worker's lifetime utility is a discounted expected stream of contemporaneous utilities, where β is a discount factor. I assume that the interest rate is consistent with the worker's discounting: $R = \beta^{-1}$.

There is a continuum of identical firms. Firms maximize expected profits by hiring workers, compensating them with labor income and collecting output. Firms observe each worker's productivity and labor supply. I assume no entry cost for firms.

2.2 Productivity histories

In each period t (where $1 \leq t \leq \bar{t}$) a worker draws productivity from a finite set $\Theta_t \subset \mathbb{R}_+$. A history is a tuple of consecutive productivity draws starting at the initial period. I denote by $|h|$ the length of the history h , i.e. the number of productivity draws it contains. The history h belongs to the set $\Theta^{|h|} = \prod_{t=1}^{|h|} \Theta_t$ and the set of all histories is $\Theta \equiv \bigcup_{t=1}^{\bar{t}} \Theta^t$. Since all histories start in period 1, the length of the history is also the current time period. The i -th element of history h is h_i and the tuple of its first i elements is $h^i = (h_1, \dots, h_i)$. In order to simplify notation, I denote the last productivity at the history h as $\theta(h) \equiv h_{|h|}$ and the history directly preceding the history h as $h^{-1} \equiv h^{|h|-1}$. For clarity, consider the following example:

$$h = (\theta_a, \theta_b, \theta_c) \in \Theta^3, \quad |h| = 3, \quad h^{-1} = (\theta_a, \theta_b), \quad \theta(h) = \theta_c.$$

The probability of drawing some history h of length t is equal $\mu(h)$ which is non-negative and sums up to 1 for all histories of this length: $\forall_t \sum_{s \in \Theta^t} \mu(s) = 1$. In practice, I will work mostly on the collections of histories that happen with positive probability, denoted by $\mathcal{H} \equiv \{h \in \Theta : \mu(h) > 0\}$. \mathcal{H}_t is the set of histories that happen with positive probability of length t . By $\mathcal{X}(h)$, where \mathcal{X} is a set of histories and $h \in \mathcal{H}$, I denote the subset of elements of \mathcal{X} that contain h : $\mathcal{X}(h) = \{s \in \mathcal{X} : s^{|h|} = h\}$. Specifically, $\mathcal{H}_t(h)$ is the set of possible histories of length t that contain sub-history h . The probability of drawing history $s \in \mathcal{H}(h)$ conditional on history h , where $\mu(h) > 0$, is

$$\mu(s | h) = \frac{\mu(s)}{\sum_{s' \in \mathcal{H}_{|s|}(h)} \mu(s')}.$$

I assume that each initial type faces productivity risk: $\forall_{\theta \in \Theta_1} \forall_{h \in \mathcal{H}_{\bar{t}}(\theta)} \mu(h | \theta) < 1$.

2.3 Labor market

I make the following assumptions about the labor market. Workers enter the market after their initial productivity is drawn and firms offer them labor contracts (which will be specified below). I assume no search friction, so all workers see all the offers immediately, which leads to a Bertrand competition between firms for workers. Firms observe each worker's productivity, so details of a labor contract are contingent on a worker's history.

Even after the initial contract has been signed, workers are free to leave their current employer and start a new job elsewhere. I impose no mobility cost. On the other hand, firms can fire their workers in any period subject to the specified firing cost.⁹ The firing cost is going to be an important policy instrument. I restrict the firing cost, denoted by f , to belong to the set $\{0, \bar{f}\}$, where \bar{f} is set sufficiently high such that no firm would ever be tempted to fire the worker. I will use the firing cost to distinguish between the *permanent workers* (those for which $f = \bar{f}$) and the *fixed-term workers* ($f = 0$).

2.4 Allocation and payoffs

Definition 1. The allocation (c, y, n) specifies consumption $c : \mathcal{H} \rightarrow \mathbb{R}_+$, labor income $y : \mathcal{H} \rightarrow \mathbb{R}$ and labor supply $n : \mathcal{H} \rightarrow \mathbb{R}_+$ at each history.

The expected utility of a worker at the history $h \in \mathcal{H}$, given the allocation (c, y, n) is

$$\mathbb{E}U_h(c, n) \equiv \sum_{s \in \mathcal{H}(h)} \mu(s | h) \beta^{|s| - |h|} U(c(s), n(s)), \quad (1)$$

I denote the expected utility from the *ex ante* perspective by $\mathbb{E}U(c, n) \equiv \sum_{\theta \in \times_1} \mu(\theta) \mathbb{E}U_\theta(c, n)$. Profits from hiring a worker at the history h given the allocation (c, y, n) are

$$\mathbb{E}\pi_h(y, n) = \sum_{s \in \mathcal{H}(h)} \mu(s | h) R^{|h| - |s|} (\theta(s) n(s) - y(s)). \quad (2)$$

2.5 Direct mechanism

I assume that the social planner observes consumption c , labor income y and the firing cost f , but does not observe the productivity θ , hours worked n or individual output θn . In order to write and solve the optimal tax problem, I use the revelation principle, according to which without the loss of generality I can focus on direct mechanisms.

Definition 2. A *direct mechanism* $(\mathcal{H}, (c, y, f))$ consists of the message space \mathcal{H} and the outcome functions (c, y, f) , each going from \mathcal{H} to a relevant subset of \mathbb{R} .

The planner sets up a direct mechanism which in each period collects type reports of workers and assigns them consumption, a labor income and a firing cost. As the government does not observe individual labor supply, it is determined in the equilibrium corresponding to the government's choice of outcomes, which I describe below.

The pure reporting strategy r is a function from the set of possible histories to the message space: $r : \mathcal{H} \rightarrow \mathcal{H}$. I impose the consistency condition: $\forall s, h \in \mathcal{H} \ s \in \mathcal{H}(h) \implies r(s) \in \mathcal{H}(r(h))$. It means that consecutive history reports cannot be at odds with which histories are in fact possible. Let's

⁹One can think about the firing cost as a severance payment to the fired worker. In the setting I consider such interpretation plays no role, as no firing is going to happen in equilibrium.

denote the set of consistent pure reporting strategies by \mathcal{R} . The truthful reporting strategy r^* is an identity: $r^*(h) = h$ for all $h \in \mathcal{H}$. I allow for mixed reporting strategies $\sigma \in \Delta_{\mathcal{R}}$, where σ is a probability distribution over the pure reporting strategies.

The expected utility of a worker at the history h , given outcome functions (c, y) and a pure reporting strategy r , is $\mathbb{E}U_h(c \circ r, n)$, where $c \circ r$ is a composite function of reporting strategy and consumption function: $(c \circ r)(h) = c(r(h))$. Similarly, the firm's profits are $\mathbb{E}\pi_h(y \circ r, n)$. The reporting strategy affects the outcomes that are assigned by the mechanism. It does not affect labor supply n , as it is decided in equilibrium by firms that observe worker's type. I allow for mixed reporting strategies. The truthful mixed reporting strategy σ^* is a probability distribution concentrated at the truthful pure reporting strategy: $\sigma^*(r^*) = 1$. The payoffs from the mixed reporting strategy $\sigma \in \Delta_{\mathcal{R}}$ given history h are

$$\sum_{r \in \mathcal{R}} \sigma(r) \mathbb{E}U_h(c \circ r, n) \quad \text{and} \quad \sum_{r \in \mathcal{R}} \sigma(r) \mathbb{E}\pi_h(y \circ r, n).$$

2.6 Equilibrium

Firms compete by offering labor contracts to the workers.

Definition 3. A *labor contract* (n, σ) consists of the labor supply allocation n and the reporting strategy σ .

A typical labor contract specifies labor supply and labor income. Since I use the direct mechanism approach and the labor income is observed by the government, the firm cannot offer any structure of labor income. Instead, firms offer reporting strategies which, together with y specified in the mechanism, constitute a map from type to a labor income. Given y , firms compete by offering the *effective labor income* $y \circ r$.

Lemma 1. *The set of equilibrium contracts is*

$$\mathcal{E}(c, y, f) \equiv \arg \max_{\substack{n : \mathcal{H} \rightarrow \mathbb{R}_+ \\ \sigma \in \Delta_{\mathcal{R}}}} \sum_{r \in \mathcal{R}} \sigma(r) \mathbb{E}U(c \circ r, n),$$

subject to the zero profit condition

$$\forall_{\theta \in \Theta_1} \sum_{r \in \mathcal{R}} \sigma(r) \mathbb{E}\pi_{\theta}(y \circ r, n) = 0 \tag{3}$$

and the limited commitment constraints

$$\forall_{\substack{r \in \mathcal{R} \\ \text{s.t. } \sigma(r) > 0}} \forall_{h \in \mathcal{H}} -f(r(h)) \leq \mathbb{E}\pi_h(y \circ r, n) \leq 0. \tag{4}$$

Since workers observe all offers, the competition between firms for workers drives profits to zero. The zero profit condition means that firms cannot redistribute. Any transfer of resources between

initial types would mean that the firm is making profit on one type and losses on another. It cannot happen in equilibrium, as the profitable type would be captured by the competing firm.

The equilibrium contract has to satisfy the limited commitment constraints: neither worker nor firm can have incentives to terminate the contract at any history. For firms, this means that the expected losses from continuing the employment relationship cannot exceed the firing cost. For workers it means that at no history the firm can make positive profits on them. If that happens, a competing firm could offer them a better deal, while still being profitable.

The mechanism (c, y, f) *implements* allocation (c, y, n) if $(n, \sigma^*) \in \mathcal{E}(c, y, f)$, that is when the labor supply allocation n and a truthful reporting strategy constitute an equilibrium contract.

2.7 The planner's problem

The planner chooses the mechanism in order to maximize the social welfare function

$$\max_{\substack{c : \mathcal{H} \rightarrow \mathbb{R}_+ \\ y : \mathcal{H} \rightarrow \mathbb{R} \\ f : \mathcal{H} \rightarrow \{0, \bar{f}\}}} \sum_{\theta \in \times_1} \lambda(\theta) \mu(\theta) \mathbb{E}U(c, n), \quad (5)$$

where λ is the non-negative Pareto weight with expected value of 1: $\sum_{\theta \in \Theta_1} \lambda(\theta) \mu(\theta) = 1$. The optimization is subject to the resource constraint

$$\sum_{h \in \mathcal{H}} R^{1-|h|} \mu(h) (y(h) - c(h)) \geq 0 \quad (6)$$

and the equilibrium constraint

$$(n, \sigma^*) \in \mathcal{E}(c, y, f). \quad (7)$$

The equilibrium constraint means that there is an equilibrium contract that involves truthful reporting and that the labor supply allocation of workers is determined by this contract. This constraint incorporates the usual incentive compatibility constraints that prevent misreporting. In general $\mathcal{E}(c, y, f)$ is not a singleton and there will be equilibrium contracts that involve misreporting. These other contracts correspond to the binding incentive constraints. I assume that if there exists a truthful equilibrium contract, agents will choose it in equilibrium.¹⁰

3 Frictionless labor market

In this section I solve the government problem under assumption of private sector operating without frictions: both workers and firms can commit to the labor contract.¹¹

¹⁰It is a usual assumption in the literature. Without it, the planner's problem could have no solution. Note that payoffs of workers and firms are identical for any contract in $\mathcal{E}(c, y, f)$.

¹¹Recall that I do not allow firms and workers to contract before the initial productivity draw. I do not consider it as a friction, but rather as a fundamental feature of the economy.

Corollary 1. *Under full commitment, the set of equilibrium contracts is*

$$\mathcal{E}^{FC}(c, y) \equiv \arg \max_{\substack{n: \mathcal{H} \rightarrow \mathbb{R}_+ \\ \sigma \in \Delta_{\mathcal{R}}}} \sum_{r \in \mathcal{R}} \sigma(r) \mathbb{E} U(c \circ r, n), \text{ s.t. } \forall_{\theta \in \Theta_1} \sum_{r \in \mathcal{R}} \sigma(r) \mathbb{E} \pi_{\theta}(y \circ r, n) = 0.$$

Since firms and workers can credibly commit not to terminate the employment relationship, we can drop the limited commitment constraints. This means that the firing cost does not influence the equilibrium. The initial zero profit condition becomes the sole constraint in determination of the equilibrium contract.

In equilibrium the firm chooses the labor supply policy that minimizes the disutility cost of working conditional on satisfying the zero profit condition. The necessary and sufficient conditions for the labor supply equalize the marginal cost of an additional unit of output at each history, for each initial type

$$\forall_{h \in \mathcal{H}} \frac{v'(n(h))}{\theta(h)} = \frac{v'(n(h_1))}{\theta(h_1)}. \quad (8)$$

Note that the output and income of a worker do not have to coincide at each history. They have to agree only in expectations over the lifetime of the worker, which is captured by the zero profit condition. Under full commitment firms can smooth labor supply of workers in order to produce the expected lifetime income at the minimal disutility cost. This labor smoothing will be a key element in subsequent analysis.

Let's define the indirect utility function that depends only on the initial type θ , lifetime consumption C and lifetime labor income Y :

$$V_{\theta}(C, Y) \equiv \sum_{t=1}^{\tau} \beta^{t-1} u \left(\left(\sum_{t=1}^{\tau} R^{1-t} \right)^{-1} C \right) - \sum_{h \in \mathcal{H}(\theta)} \beta^{|h|-1} \mu(h | \theta) v(n(h)),$$

where the allocation of labor n satisfies labor smoothing (8) and the zero profit condition:

$$\sum_{h \in \mathcal{H}(\theta_1)} R^{1-|h|} \mu(h | \theta) \theta(h) n(h) = Y.$$

Theorem 1. *Under full commitment on the labor market, the planner's problem can be expressed as*

$$\max_{(C(\theta), Y(\theta))_{\theta \in \Theta_1}} \sum_{\theta \in \Theta_1} \lambda(\theta) \mu(\theta) V_{\theta}(C(\theta), Y(\theta))$$

subject to the resource constraint

$$\sum_{\theta \in \Theta_1} \mu(\theta) (Y(\theta) - C(\theta)) \geq 0$$

and the initial incentive-compatibility constraints

$$\forall_{\theta, \theta' \in \Theta_1} V_{\theta}(C(\theta), Y(\theta)) \geq V_{\theta}(C(\theta'), Y(\theta')).$$

By Theorem 1 the planner's problem under full commitment is just the static taxation problem studied by Mirrlees (1971). The planner optimally outsources the entire insurance provision to firms and as a result workers enjoy full consumption insurance. Since firms smooth the labor of workers, only the initial type and the net present value of lifetime income matter for the determination of a worker's allocation of labor. Hence, we can express a worker's utility with an indirect utility function $V_\theta(C, Y)$. As workers need to report only their initial type, only the initial incentive-compatibility constraint is relevant and the entire taxation problem becomes static. The labor market with full commitment provides a microfoundation for interpreting the framework of Mirrlees (1971) as a model of lifetime income taxation.

