

DESIGNING LABOR MARKET INSTITUTIONS IN EMERGING AND DEVELOPING ECONOMIES: SOME THOUGHTS

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Workshop of Global Labor Markets
Paris, September 1-2, 2016



* These are preliminary thoughts. They are mine and do not necessarily reflect those of the IMF or its member countries

INTRODUCTION: MARKET FAILURES, POLICY FAILURES

- Focus on UI and EPL in EMDEs in particular
- Over-arching objectives : economic efficiency and equity
- Rationale for efficiency-based intervention = market imperfections:
 - Information asymmetries → credit and insurance market failures → case for UBs to smooth consumption (Chetty, 2008)
 - Compound with matching frictions → quality of matching (Marimon-Zilibotti, 1999; Tatsiramos, 2009) and risk taking (Acemoglu-Shimer 2009)
 - Externalities (under UBs → case for lay-off tax, Blanchard-Tirole 2008)
 - Transaction costs (in principle, state has legal and administrative capacity to run more cost-effective UI system).
 - Uneven bargaining power/monopsonistic power of firms
- But policy failures:
 - Information asymmetries and UI (monitoring always imperfect)
 - Form and stance of EPL (can be sub-optimal)

INTRODUCTION: ARE DEVELOPING ECONOMIES SPECIAL?

- Market failures greater:
 - Credit and insurance market failures (Chetty and Looney, 2006)
- But risk of policy failures also usually greater:
 - Two main reasons: informality and weak administrative capacity
 - UI as an example: both issues make moral hazard risk greater
- Set of policy choices often more restricted as a result:
 - UI as an example again: how to extend coverage without creating important distortions? (formal work disincentives)
 - Can lead to sub-optimal choices: more on this in a minute
- Key issue: how to achieve insurance and equity objectives of these institutions in cost-efficient way, considering both general and EMDE-specific challenges

UNEMPLOYMENT INSURANCE: BASIC CHALLENGES

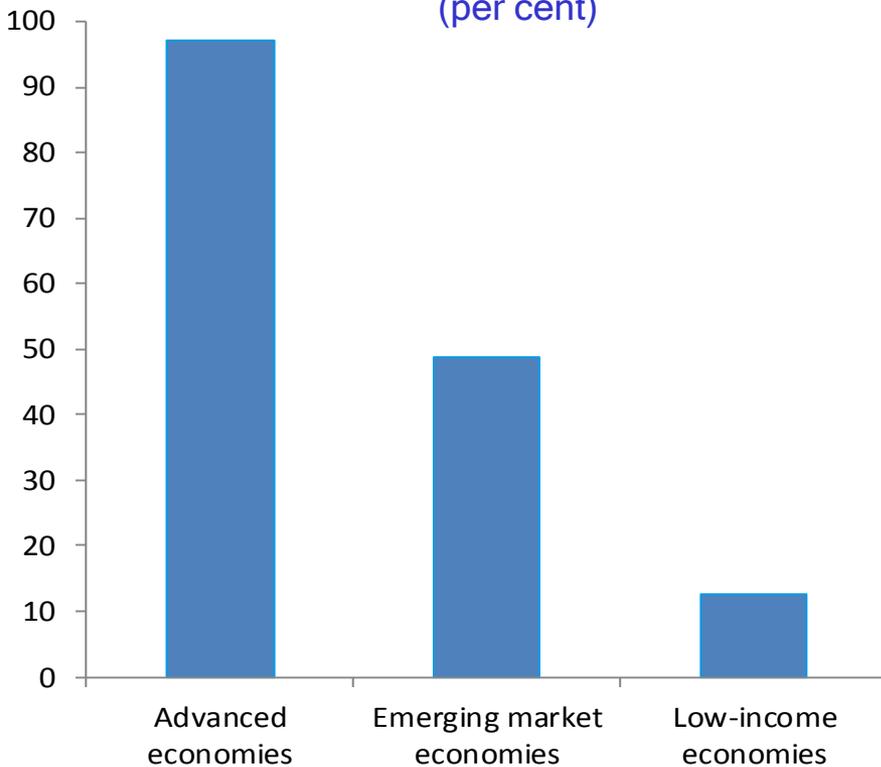
- Need balance between insurance provision and maintaining job search incentives and avoiding excessive wage levels (e.g. Blanchard-Tirole 2008):
 - Means full insurance cannot be optimal...
 - Even more so in EMDEs where moral hazard risk is stronger:
 - Poor enforcement of eligibility and job search criteria
 - Unemployed may take up informal work rather than search while receiving benefits (Hopenhayn-Nicolini, 1999; Alvarez Parra-Sanchez, 2009)
 - ...although latter effect should be weighed against positive “liquidity effect” of UBs on job search, which may dominate provided duration is short (Bardey-Jaramillo-Pena 2015)
- Partly explains low UI coverage, benefit levels and duration in EMDEs (cash transfers no substitute: anti-poverty more than income-insurance tool)
- How can UI be scaled up, in particular to cover informal workers?