Let's define the lifetime tax as $T(\theta) \equiv Y(\theta) - C(\theta)$. We can express the optimal marginal tax T' with the well-known Saez (2001) formula.

Assumption 1. For any length of the history t and any non-negative number k , if $\theta_2 > \theta_1$ then $\sum_{s \in \mathcal{H}_t(\theta_1)} \mathbb{I}_{k \geq \theta(s)} \mu(s | \theta_1) \geq \sum_{s \in \mathcal{H}_t(\theta_2)} \mathbb{I}_{k \geq \theta(s)} \mu(s | \theta_2)$.

Assumption 2. Θ_1 is an interval of real numbers. The probability density function over Θ_1 is $\tilde{\mu}(\theta)$ and the cumulative distribution function is $\tilde{M}(\theta)$.

Proposition 1. Under Assumptions 1 and 2, if the implied lifetime income schedule $Y(\theta)$ is non-decreasing, the optimal lifetime tax of an initial type $\theta \in \Theta_1$ satisfies

$$\frac{T'(\theta)}{1 - T'(\theta)} = \frac{1 - \tilde{M}(\theta)}{\theta \tilde{\mu}(\theta)} \frac{1 + \bar{\zeta}^u(\theta)}{\bar{\zeta}^c(\theta)} \mathbb{E} \left\{ (1 - \omega(\theta')) e^{\int_{\theta}^{\theta'} \frac{\bar{\xi}(\theta'')}{\bar{\zeta}^c(\theta'')} \frac{Y'(\theta'')}{Y(\theta'')} d\theta''} \middle| \theta' \geq \theta \right\}$$

where $\bar{\zeta}^c(\theta) = \sum_{h \in \mathcal{H}(\theta)} R^{1-|h|} \mu(h | \theta) \frac{\theta(h)n(h)}{Y(\theta)} \zeta^c(h)$ is the weighted lifetime average of the compensated elasticity of labor supply, $\bar{\xi}(\theta) = \left(\sum_{t=1}^T R^{1-t} \right)^{-1} \sum_{h \in \mathcal{H}(\theta_1)} R^{1-|h|} \mu(h | \theta_1) \xi(h)$ is the lifetime average wealth effect, $\bar{\zeta}^u(\theta) = \bar{\zeta}^c(\theta) + \bar{\xi}(\theta)$ is the lifetime average uncompensated elasticity of labor supply and $\omega(\theta) = \frac{\lambda(\theta)u'(c(\theta))}{\eta}$ is the marginal social welfare weight of the initial type θ .

Assumption 1 ensures that the indirect utility function $V_\theta(C, Y)$ has the single crossing property.¹² In order to apply the existing optimal tax formulas, we need to slightly modify the environment - Assumption 2 makes the initial distribution of types continuous. Given these assumptions and the additional monotonicity condition, we can express the optimal marginal tax rates with the formula derived by Saez (2001). The optimal tax rates depend on the distribution of types, the labor supply elasticities as well as social preferences. As the government is concerned only with redistribution, the marginal tax rates depend directly only on the initial distribution of types. Intuitively, if each worker had the same initial productivity, there would be no scope for the redistributive taxation - any inequality of income would be a matter of insurance. Furthermore, the elasticities that enter the tax formula are the lifetime averages. Specifically, the lifetime compensated elasticity of labor supply is an average compensated elasticity of labor supply over all histories weighted by output.

¹²The single crossing property intuitively means that the higher initial type is more eager to work than the lower initial type. If this property holds, any incentive-compatible lifetime income schedule is non-decreasing in type.

4 Frictional labor market

In this section I characterize the optimal allocation when the labor market is frictional: workers can leave firms and firms can fire workers. In this environment the type of labor contract matters, since the high firing cost prevents the firm from terminating the employment relationship in the future. The following two subsections describe the optimal allocation when the planner uses only fixed-term or only permanent contracts. Finally I describe the optimal choice of contract type.

In this section only pure reporting strategies are considered. It is without the loss of generality by Lemma A.2 (in the Appendix).

4.1 Only fixed-term contracts

Suppose that the planner assigns fixed-term contracts to workers at each history.

Lemma 2. *Under fixed-term contracts, in any equilibrium contract (r, n) at any history $h \in \mathcal{H}$ the worker's labor income is equal to the worker's output: $y(r(h)) = \theta(h)n(h)$.*

The zero firing cost under fixed-term contracts means that neither firm nor worker can commit. This lack of commitment implies that neither of the parties can owe any resources to another, as such a loan would never be repaid. As a result, the labor market becomes a sequence of spot labor markets. A worker at each history is paid exactly his current output.

Corollary 2. *Under fixed-term contracts, the planner's problem is a New Dynamic Public Finance taxation problem.*

Lemma 2 tells us that the reporting strategy uniquely determines the equilibrium labor supply policy, since output equals labor supply in each period. Hence, we can reformulate the equilibrium constraint (7) as

$$\forall_{r \in \mathcal{R}} \mathbb{E}U(c, \bar{n}(r^*)) \geq \mathbb{E}U(c \circ r, \bar{n}(r)), \text{ where } \forall_{h \in \mathcal{H}} \bar{n}(r(h)) = \frac{y(r(h))}{\theta(h)}. \quad (9)$$

This is exactly the incentive-compatibility constraint considered by NDPF.

The solution to the NDPF problem has been studied extensively. As the planner is limited by information, the consumption insurance is only partial. Golosov, Kocherlakota, and Tsyvinski (2003) show that workers' consumption evolves according to the inverse Euler equation, which implies a downward distortion of savings. More recently Farhi and Werning (2013) and Golosov, Troshkin, and Tsyvinski (2015) provide the detailed characterization of the optimal labor wedges.

4.2 Only permanent contracts

Suppose that the planner uses only permanent contracts. The firing cost in this case is assumed to be so high that no firm is ever tempted to fire a worker. Since workers are still free to leave

the firm, the labor market operates under one-sided lack of commitment. The equilibrium in this setting was characterized by [Harris and Holmstrom \(1982\)](#) and [Krueger and Uhlig \(2006\)](#).¹³ The firm overcomes a worker’s commitment problem by backloading labor compensation, i.e. shifting it to the future. As the reward for work comes in the later periods, workers have less incentives to leave the employment relationship early.

Theorem 2. *Take any allocation of consumption and labor supply that can be implemented under the frictionless labor market. The planner can implement it under permanent contracts.*

This is one of the main results of this paper. Although the labor market is frictional, as workers cannot credibly promise to stay with their employers, the planner still can provide workers with full consumption insurance.¹⁴ The reasoning is simple due to a direct mechanism approach. The utility of workers depends on their allocation of consumption and not on the allocation of labor income. The limited commitment constraints, on the contrary, depend on labor income but not on consumption. This means that the limited commitment constraints can be relaxed by backloading labor income without affecting the consumption allocation.

We can understand these results in the following way. The firm offers a labor income that is increasing in tenure and varies only with the initial productivity realization. This contract will satisfy the limited commitment constraints, as the labor income is backloaded. The initial compensation can be adjusted such that the firm makes no losses in expectations. Given that the compensation is deterministic, workers can smooth their consumption perfectly by borrowing against future labor income. If the required borrowing is not available due to the borrowing limit, the consumption can be smoothed with age-dependent taxation.

Although the planner can implement full consumption insurance, it will not always be desirable to do so, even when all workers have permanent contracts. In the next subsection I discuss cases in which the planner optimally assigns different types of contracts to different workers, essentially stripping some of them of insurance. Under some circumstances such a dual labor market allocation can be implemented even if all types are nominally assigned permanent contracts.¹⁵ For an example of such a situation, see Lemma [A.3](#) in the Appendix.

4.3 Who should have permanent contract?

In the following two subsections I investigate which workers should be assigned permanent contracts, and which fixed-term contracts. Theorem [3](#) states that workers that pay the highest taxes should have permanent contracts.

¹³In [Harris and Holmstrom \(1982\)](#) a firm and a worker learn symmetrically about the worker productivity. They receive noisy signals and the contract is based on the posterior mean of productivity. As the posterior mean is a random variable, this model is equivalent to the framework considered in this paper, where the productivity is observable, but stochastic. [Krueger and Uhlig \(2006\)](#) analyze risk-sharing contracts between risk neutral intermediaries and risk averse agents with risky endowments.

¹⁴[Harris and Holmstrom \(1982\)](#) showed that workers can receive full consumption insurance when sufficient borrowing is available (see their footnote 5). My result is more general, as it holds irrespectively of the workers’ borrowing limit.

¹⁵Dual labor market allocation are preferable, because fixed-term contract prevents labor smoothing of the deviating type. However, in some cases the limited commitment constraints of worker are enough to prevent the labor smoothing. That is the case when the deviating worker wants to work less in the first period and more in the second. For details, see Lemma [A.3](#).

Definition 4. *Initial top taxpayers* are types that belong to

$$\arg \max_{\theta \in \Theta_1} \sum_{s \in \mathcal{H}(\theta)} R^{1-|s|} \mu(s \mid \theta) (y(s) - c(s)).$$

Top taxpayers after history h are types that solve the analogous problem, where the maximization is over the set of types directly following h : $\theta \in \mathcal{H}_{|h|+1}(h)$.

Assumption 3. *The distribution of productivity has full support: $\mathcal{H} = \times_{i=1}^{\bar{t}} \Theta_i$, and satisfies the first-order Markov property: for any $h \in \mathcal{H}$ and $s \in \mathcal{H}_{|h|+1}(h)$, $\mu(h) = \mu(s, h_{|h|-1}, h)$.*

Theorem 3. *Initial top taxpayers are optimally assigned permanent contracts and full consumption insurance. Under Assumption 3, top taxpayers after every history are optimally assigned permanent contracts and full consumption insurance.*

Assigning permanent contracts allows the planner to provide more insurance and save resources, but it also increases the incentives of other workers to misreport. However, there are some types that can be mimicked without a loss for the planner: initial top taxpayers. If any other initial worker decides to report that he is a top taxpayer, he will end up contributing more resources to the planner's budget. Hence, it is always optimal to assign permanent contracts to top taxpayers. Note that top taxpayers need not be top earners. If the planner cares only about the most productive types, the least productive workers are taxed the most and they should receive permanent contracts.

This reasoning can be extended to top taxpayers after any history, but we need to make sure that the incentive compatibility constraints at the earlier histories are intact. Assumption 3 implies that the productivity process has sufficiently short memory such that sophisticated multiperiod deviations are suboptimal (see Lemma A.4 in the Appendix). Then switching the contract type does not affect incentives at earlier histories. As a result, the top taxpayers after every history should have permanent contracts.

Theorem 3 leads us to a strong conclusion: it is never optimal to assign fixed-term contracts to all workers. The planner can always Pareto improve upon the NDPF allocation by introducing permanent employment contracts.

Corollary 3. *If the planner does not want to redistribute between initial types, all workers are optimally assigned permanent contracts and full consumption insurance.*

In the particular case of no redistribution all initial types are top taxpayers. If a planner cares only about insurance, it is optimal to use only permanent contracts. In general, who will be initial top taxpayer depends both on distribution of productivities and social welfare weights. On the other hand, all workers sharing the same initial history have the same Pareto weight and it is the productivity distribution alone that determines who will pay the highest taxes.

Corollary 4. *Under Assumptions 1 and 3, the highest productivity types in each period $t > 1$ are optimally assigned permanent contracts.*

Assumption 1 means that a high productivity today corresponds to the high productivity in the future. Insurance requires that after every history the most productive workers pay the highest taxes. By Theorem 3 these workers should have permanent contracts.

4.4 Who should have fixed-term contract?

Take some allocation (c, y, n) with corresponding contract assignment f where the initial type $\underline{\theta}$ has permanent contract. Consider an alternative contract assignment f' where the worker at the history $\underline{\theta}$ (and all histories that follow) receives a fixed-term contract and the contract types of other workers are unchanged. Denote the best allocation of consumption and labor, conditional on contract assignment f' , by (c', n') . Let's write the social welfare function as $W(c, n) \equiv \sum_{\theta \in \Theta_1} \lambda(\theta) \mu(\theta) \mathbb{E}U_\theta(c, n)$. We can decompose the welfare impact of switching contract type into three components, capturing the change in efficiency, redistribution and insurance:

$$W(c', n') - W(c, n) = \underbrace{W(c', n') - W(c_2, n)}_{\Delta^{efficiency}} + \underbrace{W(c_2, n) - W(c_1, n)}_{\Delta^{redistribution}} + \underbrace{W(c_1, n) - W(c, n)}_{\Delta^{insurance}}.$$

Consumption allocation c_1 involves a consumption risk of the fixed-term contract of $\underline{\theta}$, but keeps the present value of consumption of each initial type at the same level as the original allocation c . Hence, $\Delta^{insurance}$ captures the welfare loss due to missing insurance within firm. Consumption allocation c_2 contains both the consumption risk and the change in transfers between initial types. The transition to fixed-term contract relaxes incentive-compatibility constraints between initial types for two reasons: the consumption of $\underline{\theta}$ is more volatile and income shifting is no longer possible. Thus, $\Delta^{redistribution}$ captures the welfare impact of the change in redistribution. Finally, (c', n') correspond to solving the standard government's problem given the contract allocation f' . Note that only at this stage the adjustment to labor supply are allowed. Hence, $\Delta^{efficiency}$ expresses the welfare gain from optimal adjustment of both consumption and labor along the incentive-compatibility constraints. For the details of this decomposition, see Definition 8 in the Appendix.¹⁶

Lemma 3. $\Delta^{insurance} \leq 0, \Delta^{efficiency} \geq 0, \Delta^{redistribution} \geq 0$ if $\underline{\theta} \in \arg \max_{\theta \in \Theta_1} \lambda(\theta) u'(c_1(\theta))$ and $\Delta^{redistribution} \leq 0$ if $\underline{\theta} \in \arg \min_{\theta \in \Theta_1} \lambda(\theta) u'(c_1(\theta))$.

By Lemma 3 each of the decomposition terms can be signed: the switch from permanent to fixed-term contract leads to a utility loss due to lower insurance and utility gain due to labor adjustment. The sign of the redistribution component depends on the desired direction of redistribution. Fixed-term contract improves redistribution if it is assigned to a transfer recipient, not a tax payer.

Lemma 3 suggests that there are two channels that may lead to the optimality of fixed-term contracts: redistribution and efficiency. I explore these channels in the two propositions below.

Proposition 2. Suppose that (i) Assumption 3 holds and additionally the distribution of productivities is independent of the initial productivity draw, (ii) workers are risk neutral: $U(c, n) = c - v(n)$, (iii) $\underline{\theta}$ is the initial type with the lowest productivity and has a positive lifetime income: $\max_{s \in \mathcal{H}(\underline{\theta})} y(s) > 0$, (iv) the planner is Rawlsian: $\forall \theta \neq \underline{\theta} \lambda(\theta) = 0$. Assigning fixed-term contract to type $\underline{\theta}$ is welfare improving.

¹⁶Doligalski and Rojas (2015) use the similar decomposition of welfare change into redistribution and efficiency components in the static Mirrlees (1971) framework with an informal sector.

To understand this proposition, consider a simple example with two initial types ($\Theta_1 = \{\underline{\theta}, \bar{\theta}\}, \bar{\theta} > \underline{\theta}$). The planner wants to maximize the utility of the low type and hence will redistribute from $\bar{\theta}$ to $\underline{\theta}$. What limits redistribution is ability of $\bar{\theta}$ to mimic the other type. If the low type has fixed-term contract, the mimicking is straightforward: $\bar{\theta}$ has to produce at each contingency as much as $\underline{\theta}$. If the low type has permanent contract, misreporting will also involve changing the allocation of output. $\bar{\theta}$ is more productive initially and hence will produce more in the first period. Then the firm pays him a part of the first period output in the future, allowing the mimicking worker to reduce the future labor supply. This income shifting implies that the high type gains more from misreporting when the low type has permanent contract rather than fixed-term contract.

The simplifying assumption of risk neutrality means that the planner cares only about the redistribution and not about the insurance ($\Delta^{insurance} = 0$). Since there is no utility loss from volatile consumption, the incentive constraints that prevent redistribution are relaxed only because of the prevented income shifting. With two initial types ($\Theta_1 = \{\underline{\theta}, \bar{\theta}\}, \bar{\theta} > \underline{\theta}$), we can express the redistribution gain explicitly as

$$\Delta^{redistribution} = \mu(\bar{\theta}) \sum_{s \in \mathcal{H}(\bar{\theta})} R^{1-|s|} \mu(s | \bar{\theta}) (v(\hat{n}(s)) - v(\tilde{n}(s))) > 0.$$

where \tilde{n} is labor allocation of the mimicking high type when $\underline{\theta}$ has permanent contract, while \hat{n} is the labor allocation when $\underline{\theta}$ has fixed-term contract. In line with the intuition above, the disutility from labor of the mimicking type is higher if the other type has fixed-term contract. Thus, $\Delta^{redistribution}$ is strictly positive. Since there is no utility loss due to missing insurance and $\Delta^{efficiency}$ is always non-negative, the overall welfare impact of switching contract of $\underline{\theta}$ is positive. Although the risk neutrality is a strong assumption, we can expect this result to hold also for moderate risk aversion, when $\Delta^{insurance}$ is sufficiently small.

Proposition 3. *Suppose that (i) Assumption 3 holds, (ii) there is some initial type $\underline{\theta}$ with permanent contract that supplies no labor: $\forall_{h \in \mathcal{H}(\underline{\theta})} n(h) = 0$ and faces downward labor distortions in future periods: $\exists_{h \in \mathcal{H}(\underline{\theta}) \setminus \underline{\theta}} s.t. \theta(h)u'(c(h)) > v'(0)$. Assigning fixed-term contract to type $\underline{\theta}$ is welfare improving.*

Proposition 3 shows that fixed-term contracts can improve the allocation of labor. Suppose that the distortions under permanent contracts are so severe that the some type has no lifetime earnings.¹⁷ Notice that $\Delta^{insurance}$ is zero also in this case, although this time we do not impose risk neutrality. Since $\underline{\theta}$ does not supply labor, there is no need for volatile consumption. Moreover, $\Delta^{redistribution}$ is zero as well, for there is no scope for income shifting. The low type can gain only through the efficiency considerations.

Under permanent contracts, the planner discourages misreporting by reducing labor income of $\underline{\theta}$ at all histories. This is the case, because the output produced initially can be paid to the worker at any future history. Such income shifting is not possible with fixed-term contract. Under fixed-term contract the planner can lift some of the future distortions and generate additional resources,

¹⁷Optimum under permanent contracts has this feature when $v'(0) > 0$, $\mu(\underline{\theta})$ is sufficiently low and the planner wants to redistribute to $\underline{\theta}$.

achieving $\Delta^{efficiency} > 0$. For instance, in the simplest iid case the classical ‘no distortion at the top’ result extended to the dynamic setting says that it is suboptimal to distort labor supply of the most productive type after any history. The planner should lift distortions of the most productive fixed-term workers. Note that not all distortions should be lifted, since they serve insurance purpose.

Hopenhayn and Rogerson (1993) claim that high severance payments cause labor misallocation. Their finding relies on the contractual friction: workers are paid a market wage in every period. Lazear (1990) shows that if instead labor contracts were flexible, the firm could design a compensation structure that nullifies the adverse effect of the firing cost on employment. In this paper the logic of Lazear (1990) holds: the high firing cost of permanent contract does not discourage firms from hiring workers. The firing cost does, on the other hand, encourage firms to offer a compensation structure that minimizes workers’ tax burden. The government can prevent firms from doing so either by introducing additional tax distortions or by promoting fixed-term contracts. Proposition 3 identifies the case when the latter is preferable.

5 Fiscal implementation

This section is concerned with implementing the optimum with an indirect mechanism - a tax system. The tax can depend on all observables: history of labor income, asset trades and type of contract as well as age.

Definition 5. A tax system T is a collection of functions $T = \left\{ T_t \left((y_k, a_k, f_k)_{k=1}^t \right) \right\}_{t=1}^{\bar{t}}$, where

$$T_t : (\mathbb{R} \times [-b, \infty) \times \{0, \bar{f}\})^t \rightarrow \mathbb{R}.$$

Given the tax system, we can define the set of equilibria.

Lemma 4. The set of equilibria given the tax system T is

$$\tilde{\mathcal{E}}(T) \equiv \arg \max_{\substack{c, n : \mathcal{H} \rightarrow \mathbb{R}_+ \\ y : \mathcal{H} \rightarrow \mathbb{R} \\ a : \mathcal{H} \rightarrow [-b, \infty) \\ f : \mathcal{H} \rightarrow \{0, \bar{f}\}}} \mathbb{E}U(c, n),$$

subject to the zero profit condition and the limited commitment constraints

$$\forall_{h \in \mathcal{H}_1} \mathbb{E}\pi_h(y, n) = 0,$$

$$\forall_{h \in \mathcal{H}} -f(h) \leq \mathbb{E}\pi_h(y, n) \leq 0,$$

the sequence of budget constraints

$$\forall_{h \in \mathcal{H}_1} c(h) = y(h) - a(h) - T_1(y(h), a(h), f(h)),$$

$$\forall_{h \in \mathcal{H} \setminus \mathcal{H}_1} c(h) = y(h) + Ra(h^{-1}) - a(h) - T_{|h|} \left((y(h^t), a(h^t), f(h^t))_{t=1}^{|h|} \right),$$

and no borrowing in the terminal period: $\forall_{h \in \mathcal{H}_{\bar{t}}} a(h) \geq 0$.

The tax system T implements the allocation (c, y, n) if there exist functions a and f such that $(c, y, n, a, f) \in \tilde{\mathcal{E}}(T)$. The main result of this section concerns the fiscal implementation of allocation (c, y, n) in which all workers have permanent contracts and enjoy full consumption insurance.

Definition 6. *Consumption expenditure* at the history h is $x(h) \equiv y(h) + Ra(h^{-1}) - a(h)$. *Consumption expenditure tax* is $\bar{T}_x \equiv \bar{T} \circ \bar{y}^{-1}$, where $\bar{y}(\theta) \equiv \left(\sum_{t=1}^{\bar{t}} R^{1-t} \right)^{-1} \sum_{t=1}^{\bar{t}} R^{1-t} y(h^t)$ for any $h \in \mathcal{H}_{\bar{t}}(\theta)$ is the normalized net present value of labor income of an initial type θ and $\bar{T}(\theta) \equiv \bar{y}(\theta) - c(\theta)$ is the average tax paid by initial type θ . The *extended consumption expenditure tax* $T_x : \mathbb{R}_+ \rightarrow \mathbb{R}_+$ is equal to \bar{T}_x for arguments from the image of \bar{y} and otherwise takes a prohibitively high value.

Theorem 4. *Take any allocation (c, y, n) that is implemented by some direct mechanism and involves full consumption insurance of all workers. Suppose that the borrowing limit is sufficiently high: $b \geq -\min_{h \in \mathcal{H}} (\sum_{t=1}^{|h|} R^{1-|h|} (y(h^t) - \bar{y}(h_1)))$. If \bar{T}_x is convex, then the allocation can be implemented with the tax system*

$$\forall_{t=\{1 \dots \bar{t}\}} T_t \left((y_k, a_k, f_k)_{k=1}^t \right) = T_x(x_t).$$

If T_x is not convex, the allocation can be implemented with the tax system

$$\forall_{t=\{1 \dots \bar{t}\}} T_t \left((y_k, a_k, f_k)_{k=1}^t \right) = T_x(x_t) + \alpha(x_t - x_0)^2,$$

where α is high enough such that T_t is convex in x_t .

By Theorem 4 in the simplest case all we need to for fiscal implementation is the redistributive tax based only on current consumption expenditures.¹⁸ Firms offer workers backloaded, but deterministic labor compensation. Workers borrow against it and perfectly smooth consumption. Since consumption expenditures are constant across time for each worker, it is an ideal base for a simple redistributive tax. Note that when the consumption expenditure tax is locally regressive (T_x is not convex), we need to add a corrective term that discourages variation in expenditures. Otherwise some workers could reduce their total tax burden by introducing volatility in consumption. Conversely, when the consumption expenditure tax is progressive, no history dependence is required.

Corollary 5. *Take any allocation (c, y, n) that is implemented by some direct mechanism and involves full consumption insurance of all workers. Suppose the borrowing is insufficient: $b < -\min_{h \in \mathcal{H}} (\sum_{t=1}^{|h|} R^{1-|h|} (y(h^t) - \bar{y}(h_1)))$. The allocation can be implemented with the tax system as in Theorem 4 combined with the governmental lending to workers.*

¹⁸It is recognized in the literature that a non-linear consumption tax is difficult to implement if the government does not observe each individual transaction. However, the tax I propose does not differentiate between different consumption goods. Hence, the government can simply base the non-linear tax on the total income net of new savings, which by the budget constraint equals consumption expenditures. Note that the tax code in US has this feature, as the capital gains are taxed only when they are realized, i.e. when they cease to be savings.

In this setting nothing prevents the government from lending to workers. As the debt repayment is contingent only on time, the government can always enforce repayment with taxation. Hence, the government in this setting can always relax the borrowing constraint of the workers enough for Theorem 4 to hold. Cole and Kocherlakota (2001) found the similar relaxation of the borrowing limits to be optimal in the hidden income model with private storage.

Kocherlakota (2005) showed that NDPF can be implemented with the labor income tax that depends on the whole history of labor income and capital income tax which depends on current and previous labor income. Albanesi and Sleet (2006) provide a simpler implementation in the environment with independently and identically distributed productivity shocks. Their tax depends jointly of current income and assets. In these implementations taxes are allowed to vary with time period, or equivalently age of a worker. By Theorem 4 the fiscal implementation of the optimum can be made still simpler with permanent contracts. The tax schedule is time invariant, depends only on current total income net of new savings (with the possible correction term if the tax schedule is regressive) and no additional tax on capital is required. This result holds irrespective of the persistence of productivity shocks. Although assigning permanent contracts to all workers is not always optimal, this is the feature of utilitarian optimum in the calibrated model I consider in Section 7.

Existing tax codes bear a similarity to the consumption expenditure tax, in which savings are taxed only when they are spent on consumption. Unrealized capital gains are not taxed in US - income from the increased value of stocks is taxed only when the stocks are sold. Le Maire and Schjerning (2013) describe the Danish income tax for self-employed, which allows to retain earnings within the firm and pay them later in order to smooth the tax payments. Progressive consumption expenditure tax has been advocated by Bradford (2000). A flat tax proposed by Hall and Rabushka (1995) is a special case of such tax.¹⁹

When the dual labor market is optimal, the fiscal implementation is more complicated, as the tax system of fixed-term workers both redistributes and insures. Specifically, it involves capital taxation of fixed-term workers.

Proposition 4. *Take any allocation (c, y, n) that is implemented by some direct mechanism and involves dual labor market, where consumption of fixed-term workers is bounded away from zero. Fiscal implementation requires taxing assets of fixed-term workers.*

This result is an implication of the inverse Euler equation, which holds in this environment, and the volatile consumption of fixed-term workers. By discouraging savings, capital taxation helps to provide incentives for hard work in the next periods. Following Golosov and Tsyvinski (2006) we can interpret this result as public insurance program with assets testing.