UNEMPLOYMENT INSURANCE: STILL IN INFANCY

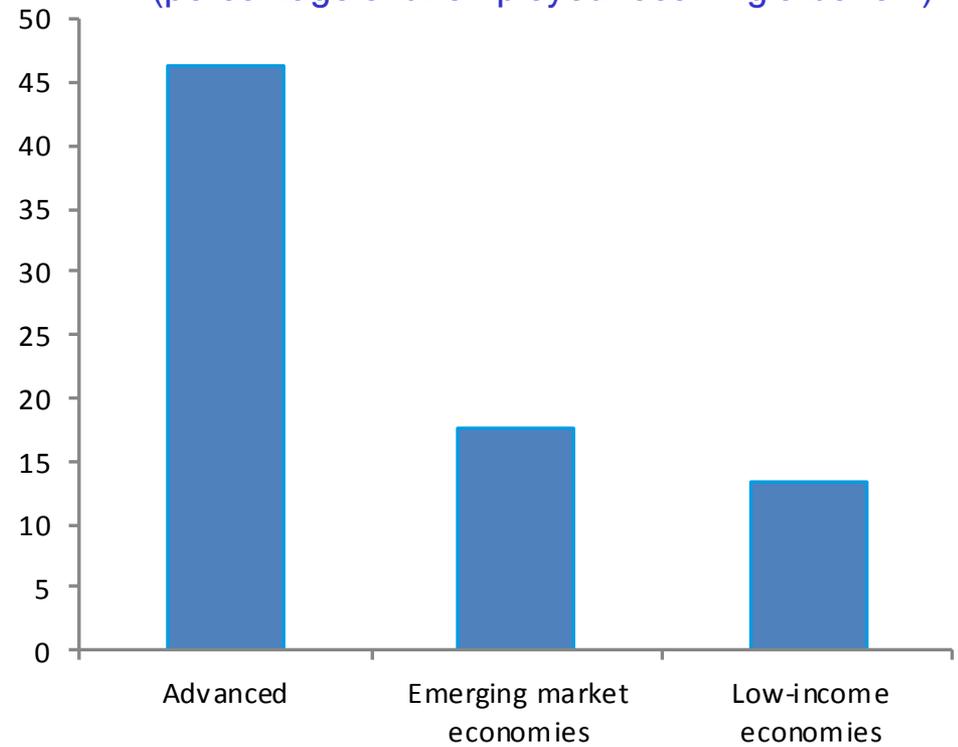
Proportion of countries with UI system for different country income groups

(per cent)



Unemployment benefit coverage for different country income groups

(percentage of unemployed receiving a benefit)



Source: International Labour Organization, 2014. "World Social Protection Report 2014/15: Building economic recovery, inclusive development and social justice". International Labour Office - Geneva: ILO, 2014.