6 Empirical evidence

The model yields testable implications about the income risk of labor contracts with different firing cost. In this section I use the administrative data of employment spells in Italy to show

¹⁹Bradford (2000) and Hall and Rabushka (1995) support the consumption tax because it encourages savings while allowing for redistribution. In my model savings play no productive role, since there is no capital. Instead, asset trades alleviate the contracting friction within the firm.

that indeed fixed-term contracts coincide with a higher residual variance of income (conditional on continuous employment) and that this difference is economically significant. In a related study [Guiso, Pistaferri, and Schivardi \(2005\)](#) show that Italian firms insure their workers, but they do not differentiate between different types of contracts. [Lagakos and Ordonez \(2011\)](#) document that high-skilled workers receive more insurance within the firm than low-skilled in US. It is consistent with the evidence provided by [Bishow and Parsons \(2004\)](#) that white collar workers are more frequently offered severance pay than blue collar workers.

6.1 Labor contracts in Italy

Italy in its modern history experienced a proliferation of distinct labor contracts.²⁰ I focus on only two types of contract: permanent (*il contratto a tempo indeterminato*) and fixed-term (*il contratto a tempo determinato*). Prior to the reforms in 2014 permanent contract used to feature exceptionally high firing cost. An employer could legally dismiss permanent workers for two reasons: difficult situation of the firm or inadequate fulfillment of tasks by the worker. Any fired worker could sue the company for an unfair dismissal. If the judge decides that dismissal was unfair, the worker had a right to be rehired by the original firm and compensated for the income lost during the legal process.²¹ [Ichino, Polo, and Rettore \(2003\)](#) provide evidence that judges decision are not impartial: judges were less likely to find a dismissal justified when the unemployment was high. [Flabbi and Ichino \(2001\)](#) suggests that high firing cost leads to very low turnover rate in large Italian service companies.

Fixed-term contracts do not allow for worker's dismissal justified by a difficult situation of the company. However, as the contract expires, the firm may decide not to extend the contract and hence terminate the employment relationship at no cost.²² I conclude that permanent and fixed-term contracts in Italy are close empirical counterparts of permanent and fixed-term contracts as described in the theoretical framework.

6.2 Empirical model

I measure the lack of insurance residually, as a variation in income which cannot be explained by fixed personal characteristics, age, tenure, labor market experience, firm type, sector, location or time effects. Consider the following model:

$$\log(y_{ijt}) = \rho + W'_{it}\alpha + F'_{jt}\beta + M'_{ijt}\gamma + D'_t\delta + \epsilon_{ijt}, \quad (10)$$

²⁰[Tealdi \(2011\)](#), who provides an overview of labor reforms in Italy, state that in 2006 there were 46 different labor contracts.

²¹As [Ichino, Polo, and Rettore \(2003\)](#) put it, "...firing costs are higher in Italy than anywhere else, because this is the only country in which, if firing is not sustained by a just cause (...), the firm is always forced to take back the employee on payroll and to pay the full wage that he/she has lost during the litigation period plus welfare contributions; in addition, the firm has to pay a fine to the social security system for the delayed payment of welfare contributions up to 200 percent of the original amount due."

²²In the period I consider the firm could extend fixed-term contract once. The second extension lead to the automatic conversion of the contract into a permanent one. Labor reforms in 2014 allowed to up to 5 extensions that together with the original contract last no longer than 3 years.

where W_{it} includes worker's time invariant and time varying characteristics, F_{jt} includes firm's time invariant and time varying characteristics, M_{ijt} includes match characteristics such as tenure and type of contract, D_t are yearly fixed effects and ϵ_{ijt} is the error term. The parameter of interest is the variance of ϵ_{ijt} , which captures the residual income risk, conditional on being continuously employed. Let's compute the difference of (10)

$$\log \left(\frac{y_{ijt}}{y_{ijt-1}} \right) = \Delta W'_{it} \alpha + \Delta F'_{jt} \beta + \Delta M'_{ijt} \gamma + \Delta D'_t \delta + \Delta \epsilon_{ijt} \quad (11)$$

Take a vector of variables $X \in \{W, F, M\}$ and denote its vector of parameters by ξ . Divide X into three components:

$$X_{ijt} = [X_{ij}^1, X_{ijt}^2, X_{ijt}^3],$$

where X_{ij}^1 involves variables which are fixed in time, X_{ijt}^2 variables that depend linearly on year, such as age, labor market experience or tenure, and X_{ijt}^3 are variables that depend on time non-linearly. Let's separate the vector of parameters ξ in the same way into ξ_1 , ξ_2 and ξ_3 . Then we can write

$$\Delta X'_{ijt} \xi = \sum \xi_2 + \Delta X'^{3'}_{it} \xi_3,$$

and equation (11) becomes

$$\log \left(\frac{y_{ijt}}{y_{ijt-1}} \right) = \sum \alpha_2 + \sum \beta_2 + \Delta W'^{3'}_{it} \alpha_3 + \Delta F'^{3'}_{jt} \beta_3 + \Delta M'^{3'}_{ijt} \gamma_3 + \Delta D'_t \delta + \varepsilon_{ijt},$$

where $\varepsilon_{ijt} = \Delta \epsilon_{ijt}$. In this way we avoid the need to estimate the fixed effects of workers, firms and a match, which greatly reduced the number of parameters. Furthermore, this specification is robust to possible correlation between individual fixed effects and tenure or labor market experience.²³

How does the variance of the error term in (10) depend on a type of employment contract? Assume that the distribution of error ϵ_{ijt} is independent of time and denote the variance of error with permanent contract by σ_P^2 and the variance of error with fixed-term contract by σ_{FT}^2 . Let's call $\frac{\sigma_{FT}^2}{\sigma_P^2}$ a *risk ratio*. The risk ratio greater than 1 means that fixed-term contracts imply more income risk, or equivalently less income insurance, than permanent contracts. The risk ratio is equal

$$\frac{\sigma_{FT}^2}{\sigma_P^2} = \frac{1 - \rho_P}{1 - \rho_{FT}} \frac{Var(\varepsilon^{FT})}{Var(\varepsilon^P)}$$

where ρ_x is the autocorrelation of errors when contract is $x \in \{P, FT\}$. If errors for two contract types have the same autocorrelation, then the risk ratio is simply given by the ratio of variances of errors from the differenced equation (11).

²³See discussion in Guiso, Pistaferri, and Schivardi (2013).

6.3 Data

The data comes from *Work Histories Italian Panel* (WHIP), a sample of administrative records of Italian employment histories.²⁴ The time-span in which permanent and fixed-term contracts can be observed separately is 1997-2004. The data is at the annual frequency. I consider only a full time jobs and annualize the real income from a given job by dividing it by an average number of working days.

I extract all two-period employment spells of a given individual at the given firm with a contract of a given type. As an illustration of this procedure, consider the following example of a work history.

Table 1: An example of an employment history

year	company	contract
1998	A	fixed-term
1999	A	fixed-term
2000	B	fixed-term
2001	B	permanent
2002	B	permanent
2003	B	permanent

A worker with such an employment history was working on a fixed term contract for company *A* for two years. Then the worker moved to a company *B* for one year of fixed-term employment followed by the permanent employment. From this employment history extract three two-period employment spells are extracted: 1998 : 1999 at the company *A* with a fixed term contract and 2001 : 2002, 2002 : 2003 at the company *B* with permanent contract. I do not use the spell 1999 : 2000, as it involved a change of an employer, nor the spell 2000 : 2001, as it involved a change of contract.

For each 2-period employment spell, the logarithm of ratio of annualized income is computed. I remove outliers separately for two types of contract by considering only the spells with $\log\left(\frac{y_{ijt}}{y_{ijt-1}}\right)$ within three standard deviations from the sample mean. The explanatory variables used are: worker characteristics (gender, geographical region), firm characteristics (firm's age, sector), match characteristics (tenure, type of job) as well as annual dummies.

6.4 Results

Equation (11) is estimates with OLS separately for each type of contract.²⁵ Then I take squared residuals from both regressions, pool them into a one vector and regress them on a set of explanatory variables that includes a 'fixed-term contract' dummy variable. This procedure is essentially the White (1980) test for heteroskedasticity of the error term. A significant positive estimate of the parameter of the 'fixed-term contract' dummy means that fixed-term contracts are associated with higher variance of errors from the difference equation (11). The main results of this regression are reported in Table 2, the full results and auxiliary estimates are reported in Appendix B.

²⁴Work Histories Italian Panel is a database of work histories developed thanks to the agreement between INPS and University of Turin. For more information, see <http://www.laboratoriorevelli.it/whip>.

²⁵There are 179,831 two-period spells with permanent contract and 3,486 with fixed-term contract.

Table 2: Regression of $\hat{\varepsilon}_t^2$ (main estimates)

variable	coefficient	t	95% confidence interval
constant	0.0347***	10.557	(0.028, 0.041)
fixed-term contract	0.009***	13.058	(0.008, 0.01)
$\log(y_{ijt})$	-0.0019***	-5.591	(-0.003, -0.001)

*** - statistically significant at the 1% level.

Table 3: Regression of $\hat{\varepsilon}_{t-1}\hat{\varepsilon}_t$ (main estimates)

variable	coefficient	t	95% confidence interval
constant	0.0031	1.383	(-0.001, 0.008)
fixed-term contract	-0.0012	-1.568	(-0.003, 0.001)
$\log(y_{ijt})$	-0.0006*	-2.742	(-0.003, -0.001)

* - statistically significant at the 10% level.

The fixed-term dummy is positive and highly significant, which means that the variance of errors of the auxiliary differenced regression are higher for fixed-term contracts: $Var(\varepsilon^{FT}) > Var(\varepsilon^P)$. Since variance of errors vary with other characteristics as well (such as log income, as reported in Table 2), in order compute the lower bound on the risk ratio, consider a male worker from north-west of Italy in 1998, who starts a job in services at the median income ($\approx 20,000$ euros). In this case $Var(\varepsilon^{FT})/Var(\varepsilon^P) = 1.78$.

I use similar method to examine the impact of the type of contract on the autocorrelation of errors. The product of the lagged and current residuals is regressed on a set of explanatory variables and a ‘fixed-term contract’ dummy. In this case the impact of fixed-term contract is statistically insignificant at 10% level (see Table 3). Moreover, using the point estimate for a median male worker as before, we arrive at the correlation ratio $\frac{1-\rho^P}{1-\rho^{FT}} = 0.9997$. Hence, the risk ratio is very well approximated by the ratio of variances of error from the differenced equation

$$\frac{\sigma_{FT}^2}{\sigma_P^2} \approx \frac{Var(\varepsilon^{FT})}{Var(\varepsilon^P)} = 1.78.$$

The income risk faced by the median worker with fixed-term contract is 78% higher than the income risk faced by the similar worker with permanent contract. It is an economically significant value. A worker with permanent contract earning a median income can expect that with 95% probability his next year income will be between 17,509 and 23,777 euros. The same worker with a fixed-term contract will have a wider confidence interval of 16,522 to 24,927 euros.

The analysis above may suffer from a selection problem. That would be the case if firms offering more risky jobs used fixed-term contracts, while more stable firms hire on a permanent basis. A proper causal analysis of relation between a type of contract and the residual volatility of income is an interesting topic for future research.

7 Quantitative exercise

In this section I calibrate the simple life-cycle model using the Italian data (WHIP) and describe the set of constrained efficient allocations.

7.1 Calibration

The sample is divided into two age groups: young (below the median age) and old (above or equal to the median age). Only wage workers with a full-time job are considered. With the data at hand the persistence of income on such a long time period is not observed - at most 8 years of income for each individual are available. Rather than assuming the earning process that is independent across time, I use the data on total employment spell with a given employer. Within each age group, I divide workers between permanently employed (with permanent employment contract and sufficiently long total employment spell at the current employer) and temporarily employed (fixed-term workers and workers with shorter total employment spell). I assume that income of permanently employed old is informative about the future income of permanently employed young²⁶. Another rationale for this division is that, according to the theory, the data on labor income is more informative of productivity for workers that are not engaged in long-term relationship with their employers. As it turns out, for both types of workers at each history the income is strictly increasing in age (see table 4). Under assumption of no borrowing in the data, the income process is informative about the productivity for all age/contract type groups.²⁷

I take the mean labor income of young within each contract group and assign probability of each contract group by relative frequency in the data. The earnings distribution of old workers is described with the Gaussian mixture model. The Gaussian mixtures can approximate well complex distributions (Marin, Mengersen, and Robert (2005)) and were successfully used to capture higher moments of the US earnings distribution (Guvenen, Karahan, Ozkan, and Song (2015)). I estimate the mixture by maximum likelihood Expectation-Maximization algorithm of Dempster, Laird, and Rubin (1977). Then, in order to keep the model simple, I take the estimated means of each component of the mixture as a distinct earning realization that occurs with the probability equal to the weight of this component in the mixture. In practice, for both groups of old workers (permanently and temporarily employed) the mixture of two normal distributions fits the data well. Table 4 presents the estimation results. Income is reported in euros per year at the 2004 prices.

I use logarithmic utility from consumption and iso-elastic disutility from labor with compensated elasticity of 1:

$$u(c) - v(n) = \log(c) - \Gamma \frac{n^2}{2}.$$

There are 7 parameters left to determine: the productivity at each history and the labor disutility

²⁶In fact, in the dataset some permanent workers cross the threshold between age groups.

²⁷Since I consider only two periods, the upward time trend dominates the stochastic variation. In the future work I plan to estimate the model for more age groups, where the issue of disentangling current output and insurance is likely to emerge.

Table 4: Estimated income process

Age ↓ \ contract type →	Temporary workers ($\underline{\theta}$)			Permanent workers ($\bar{\theta}$)		
Young	$y(\underline{\theta}) :$	16,745		$y(\bar{\theta}) :$	20,147	
	$\mu(\underline{\theta}) :$	0.53		$\mu(\bar{\theta}) :$	0.47	
Old		Unlucky	Lucky		Unlucky	Lucky
	$y(\underline{\theta}, \theta') :$	18,839	25,506	$y(\bar{\theta}, \theta') :$	20,349	26,504
	$\mu((\underline{\theta}, \theta') \underline{\theta}) :$	0.51	0.49	$\mu(\bar{\theta}, \theta' \bar{\theta}) :$	0.4	0.6

parameter Γ . The productivities are pinned down with the first-order condition of labor supply

$$\theta = y(\theta) \sqrt{\Gamma \frac{1 - T(y(\theta)) / y(\theta)}{1 - T'(y(\theta))}}, \quad (12)$$

where $T(y)$ is the actual tax Italian tax schedule.²⁸ Without the loss of generality Γ is set to 1 - by the first order condition (12) varying Γ would simply rescale all the productivities. The discount factor β is equal to 0.5, corresponding to the period of 17 years.

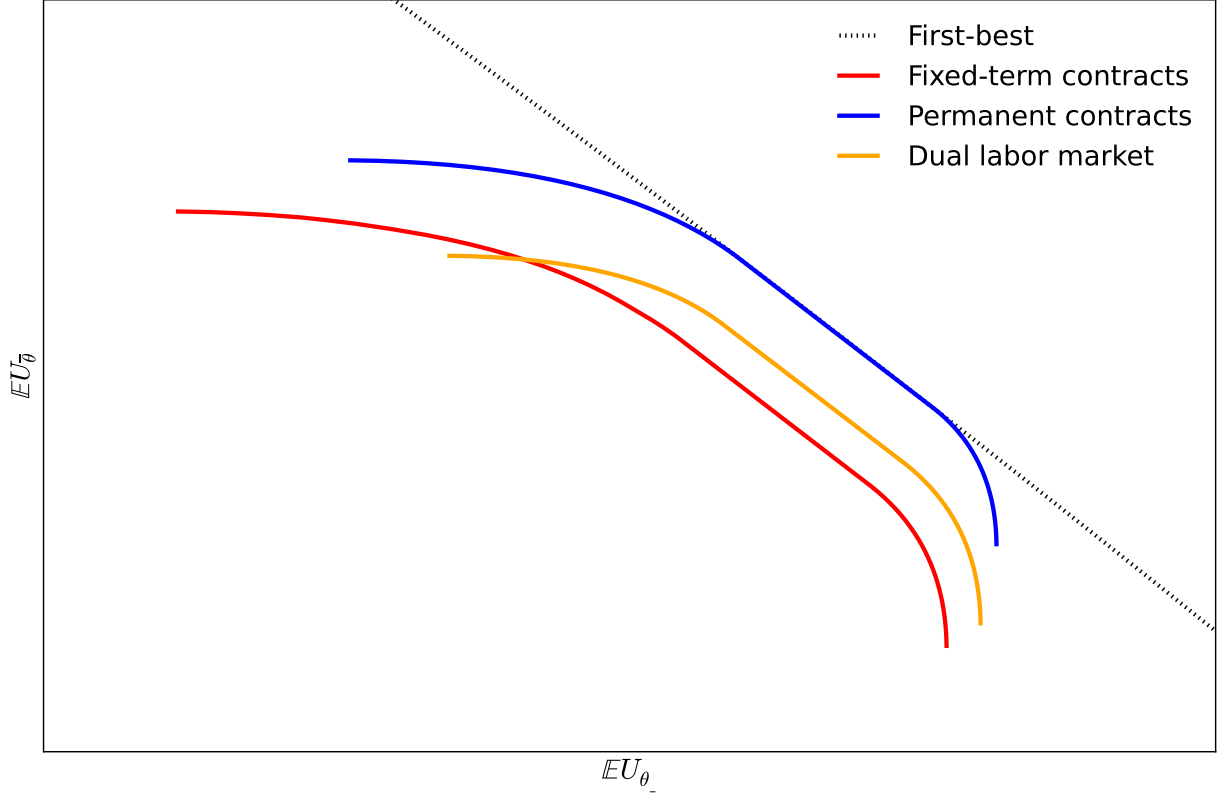
7.2 Pareto Frontiers

Figure 1 shows Pareto frontiers of three different regimes. ‘Fixed-term contracts’ regime corresponds to the NDPF economy, in which all workers receive fixed-term contracts and firms do not engage in insurance provision. ‘Permanent contracts’ regime is characterized by both initial types receiving permanent employment. Finally, the ‘Dual labor market’ frontier describes the economy in which the initially more productive type is employed permanently, while the other is employed on a fixed-term basis.²⁹ I plot as well the Pareto frontier of the first-best allocation as an indicator of what is feasible, even if we abstract from the incentive issues. The first-best is characterized by the full consumption insurance and efficient allocation of labor at each history. In each regime the government raises the same net tax revenue as the actual Italian tax schedule.

²⁸Italy undertook a series of tax reforms in the considered period. I use the tax schedule from year 2000, which captures the average shape of the tax function in these years.

²⁹I do not plot the Pareto frontier of the fourth configuration, in which the initially low productivity type receives permanent contract and the initially high type receives fixed-term contract, as it is already implicitly incorporated in the ‘Permanent contracts’ frontier - see Lemma A.3.

Figure 1: Pareto frontiers in the calibrated economy



Whenever the worker is employed on fixed-term contract, the only source of insurance against the productivity risk is the tax system. Information constraints prevent the government from implementing simultaneously full consumption insurance and efficient allocation of labor. As a result, the Pareto frontier of any regime in which some workers are employed on a fixed-term basis is bounded away from the first-best Pareto frontier. On the other hand, permanent contracts allow for coexistence of full insurance and efficient labor supply if the redistribution between initial types is limited. The permanent contracts frontier coincides with the first-best when the social preferences are not strongly redistributive.

By Theorem 3 we know that the regime with only fixed-term contracts is Pareto dominated by some regime in which at least some workers receive permanent contracts. Figure 1 shows that for the calibrated parameter values it is always optimal to assign permanent contracts to all workers. Furthermore, in any constrained efficient allocation all workers enjoy full consumption insurance.³⁰ The dual labor market regime improves upon the fixed-term regime when the planner cares predominantly about the initially less productive workers, but the gains from assigning permanent contract to both types are even greater. The welfare gap between the permanent contracts and the dual labor market regimes is 0.6% in consumption equivalent terms.

³⁰For some parameter values when the planner wants to redistribute from the bottom to the top, a dual labor market in which initial high productivity workers have fixed-term contract is optimal. In such case the permanent contracts allocation would not involve full consumption insurance of the high productivity workers.

Table 5: Optimal allocations for different social welfare functions

Social preferences:	utilitarian	libertarian	Rawlsian	anti-Rawlsian
Objective	$\mathbb{E}U$	$\sum_{\theta \in \Theta_1} \lambda^{lf}(\theta) \mu(\theta) \mathbb{E}U_\theta$	$\min_{\theta \in \Theta_1} \mathbb{E}U_\theta$	$\max_{\theta \in \Theta_1} \mathbb{E}U_\theta$
Consumption insurance	full	full	full	full
Allocation of labor	efficient	efficient	distorted	distorted
Welfare (cons. equiv.)				
laissez-faire = 100%	104.3%	104.1%	108.3%	107.2%
NDPF = 100%	101.5%	101.5%	101%	101.2%
Relative gain from permanent contracts	53.3%	59.7%	12.9%	20.3%

Note: The libertarian planner maximizes individual utility subject to no redistribution between initial types. Taxation plays only an insurance role and workers would voluntarily decide to participate in a public insurance scheme. The libertarian welfare weights λ^{lf} are welfare weights under which in the first-best there is no redistribution. The anti-Rawlsian planner is the opposite of the Rawlsian planner and maximizes the utility of the most well-off type.

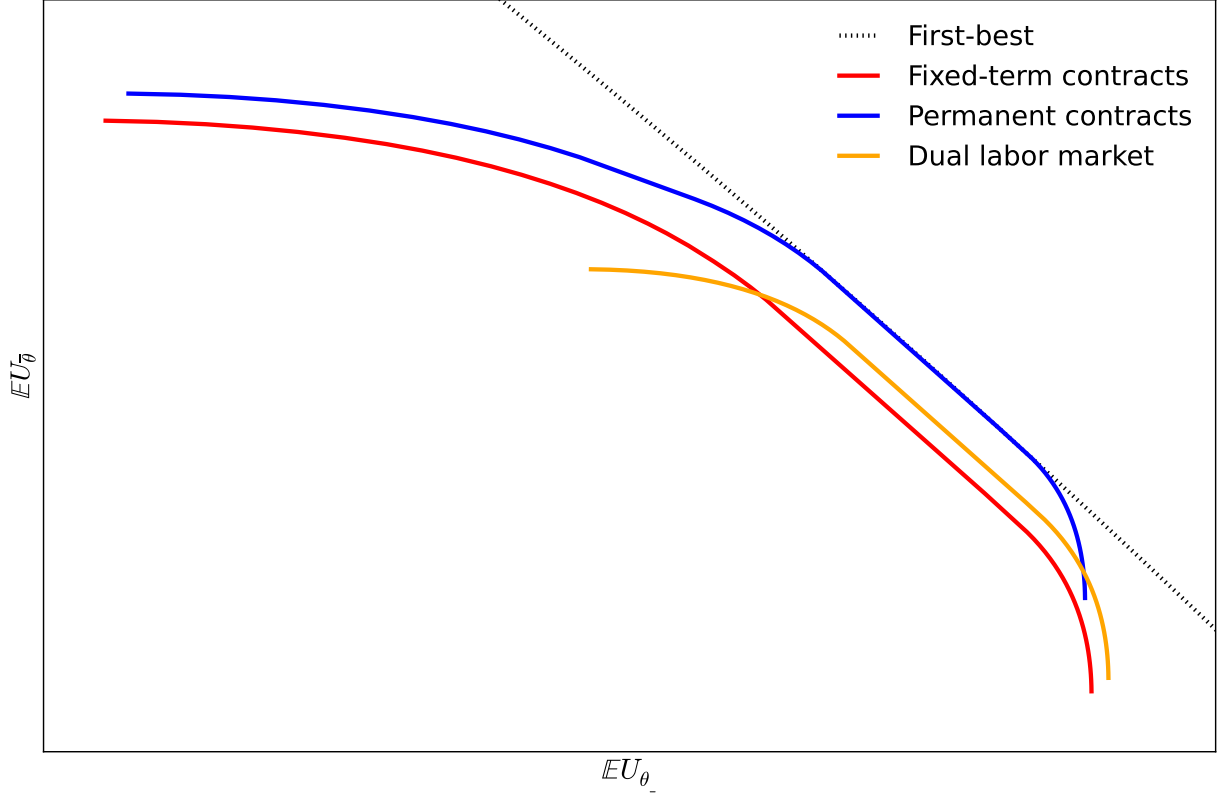
Table 5 presents the optimal allocations under different assumptions about the social preferences. Interestingly, the utilitarian planner does not introduce labor distortions and chooses the allocation that lays on the first-best Pareto frontier.³¹ Labor distortions augment redistribution and are used only by the two most redistributive social planners: Rawlsian and anti-Rawlsian, who care only about one initial type of workers. The middle rows of Table 5 compare the constrained efficient allocations with the laissez-faire (fixed-term contracts, no public insurance, uniform lump-sum taxation to cover the government expenditures) and NDPF allocations in terms of welfare. The welfare metric is the consumption equivalent measure: by which factor shall we increase consumption of workers at each history in the benchmark allocation (laissez-faire or NDPF) to obtain the same welfare as in the constrained efficient allocation. When we consider the less redistributive social planners (utilitarian and libertarian), the NDPF captures less than two-thirds of the gains from constrained efficient allocation. It means that the simpler tax systems that encourages firms' insurance improve upon the complicated tax systems prescribed by NDPF by more than 50% in terms of welfare (the last row of Table 5). The relative welfare gain from using permanent contracts in comparison to fixed-term contracts is smaller for social preferences focused on redistribution.

Consider the alternative economy in which the initial differences between two types are greater than in Italy: suppose that the initial productivity of less productive type is lower by 10%. The Pareto frontiers of different regimes are shown on Figure 2. Now the Rawlsian planner implement dual labor markets. The greater difference in initial productivities means that the deviating high type gains more by smoothing labor, which is not possible when the initial low type has fixed-term contract. The welfare gain of the dual labor market over the permanent contract regime is large: 1.8% in consumption equivalent terms.³² Note that in this case the Rawlsian planner prefers even the NDPF allocation to the permanent contracts allocation. The dual labor market becomes optimal also when we increase the population share of initial high productivity type in comparison to the calibrated case.

³¹Although the constrained efficient allocation chosen by the utilitarian planner lays on the first-best Pareto frontier, it does not coincide with the first-best utilitarian optimum. The planner constrained only by the budget constraint would equalize consumption between two types, while keeping the labor supply undistorted. Such allocation is not incentive compatible even with permanent contracts.

³²The dual labor market and the permanent contract regime yield roughly the same welfare when the initial low productivity is lower by 4% in comparison to the calibrated value.

Figure 2: Pareto frontiers in the alternative economy with increased initial differences



8 Conclusions

Firms are the natural insurers of their employees. First, competition in the labor market gives firms strong incentives to shelter workers from risk. Second, companies arguably have the best knowledge of their workers' productivity (with an exception of workers themselves). The insurance role of firms should be acknowledged by the optimal tax theory, as it can resolve its shortcoming: the excessive complexity. In this paper I show that incorporating firms into the dynamic taxation framework leads to a fully optimal tax system that is simple and realistic. The government optimally outsources insurance to firms by promoting permanent employment contracts. The only remaining role for the government is redistribution, which can be conducted with simple tax instruments. In a calibrated model of Italy all constrained efficient allocations can be implemented with a time-invariant tax schedule that depends exclusively on current consumption expenditure.

Empowering the private sector to insure workers comes at a price. Firms insure their workers by shifting income from the times of high to the times of low productivity. However, this intertemporal reallocation can be used to avoid taxes in the following way: a productive worker shifts the income to the future and collects income support today. A redistributive government can limit such a behavior without reducing the generosity of transfers by promoting fixed-term contracts at low levels of earnings. This redistributive argument provides a novel perspective on dual labor markets

in which permanent and fixed-term contracts coexist.

The analysis could be extended in several directions. The focus of this paper is on workers' heterogeneity. Introduction of heterogeneous production opportunities for firms would allow for analysis of temporary jobs, which in fact are the primary reason for existence of fixed-term contract. Limited commitment of workers may be muted by search and mobility costs. Careful treatment of employees' outside option is vital to understanding insurance within firm. Finally, it is worth examining how the trade-off between redistribution and insurance influences the optimal regulation of other insurance markets.

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A Proofs and auxiliary lemmas

A.1 Section 2

Proof of Lemma 1. Suppose that there is an equilibrium contract (σ, n) which at some history $h \in \mathcal{H}$ yields positive profits. A competitor could profitably steal the worker by offering contract (σ', n') , where $\sigma' = \sigma$, $n'(h) = n(h) - \sum_{r \in \mathcal{R}} \sigma(r) \mathbb{E} \pi_h(c \circ r, n) / 2\theta(h)$ and $n'(s) = n(s)$ for any other history $s \neq h$. This contract yields half of the profits of the original contract (r, n) and would be preferred by the worker, as it involve less labor supply. Suppose instead that profits are negative and lower than $f(r(h))$. Then the firm would prefer to terminate the contract and incur firing cost rather than keep the worker. Hence, all equilibrium contracts satisfy $\forall_{h \in \mathcal{H}} f(r(h)) \leq \sum_{r \in \mathcal{R}} \sigma(r) \mathbb{E} \pi_h(c \circ r, n) \leq 0$. Moreover, the firm cannot expect losses initially, as it could offer a contract that yields zero profits by equalizing worker’s output to worker’s income at each history. Hence, $\forall_{\theta \in \Theta_1} \sum_{r \in \mathcal{R}} \sigma(r) \mathbb{E} \pi_\theta(c \circ r, n) = 0$.

Suppose there is an equilibrium contract (σ, n) which does not belong to $\mathcal{E}(c, y, f)$. It means there is another contract (σ', n') which yields strictly greater expected utility to the worker subject to the zero profit condition and limited commitment constraints. Define $\sigma'' = \sigma'$ and $\forall_{h \in \mathcal{H}} n''(h) = n'(h) + \epsilon$, where $\epsilon > 0$. For epsilon sufficiently small (σ'', n'') yields greater expected utility than (σ, n) and positive profits. Hence, (σ, n) cannot be an equilibrium contract.

Suppose that there is a contract $(\sigma, n) \in \mathcal{E}(c, y, f)$ that is not an equilibrium contract. It means that there is another contract (σ', n') that yields positive profits and the expected utility greater than (σ, n) . This in turn implies that there is yet another contract which yields zero profits at each history and the expected utility greater than (σ', n') . It contradicts the fact that $(\sigma, n) \in \mathcal{E}(c, y, f)$. \square

A.2 Section 3

Proof of Theorem 1. I will show that the optimum under full commitment in the labor market is characterized by: (i) full consumption insurance: $\forall h \in \mathcal{H} c(h) = c(h_1)$, (ii) lifetime labor income that is a deterministic function of initial type: $\forall h \in \mathcal{H}_t(\theta_1) \sum_{t=1}^{\bar{t}} R^{1-t} y(h^t) = Y(h_1)$.

Take any outcomes (c, y) which are incentive-compatible (i.e. σ^* is the equilibrium reporting strategy) and do not involve full consumption insurance. For each initial type $h_1 \in \times_1$ find a full-insurance consumption level $\bar{c}(h_1)$ with equality $\sum_{t=1}^{\bar{t}} \beta^{t-1} u(\bar{c}(h_1)) = \sum_{s \in \mathcal{H}(h_1)} \beta^{1-|s|} \mu(s | h_1) u(c(h))$. Set $\bar{y}(h)$, where $h \in \mathcal{H}(\theta)$, to the average of histories of this length: $\sum_{s \in \mathcal{H}_{|h|}(\theta)} \mu(s | \theta) y(s)$. This way both the lifetime consumption and labor income are deterministic functions of the initial type report. The worker has the same lifetime output as before (as it is equal to the lifetime income). Furthermore, the worker receives more consumption insurance, which allows the planner to save some resources. Before we prove that truthtelling is the equilibrium strategy given the new outcomes, let's define a useful reporting strategy.

Definition 7. The “statistical mimicking” strategy $\sigma_{\theta, \theta'}^{stat}$ is a reporting strategy such that

- for all $r \in \mathcal{R}$ such that $\exists h \in \mathcal{H} \setminus \mathcal{H}(\theta) r(h) \neq h$ implies that $\sigma_{\theta, \theta'}(r) = 0$.
- $\forall h \in \mathcal{H}(\theta') \mu(h | \theta') = \sum_{s \in \mathcal{H}_{|h|}(\theta)} \mu(s | \theta) \sum_{r \in \mathcal{R}} \mathbb{I}_{r(s)=h} \sigma(r)$, where \mathbb{I} is an indicator function.

The first point means that apart from the history following the initial type θ , $\sigma_{\theta, \theta'}^{stat}$ is truthful. The second point means that along the history following the initial type θ , $\sigma_{\theta, \theta'}^{stat}$ generates the distribution of type reports consistent with truthful reporting of initial type θ' .

In order to check that the truthful reporting is the equilibrium strategy given the new outcomes, note that the initial type report uniquely determines the payoff of the worker. Consider a reporting strategy \bar{r} such that $\bar{r}(\theta_1) = \theta_2$ (involves type θ_1 mimicking type θ_2) and $\bar{r}(\theta) = \theta$ for $\theta \in \Theta_1 \setminus \theta_1$ (is truthful elsewhere). The utility from following this strategy given outcomes (\bar{c}, \bar{y}) is equal to the utility from following the strategy $\sigma_{\theta_1, \theta_2}^{stat}$ with outcomes (c, y) . To see this, note that the utility from consumption and the expected lifetime income generated by $\sigma_{\theta_1, \theta_2}^{stat}$ are identical to those generated by truthful reporting of type θ_2 . Since truthful reporting was a equilibrium reporting strategy given outcomes (c, y) , the truthful reporting is an equilibrium strategy also with outcomes (\bar{c}, \bar{y}) . Hence, the planner can get free resources without hurting any worker by implementing the full consumption insurance.

Now I will show that the full consumption insurance is incentive compatible (i.e. implies a truthful equilibrium reporting) is and only if and only if the lifetime labor income along any history depends only on the initial type:

$$\forall \theta \in \Theta_1 \forall h, s \in \mathcal{H}_{\bar{t}}(\theta) \sum_{t=1}^{\bar{t}} R^{1-t} y(h^t) = \sum_{t=1}^{\bar{t}} R^{1-t} y(s^t).$$

Denote by \underline{h} (\bar{h}) a history originating from θ that yields the lowest (highest) lifetime income:

$$\underline{h} \in \arg \min_{h \in \mathcal{H}_{\bar{t}}(\theta)} \sum_{t=1}^{\bar{t}} R^{1-t} y(h^t), \quad \bar{h} \in \arg \min_{h \in \mathcal{H}_{\bar{t}}(\theta)} \sum_{t=1}^{\bar{t}} R^{1-t} y(h^t).$$

Suppose that the lifetime income is strictly greater along \bar{h} in comparison to \underline{h} . Because of full insurance, consumption allocation is identical along \underline{h} and \bar{h} . By the zero profit condition, the worker can reduce the average level of labor supply by always reporting \underline{h} . Hence, the equilibrium labor contract involves reporting \underline{h} whenever \bar{h} happens. By contradiction, it means that whenever there is a full consumption insurance, the lifetime income has to be a deterministic function of the initial type. Conversely, if a worker prefers reporting h to s , when both these allocations involve full insurance, it must be that at the history s the worker supplies more labor. Supplying more labor by the zero profit condition means that the life-time income at the history s is greater than at the history h . \square

Lemma A.1. *Under Assumption 1 the function $V_{\theta}(C, Y)$ satisfies the single-crossing condition.*

Proof of Lemma A.1. I will show that under Assumption 1 $\frac{\partial V_{\theta_1}(C, Y)}{\partial Y}$ is increasing with θ . Then I will show that it implies that $V_{\theta}(C, Y)$ has the single crossing property, as in [Milgrom and Shannon \(1994\)](#).

First note that $\frac{\partial V_{\theta_1}(C, Y)}{\partial Y} = -\frac{v'(n(h))}{\theta(h)}$ for any $h \in \mathcal{H}(\theta_1)$. Suppose that $\frac{v'(n(h))}{\theta(h)}$ does not decrease with θ_1 . It means that for all s such that $s \in \times_{i=2}^k \Theta_i$, $k \leq \bar{t}$, we have $n(\theta_1, s) \leq n(\theta_2, s)$ for $\theta_2 > \theta_1$. Then the following inequalities are implied by the weak FOSD (Assumption 1)

$$\forall_{t \in \{1, \dots, \bar{t}\}} \sum_{s \in \mathcal{H}_t(\theta_1)} \mu(s | \theta_1) \theta(s) n(s) \leq \sum_{s \in \mathcal{H}_t(\theta_2)} \mu(s | \theta_2) \theta(s) n(s).$$

At least one, initial inequality ($t = 1$) is always strict, so the initial type θ_2 produces strictly more in expected value than θ_1 . It leads to a contradiction, as the initial zero-profit condition is slack, which cannot happen in equilibrium.

[Milgrom and Shannon \(1994\)](#) strict single crossing condition means that

$$V_{\theta_1}(C_2, Y_2) \geq V_{\theta_1}(C_1, Y_1) \implies V_{\theta_2}(C_2, Y_2) > V_{\theta_2}(C_1, Y_1),$$

where $\theta_2 > \theta_1$ and $Y_2 > Y_1$ (which naturally implies that $C_2 > C_1$). Given the additive separability between consumption and labor, this statement is true if the following holds for any C :

$$V_{\theta_1}(C, Y_1) - V_{\theta_1}(C, Y_2) > V_{\theta_2}(C, Y_1) - V_{\theta_2}(C, Y_2).$$

Since V_{θ} is monotone in Y , we can write this inequality as

$$\int_{Y_1}^{Y_2} \frac{dV_{\theta_1}(C, Y)}{dY} dY < \int_{Y_1}^{Y_2} \frac{dV_{\theta_2}(C, Y)}{dY} dY,$$

which is true, since, as it was shown before, $\frac{dV_\theta(C,Y)}{dY}$ is increasing in θ . \square

Proof of Proposition 1. By Theorem 1 the planner's problem under full commitment can be expressed as the static Mirrlees (1971) taxation problem. The solution to the Mirrlees model, when the first order approach is valid, was expressed in terms of elasticities by Saez (2001). The first-order approach is valid if the single crossing condition holds and the resulting income schedule is non-decreasing. The single crossing holds by Assumption 1 and Lemma A.1. Hence, what remains to be shown are the relevant elasticities, which I derive below.

First, let's define $\phi(\theta_1, Y)$ as $\frac{v'(n(h))}{\theta(h)}$ where $h \in \mathcal{H}(\theta_1)$ and $Y(\theta_1) = Y$. Let's define the marginal tax rate $T'(\theta_1)$ as $1 - \frac{\phi(\theta_1, Y(\theta_1))}{u'((\sum_{t=1}^T R^{1-t})^{-1} C(\theta_1))}$. I will derive the elasticities by varying the marginal tax rate.

The compensated elasticity is given by

$$\bar{\zeta}^c = \frac{\partial Y(\theta_1)}{\partial 1 - T'(\theta_1)} \Big|_{dC(\theta_1)=0} \frac{1 - T'(\theta_1)}{Y(\theta_1)} = \frac{\phi(\theta_1, Y(\theta_1))}{\phi_Y(\theta_1, Y(\theta_1)) Y(\theta_1)}.$$

With an implicit function theorem we can get the derivative of ϕ with respect to income. First, with (8) express $n(h)$ as $g(\theta(h) \phi(h, Y(h_1)))$, where g is an inverse function of v' . Plug this expression into the zero profit condition to get

$$H = \sum_{h \in \mathcal{H}(\theta_1)} R^{1-|h|} \mu(h | \theta_1) \theta(h) g(\theta(h) \phi(\theta_1, Y(\theta_1))) - Y(\theta_1) = 0.$$

By the implicit function theorem we have

$$\begin{aligned} \phi_Y(\theta_1, Y(\theta_1)) &= -\frac{\partial H}{\partial Y(\theta_1)} \left(\frac{\partial H}{\partial \phi(\theta_1, Y(\theta_1))} \right)^{-1} = \left(\sum_{h \in \mathcal{H}(\theta_1)} R^{1-|h|} \mu(h | \theta_1) (\theta(h))^2 g'(\theta(h) \phi(\theta_1, Y(\theta_1))) \right)^{-1} = \\ &= \left(\sum_{h \in \mathcal{H}(\theta_1)} R^{1-|h|} \mu(h | \theta_1) \frac{(\theta(h))^2}{v''(n(h))} \right)^{-1}. \end{aligned}$$

Hence, we have

$$\bar{\zeta}^c = Y(\theta_1)^{-1} \sum_{h \in \mathcal{H}(\theta_1)} R^{1-|h|} \mu(h | \theta_1) \frac{\theta(h) n(h) v'(n(h))}{n(h) v''(n(h))} = \sum_{h \in \mathcal{H}(\theta_1)} R^{1-|h|} \mu(h | \theta_1) \frac{\theta(h) n(h)}{Y(\theta_1)} \zeta^c(h),$$

where $\zeta^c(h)$ is the compensated elasticity of labor supply at history h . The lifetime compensated elasticity is the average compensated elasticity across all histories starting in θ_1 , weighted by the realized output.

The uncompensated elasticity is given by

$$\bar{\zeta}^u = \frac{\partial Y(\theta_1)}{\partial 1 - T'(\theta_1)} \frac{1 - T'(\theta_1)}{Y(\theta_1)} = \bar{\zeta}^c + \frac{\left(\sum_{t=1}^T R^{1-t} \right)^{-1} u'' \left(\left(\sum_{t=1}^T R^{1-t} \right)^{-1} C(\theta_1) \right)}{\phi_Y(\theta_1, Y(\theta_1))} (1 - T'(\theta_1)).$$

Denote the wealth effect by $\bar{\xi} = \bar{\zeta}^c - \bar{\zeta}^u$. Then

$$\begin{aligned}\bar{\xi} &= \left(\sum_{t=1}^{\tau} R^{1-t} \right)^{-1} \left(\sum_{h \in \mathcal{H}(\theta_1)} R^{1-|h|} \mu(h | \theta_1) \frac{(\theta(h))^2 (1 - T'(\theta_1)) u''}{v''(n(h))} \right) \\ &= \left(\sum_{t=1}^{\tau} R^{1-t} \right)^{-1} \sum_{h \in \mathcal{H}(\theta_1)} R^{1-|h|} \mu(h | \theta_1) \xi(h),\end{aligned}$$

where $\xi(h)$ is the wealth effect at the history h . The lifetime wealth effect is the average wealth effect across all histories. Now what remains to be done is to plug the derived elasticities in the [Saez \(2001\)](#) formula. \square

A.3 Section 4

Lemma A.2. *If workers cannot commit, the payoff from any mixed reporting strategy is not greater than the payoff from some pure reporting strategy.*

Proof of Lemma A.2. Suppose that there is some initial type θ and a mixed reporting strategy σ that randomizes between two pure reporting strategies r_1 and r_2 with probabilities such that

$$\sum_{r \in \mathcal{R}} \sigma(r) \mathbb{E} U_{\theta}(c \circ r, \tilde{n}) > \sigma(r_1) \mathbb{E} U_{\theta}(c \circ r_1, n_1) + \sigma(r_2) \mathbb{E} U_{\theta}(c \circ r_2, n_2),$$

where n_1, n_2 and \tilde{n} are the labor supply allocations corresponding to the three reporting strategies. Since the consumption allocation is fixed by the mechanism, we can subtract it from both sides. The only source of utility gain could only be a more efficient allocation of labor

$$\sum_{h \in \mathcal{H}(\theta)} \beta^{1-|h|} \mu(h) v(\tilde{n}(h)) > \sigma(r_1) \sum_{h \in \mathcal{H}(\theta)} \beta^{1-|h|} \mu(h) v(n_1(h)) + \sigma(r_2) \sum_{h \in \mathcal{H}(\theta)} \beta^{1-|h|} \mu(h) v(n_2(h)). \quad (13)$$

The inequality requires that the expected lifetime income under r_1 and r_2 is different, since otherwise otherwise n_1, n_2 and \tilde{n} would be identical.³³ Without the loss of generality suppose that $\sum R^{1-|h|} \mu(h) y(r_1(h)) < \sum R^{1-|h|} \mu(h) y(r_2(h))$. As the expected lifetime labor income implied by the labor policy on the left-hand and the right-hand side of (13) are equal, the only source of lower disutility from labor can be more efficient allocation of labor. As n_1 and n_2 are optimized conditional on each reporting strategy, it has to be the case that \tilde{n} smooths labor supply across the two pure reporting strategies. Such smoothing requires that the agent that has drawn r_1 works a bit more than in n_1 and the agent that has drawn r_2 works a bit less than n_2 . However, it means that the agent that has drawn r_1 would benefit from taking a pure labor contract (r_1, n_1) . Hence, the randomized strategy (\tilde{n}, σ) is not an equilibrium contract. Since it has to be the case that

$$\sum_{r \in \mathcal{R}} \sigma(r) \mathbb{E} U_{\theta}(c \circ r, \tilde{n}) \leq \sigma(r_1) \mathbb{E} U_{\theta}(c \circ r_1, n_1) + \sigma(r_2) \mathbb{E} U_{\theta}(c \circ r_2, n_2),$$

³³Conditional on reporting strategy, the optimal labor supply is depends only on the expected lifetime income.

the mixed reporting strategy cannot bring more utility than at least one of the two pure reporting strategies. \square

Proof of Lemma 2. With fixed-term contract and given a reporting strategy r , the limited commitment constraints mean that $\forall_{h \in \mathcal{H}} \mathbb{E} U_h(c \circ r, n) = 0$. I will show by induction that it implies that income and output coincide at each history. Zero profit conditions at the histories of length \bar{t} imply $\forall_{h \in \mathcal{H}_{\bar{t}}} y(r(h)) = \theta(h) n(h)$. Consider history of length t and suppose that for all histories of length greater than t labor income equals output. Then $\forall_{h \in \mathcal{H}_t} \mathbb{E} \pi_h(c \circ r, n) = \theta(h) n(h) - y(r(h))$, which is equal to zero by the zero profit condition. \square

Proof of Theorem 2. Take any allocation under full commitment on the labor market: (c^{FC}, y^{FC}, n^{FC}) , where $(\sigma^*, n^{FC}) \in \mathcal{E}^{FC}(c^{FC}, y^{FC})$. We will find a new allocation of labor income y such that $(\sigma^*, n^{FC}) \in \mathcal{E}(c^{FC}, y, f^P)$, where only permanent contracts are used: $\forall_{h \in \mathcal{H}} f^P(h) = \bar{f}$. For any non-initial history $s \in \mathcal{H} \setminus \mathcal{H}_1$ set $y(s) = \max_{s' \in \mathcal{H}_{|s|}(s^{-1})} \theta(s') n(s')$. The limited commitment constraint holds at s : $\mathbb{E} \pi_s(y, n) \leq 0$, as the firm pays the worker at least his output. Then modify the initial labor income such that the zero profit condition holds:

$$\forall_{h \in \mathcal{H}_1} y(h) = y^{FC}(h) - \sum_{s \in \mathcal{H}(h) \setminus \{h\}} R^{1-|s|} \mu(s | h) (y(s) - y^{FC}(s)).$$

As the expected lifetime income of each initial type is unchanged, the zero profit condition holds. Hence, (σ^*, n^{FC}) belongs to the constraint set of the maximization problem that defines $\mathcal{E}(c^{FC}, y, f^P)$. To see that in the constraint set there is no better contract for the worker, note that if there was, then (σ^*, n^{FC}) would not be an equilibrium contract under full commitment. \square

Lemma A.3. Suppose that (i) there are two time periods, (ii) there are two initial types: $\bar{\theta} > \underline{\theta}$, (iii) second period productivity is independent of the initial type. Consider allocation (c, y, n) implemented with mechanism (c, y, f) , where $f(\bar{\theta}) = 0$. The planner can implement the same allocation with a mechanism (c, y, f') , where $f'(\bar{\theta}) = \bar{f}$ and $f'(\underline{\theta}) = f(\underline{\theta})$.

Proof of Lemma A.3. Since there is no redistribution from the high to the low type, the labor supply of $\underline{\theta}$ will be undistorted, while the labor supply of $\bar{\theta}$ can be either undistorted or distorted upwards. Consider the mechanism with the contract assignment f' . When $\underline{\theta}$ mimics the other type, he could in principle use labor smoothing. Since $\underline{\theta}$ is comparatively less productive initially, the beneficial labor smoothing would require producing more in the second period. However, the limited commitment constraints do not allow to increase the second period output above income. Hence, the low type cannot gain from labor smoothing and the utility from deviation is the same regardless of type of contract of $\bar{\theta}$. The truthful revelation is still an equilibrium contract under f' . \square

Lemma A.4. Suppose that only fixed-term contracts are used. Under Assumption 3, if the incentive constraints with respect to one-shot deviations hold, the incentive constraints with respect to all reporting strategies are satisfied.

Proof of Lemma A.4. First I'll prove a useful property that holds under Assumption 3. Take any reporting strategy r' and some history h . Construct another reporting strategy r'' such that $r''(s) = s$ for $s \notin \mathcal{H}(r'(h))$ and $r''(s) = r'(h, s_{|h|+1}, \dots, s_{|s|})$ for $s \in \mathcal{H}(r'(h))$. For any $\theta \in \mathcal{H}_{|h|+1}(h)$

$$\mathbb{E}U_{(h,\theta)}(c \circ r', \bar{n}(r')) = \mathbb{E}U_{(r'(h),\theta)}(c \circ r'', \bar{n}(r'')). \quad (14)$$

The full support assumption guarantees that $(r'(h), \theta)$ is a history with a positive probability. Note that history of reports on both sides of equation are identical. Moreover, the last productivity draw is the same, so by the Markov property productivity distribution is the same. Finally, the function from new productivity draws to reports is identical as well. Hence, the payoffs are equal.

Take any allocation (c, y, n) . I'll show that if (i) the payoff from any reporting strategy r that is truthful before history $h \in \mathcal{H}_{t+1}$ is dominated by the payoff from the one-shot deviation $r_{h,r(h)}$ and (ii) the incentive constraints w.r.t. all one-shot deviations that are truthful before period $t+1$ hold, then the payoff from any reporting strategy r' that is truthful before any history $h' \in \mathcal{H}_t$ is dominated by the payoff from the one-shot deviation $r_{h',r'(h')}$. Before the proof of the induction step, note that the assumption (i) holds trivially when $t+1 = \bar{t}$, since the only reporting strategies that are truthful before the terminal period are one-shot deviations.

Take some reporting strategy r' that is truthful before history $h \in \mathcal{H}_t$ and define r'' as in the first paragraph of this proof. For any $\theta \in \Theta_{t+1}$

$$\begin{aligned} \mathbb{E}U_{(h,\theta)}(c \circ r', \bar{n}(r')) &= \mathbb{E}U_{(r'(h),\theta)}(c \circ r'', \bar{n}(r'')) \\ &\leq \mathbb{E}U_{(r'(h),\theta)}(c \circ r_{(r'(h),\theta),r''(r'(h),\theta)}, \bar{n}(r_{(r'(h),\theta),r''(r'(h),\theta))}) \\ &\leq \mathbb{E}U_{(r'(h),\theta)}(c, n) \\ &= \mathbb{E}U_{(h,\theta)}(c \circ r_{h,r'(h)}, \bar{n}(r_{h,r'(h)})). \end{aligned}$$

The first equality comes from the property (14). The second step is implied by the assumption (i) that the one-shot deviations dominate all other reporting strategies that are truthful before period $t+1$. The consecutive inequality is implied by incentive compatibility w.r.t. one-shot deviations. The final equation is again implied by (14). Summing up payoffs for all $\theta \in \Theta_{t+1}$, weighted by their conditional probability, and adding the instantaneous utility at the history h leads to

$$\mathbb{E}U_h(c \circ r', \bar{n}(r')) \leq \mathbb{E}U_{(h,\theta)}(c \circ r_{h,r'(h)}, \bar{n}(r_{h,r'(h)})). \quad (15)$$

This inequality means that the payoff from r' is bounded above by the payoff from the corresponding one-shot deviation. Hence, by induction, if incentive constraints with respect to all one-shot deviations are satisfied, the incentive constraints w.r.t. all possible reporting strategies are satisfied. \square

Proof of Theorem 3. Suppose that some initial top taxpayer θ has fixed-term contract. Assign this type permanent contract and fully smooth consumption, keeping the utility level constant. More insurance means that the planner saves some resources. If any other type is tempted to mimic θ , assign them the same outcomes as for θ . They are weakly better-off as well. Furthermore, the

planner has more resources, as the mimicking types are now contributing more, as they become top-taxpayers.

Consider any history h . Assigning permanent contract to top taxpayers after history h allows the planner to save some resources by the same argument as above. However, we need to confirm that it does not violate any incentive compatibility constraints before history h . By Lemma A.4, we can focus only on one-shot deviations from truthtelling. By the Markov property, $\mathbb{E}U_{(h',\theta)}(c \circ r_{h',h}, n)$ does not depend on $h' \in \Theta^{|h|}$. This means that assigning permanent contract at history (h, θ) does not affect incentive constraints at any earlier history. \square

Definition 8 (Welfare impact decomposition). Consumption allocation c_1 is defined as follows. c_1 is equal to c for all $h \in \mathcal{H} \setminus \mathcal{H}(\underline{\theta})$. For the histories following from the initial type $\underline{\theta}$, it is defined as

$$c_{1|\mathcal{H}(\underline{\theta})} \in \arg \max_{\tilde{c}: \mathcal{H}(\underline{\theta}) \rightarrow \mathbb{R}_+} \mathbb{E}U_{\underline{\theta}}(\tilde{c}, n)$$

subject to keeping the present value of consumption constant $\sum_{h \in \mathcal{H}(\underline{\theta})} R^{-|h|} \mu(h)(\tilde{c}(h) - c(h)) = 0$ and the incentive constraints corresponding to insurance

$$\begin{aligned} \forall \quad & r \in \mathcal{H}(\underline{\theta}) \rightarrow \mathcal{H}(\underline{\theta}) \quad \mathbb{E}U_{\underline{\theta}}(\tilde{c}, n) \geq \mathbb{E}U_{\underline{\theta}}(\tilde{c} \circ r, \bar{n}(r)). \\ \text{s.t. } & \exists r' \in \mathcal{R} \forall h \in \mathcal{H}(\underline{\theta}) r'(h) = r'(h) \end{aligned}$$

Consumption allocation c_2 (and the associated allocation of income y_2) is defined by

$$(c_2, y_2) \in \arg \max_{\substack{\tilde{c}: \mathcal{H} \rightarrow \mathbb{R}_+ \\ \tilde{y}: \mathcal{H} \rightarrow \mathbb{R}}} W(\tilde{c}, \tilde{n})$$

subject to the budget constraint $\sum_{h \in \mathcal{H}} R^{-|h|} \mu(h)(\tilde{c}(h) - c(h)) = 0$ and the incentive compatibility constraints

$$\forall r \in \mathcal{R} \forall n_r: \mathcal{H} \rightarrow \mathbb{R}_+ \mathbb{E}U_{\underline{\theta}}(\tilde{c}, n) \geq \mathbb{E}U_{\underline{\theta}}(\tilde{c} \circ r, n_r),$$

where both n and n_r satisfy zero profit (3) and limited commitment (4) constraints given the labor income allocation \tilde{y} . Finally, consumption allocation c' (and the associated allocation of income y') is defined by

$$(c', y') \in \arg \max_{\substack{\tilde{c}: \mathcal{H} \rightarrow \mathbb{R}_+ \\ \tilde{y}: \mathcal{H} \rightarrow \mathbb{R}}} W(\tilde{c}, \tilde{n})$$

subject to the budget constraint $\sum_{h \in \mathcal{H}} R^{-|h|} \mu(h)(\tilde{y}(h) - \tilde{c}(h)) = 0$ and the equilibrium constraint

$$(\tilde{n}, r^*) \in \mathcal{E}(c', y', f').$$

The labor supply allocation n' is the labor allocation corresponding to the truthful reporting strategy in $\mathcal{E}(c', y', f')$.

Proof of Lemma 3. $\Delta^{\text{insurance}}$ is non-positive, since both c_1 and c have the same net present value, but c_1 has to satisfy additional incentive-compatibility constraints implied by fixed-term contract. Specifically, full consumption insurance of $\underline{\theta}$ is ruled out. $\Delta^{\text{redistribution}}$ is non-negative, because the

incentive constraints between initial types are always (weakly) relaxed by introducing fixed-term contracts. $\Delta^{efficiency}$ is non-negative, since the planner can choose outcomes (c_2, y_2, f') . Under these outcomes, the welfare is weakly higher than $W(c_2, n_2)$, as the firms can optimize over labor. Note that when we found the allocation c_2 , the firms were allowed to optimize over labor only when deviating.

Suppose that $\underline{\theta} \in \arg \max_{\theta \in \Theta_1} \lambda(\theta) u'(c_1(\theta))$. It means that the planner wants to redistribute to $\underline{\theta}$. By assigning fixed-term contract to this type, the incentive constraint that prevent redistribution from other initial types to $\underline{\theta}$ are (weakly) relaxed for two reasons: the consumption of $\underline{\theta}$ is more volatile and the fixed-term contract prevents labor smoothing after deviation. Since incentive constraints are relaxed, the planner can redistribute to $\underline{\theta}$, raising the social welfare ($\Delta^{efficiency} \geq 0$). In the second case, when $\underline{\theta} \in \arg \min_{\theta \in \Theta_1} \lambda(\theta) u'(c_1(\theta))$, the planner wants to redistribute from $\underline{\theta}$. However, assigning fixed-term contract weakly decreases utility of this type because of more volatile consumption. Hence, $\underline{\theta}$ is even more tempted to mimic other types and the redistribution has to be reduced, leading to lower welfare ($\Delta^{efficiency} \leq 0$). \square

Proof of Proposition 2. Suppose that the planner maximizes the utility of $\underline{\theta}$. Denote by $C(\theta)$ and $Y(\theta)$ the present value of consumption and labor income of θ under truthful revelation. Denote by n_0 the labor supply allocation when type $\underline{\theta}$ has permanent contract. When $\underline{\theta}$ has a permanent contract, the incentive constraint that prevents the redistribution from type θ to $\underline{\theta}$ is

$$C(\theta) - \sum_{s \in \mathcal{H}(\theta)} \beta^{|s|-1} \mu(s | \theta) v(n(s)) \geq C(\underline{\theta}) - \sum_{s \in \mathcal{H}(\underline{\theta})} \beta^{|s|-1} \mu(s | \underline{\theta}) v(\tilde{n}(s)), \quad (16)$$

where \tilde{n} produces $Y(\underline{\theta})$ and satisfies the labor smoothing condition (8) whenever it is consistent with limited commitment. When $\underline{\theta}$ has a fixed-term contract, keeping the net present value of consumption and the allocation of labor unchanged, the analogous incentive constraint is

$$C(\theta) - \sum_{s \in \mathcal{H}(\theta)} \beta^{|s|-1} \mu(s | \theta) v(n(s)) \geq C(\underline{\theta}) - \sum_{s \in \mathcal{H}(\underline{\theta})} \beta^{|s|-1} \mu(s | \underline{\theta}) v(\hat{n}(s)), \quad (17)$$

where $\hat{n}(s) = \frac{r_{\theta, \underline{\theta}}(s)}{\theta(s)} n_0(s)$. First, by Lemma A.4 we can focus only on one-shot deviation. Second, since future productivities are independent of initial draw, the net present value of consumption of deviating type θ is equal to $C(\underline{\theta})$ and $Y(\underline{\theta})$.

I will show that the right-hand side of (16) is strictly greater than of (17). Note that \tilde{n} and \hat{n} produce the same output $Y(\underline{\theta})$. Moreover, the labor supply allocation n satisfies

$$\forall_{s \in \mathcal{H}(\underline{\theta})} \frac{v'(n(\underline{\theta}))}{\underline{\theta}} = \frac{v'(n(s))}{\theta(s)}.$$

Since $\theta > \underline{\theta}$, this implies that

$$\forall_{s \in \mathcal{H}(\underline{\theta})} \frac{v'(\hat{n}(\theta))}{\theta} < \frac{v'(\hat{n}(s))}{\theta(s)}.$$

The initial type θ could reduce the disutility from labor by producing more in the initial period, which does not violate the limited commitment constraints. It means that $\hat{n}(\theta) < \tilde{n}(\theta)$ and hence

the right-hand side of (16) is strictly greater than of (17). Hence, the incentive constraint is relaxed when $\underline{\theta}$ receives fixed-term contract. Since it is true for all types $\theta \in \Theta \setminus \underline{\theta}$, we have $\Delta^{redistribution} > 0$. \square

Proof of Proposition 3. Note that assigning fixed-term contract to $\underline{\theta}$, while keeping outcome functions c and y constant, does not change the utility from truthfully or untruthfully reporting $\underline{\theta}$ ($\Delta^{insurance} = \Delta^{redistribution} = 0$). Below I show that when $\underline{\theta}$ has fixed-term contract, the planner can perturb the outcome functions of this type to save resources without changing his utility level nor violating any incentive constraint.

Take history $h \in \mathcal{H}(\underline{\theta})$ at which the labor supply is distorted downwards: $\theta(h)u'(c(h)) > v'(y(h)/\theta(h))$. Perturb consumption and income such that $\theta(h)u'(c'(h)) = v'(y'(h)/\theta(h))$ and the instantaneous utility at this history is unchanged. Since distortions are lifted, the planner obtains additional resources. Furthermore, if any other type $h' \in \mathcal{H}(h^{-1})$ decides to mimic h , he will end up paying higher taxes. The incentive constraints corresponding to deviations at earlier dates are unaffected by Assumption 3 (see similar reasoning in the proof of Theorem 3). Hence, when $\underline{\theta}$ has fixed-term contract, the planner can lift some future distortions and obtain additional resources without violating incentive compatibility. These resources can be spend on uniform raise of expected utility of all types, leading to $\Delta^{efficiency} > 0$. \square

Proof of Lemma 4. It follows from Lemma 1. \square

Proof of Theorem 4. First I will show that there exists a history dependent asset policy a such that, given the tax T , the allocation together with a belongs to $\tilde{\mathbb{E}}$. Define $a(h) = \sum_{t=1}^{|h|} R^{1-|h|} (y(h^t) - \bar{y}(h_1))$. Then at each history consumption expenditure is equal $\bar{y}(h_1)$. Hence at each history $T_x(x(h)) = \bar{T}(\theta)$ and the right-hand side of the budget constraint equals $c(h)$.

Suppose that \bar{T}_x is convex. Take some initial type θ . He may deviate either to a constant, but different level of consumption expenditures, or he may introduce some volatility to consumption expenditures. The first deviation is taken care of by the equilibrium constraint from the corresponding direct mechanism as well as a punitively high tax whenever worker deviates to a level that do not correspond to consumption expenditures of any other tax. The introduction of volatility in consumption expenditures with the expected value \bar{x} means, due to convexity of the tax system, that the expected tax paid is not lower than $T_x(\bar{x})$. Since the labor supply allocation is the same both cases (labor allocation depends on expected lifetime income, which is equal to the expected lifetime expenditure), the utility from introducing volatility is bounded above by a utility of deviation to the constant consumption expenditure \bar{x} (which was taken care of above). Note that deviations to fixed-term contract imply volatile consumption expenditures and are not tempting by the same argument.

When \bar{T}_x is not convex, we can add an auxiliary correction term $\alpha(x_t - x_0)^2$ which punishes volatile consumption expenditures. The parameter α should be high enough such $\bar{T}_x(x_t) + \alpha(x_t - x_0)^2$ is convex. \square

Proof of Proposition 4. I will show that the inverse Euler equation holds. The proof follows the intuition from [Goloso, Kocherlakota, and Tsyvinski \(2003\)](#). Take any allocation (c, y, n) implemented by some direct mechanism (c, y, f) . Take some history $h \in \mathcal{H} \setminus \mathcal{H}_{\bar{t}}$ and consider a small perturbation δ such that

$$c'(h) = c(h) + \frac{\delta}{u'(c(h))}, \quad \forall_{s \in \mathcal{H}_{|h|+1}(h)} c'(s) = c(s) - \frac{\delta}{\beta u'(c(s))},$$

and c' equal c elsewhere. As the utility from any reporting strategy is unchanged, truthful revelation still holds in equilibrium. In the optimum such perturbation cannot yield free resources

$$-\frac{\delta \mu(h)}{u'(c(h))} + \sum_{s \in \mathcal{H}(h)_{|h|+1}} \frac{\mu(s|h) \delta}{\beta u'(c(s))} = 0,$$

which implies that the inverse Euler equation holds. To see how the inverse Euler equation together with volatile consumption implies a savings distortion and capital tax, see for instance [Goloso, Kocherlakota, and Tsyvinski \(2003\)](#). \square

B Auxiliary estimates

Table 6: The regression of $\log\left(\frac{y_{ijt}}{y_{ijt-1}}\right)$ for permanent contracts.

variable	coef	std err	t	p-value
const	0.0285***	0.001	27.766	0.000
male	0.0072***	0.001	11.940	0.000
tenure	-0.0015***	4.97e-05	-30.120	0.000
d1999	-0.0094***	0.001	-11.243	0.000
d2000	-0.0073***	0.001	-8.857	0.000
d2001	-0.0056***	0.001	-6.812	0.000
d2002	-0.0095***	0.001	-11.697	0.000
white_colar	0.0169***	0.001	28.766	0.000
cadre	0.0106***	0.001	7.288	0.000
manager	-0.0391***	0.002	-18.043	0.000
North-East	0.0008	0.001	1.274	0.202
Center	-0.0036***	0.001	-4.959	0.000
South	-0.0056***	0.001	-6.717	0.000
Islands	-0.0055***	0.001	-4.616	0.000
young_firm	0.0011*	0.001	1.660	0.097
agriculture	-0.0096**	0.005	-2.093	0.036
heavy_industry	-0.0072***	0.002	-3.892	0.000
manufacturing	-0.0038***	0.001	-6.149	0.000
construction	-0.0174***	0.001	-16.560	0.000
services1	0.0002	0.001	0.224	0.823

Table 7: The regression of $\log\left(\frac{y_{ijt}}{y_{ijt-1}}\right)$ for fixed-term contracts.

variable	coef	std err	t	p-value
const	0.0388***	0.010	3.753	0.000
male	0.0031	0.006	0.541	0.588
tenure	-0.0037***	0.001	-3.464	0.001
d1999	-0.0042	0.010	-0.421	0.674
d2000	0.0053	0.009	0.558	0.577
d2001	-6.927e-05	0.009	-0.007	0.994
d2002	-5.987e-05	0.009	-0.007	0.994
white_colar	0.0323***	0.006	5.358	0.000
cadre	0.0103	0.034	0.302	0.763
manager	-0.0192	0.037	-0.517	0.605
North-East	-0.0111*	0.007	-1.643	0.100
Center	-0.0165**	0.007	-2.293	0.022
South	-0.0031	0.009	-0.341	0.733
Islands	-0.0213*	0.011	-1.902	0.057
young_firm	-0.0047	0.007	-0.698	0.485
agriculture	-0.0392	0.041	-0.955	0.339
heavy_industry	-0.0006	0.051	-0.012	0.991
manufacturing	-0.0196***	0.006	-3.096	0.002
construction	-0.0313**	0.013	-2.370	0.018
services1	0.0085	0.011	0.765	0.445

Table 8: The regression of $\hat{\varepsilon}_t^2$ - full results.

variable	coef	std err	t	p-value
const	0.0347***	0.003	10.557	0.000
C_fixed_term	0.0090***	0.001	13.058	0.000
log_income	-0.0019***	0.000	-5.591	0.000
male	-0.0041***	0.000	-17.433	0.000
tenure	-0.0002***	1.91e-05	-12.155	0.000
d1999	0.0005*	0.000	1.747	0.081
d2000	0.0005*	0.000	1.644	0.100
d2001	-0.0003	0.000	-0.996	0.319
d2002	-0.0007**	0.000	-2.257	0.024
white_colar	0.0013***	0.000	5.330	0.000
cadre	0.0025***	0.001	4.130	0.000
manager	-0.0047***	0.001	-5.317	0.000
North-East	-0.0013***	0.000	-5.223	0.000
Center	0.0002	0.000	0.916	0.360
South	0.0018***	0.000	6.069	0.000
Islands	-0.0003	0.000	-0.794	0.427
young_firm	0.0017***	0.000	7.015	0.000
agriculture	-0.0066***	0.002	-3.982	0.000
heavy_industry	-0.0017	0.001	-2.505	0.012
manufacturing	-0.0002	0.000	-0.837	0.402
construction	0.0023***	0.000	6.066	0.000
services1	0.0011***	0.000	3.460	0.001

Table 9: The regression of $\hat{\varepsilon}_{t-1}\hat{\varepsilon}_t$ - full results.

variable	coef	std err	t	p-value
const	0.0031	0.002	1.383	0.167
C_fixed_term	-0.0012	0.001	-1.568	0.117
log_income	-0.0006***	0.000	-2.742	0.006
male	0.0018***	0.000	11.332	0.000
tenure	-2.907e-05**	1.3e-05	-2.243	0.025
white_colar	0.0008***	0.000	5.051	0.000
cadre	0.0007*	0.000	1.746	0.081
manager	0.0031***	0.001	5.273	0.000
North-East	0.0003**	0.000	1.999	0.046
Center	-0.0004**	0.000	-1.987	0.047
South	-0.0010***	0.000	-5.057	0.000
Islands	-0.0003	0.000	-0.895	0.371
young_firm	-0.0002	0.000	-1.172	0.241