UNEMPLOYMENT INSURANCE: OPTIONS

- Extend coverage of contributory system to non-contributing workers:
 - Has been done e.g. for health and pensions (Mexico: Levy, 2008)
 - But sharp trade-off with efficiency: the smaller the difference in benefits, the greater the marginal tax on taking up a formal job
- UISAs:
 - Address incentive issues in principle, and have been tested (e.g. Chile)
 - But provide insufficient insurance for some workers (youth, high U risk)
 - In practice countries with UISAs *also* have state-provided UI featuring risk pooling (e.g. Chile)
- Way forward = two-tier system?
 - Fully funded, mandatory, non-redistributive first tier (UISA)
 - Transparent and progressive subsidies to encourage opting-in

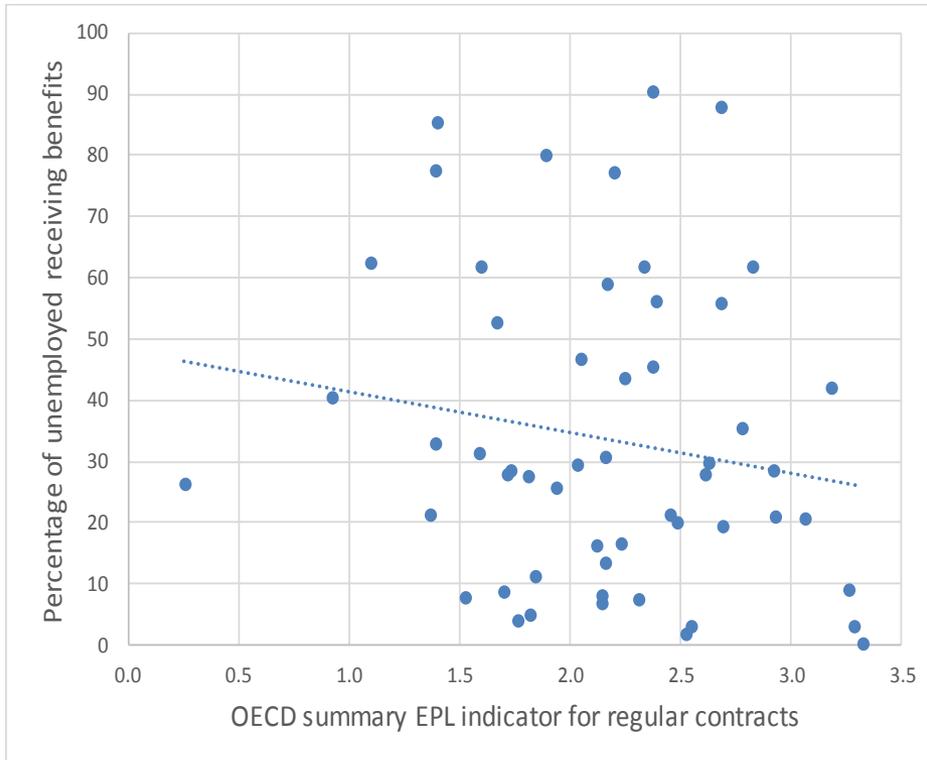
UNEMPLOYMENT INSURANCE: INTERACTIONS

- UI-ALMPs:
 - Complementary: stronger ALMPs needed for more extensive UI (DNK)
 - Even more so in EMDEs: serve as job-search test and matching device
- UI-informality/administrative capacity:
 - Also complementary: addressing these issues facilitates UI extension
- UI-tax policies:
 - Labor tax wedges in EMDEs (surprisingly high) can reduce formal and overall employment (Betcherman-Daysal-Pages 2010; Kugler-Kugler 2009)
 - Consider other sources of financing that distort less decision to create and take up formal vs. informal jobs (e.g. VAT)
- UI-EPL:
 - Substitute in theory (insurance against risk of job loss)—but UI superior
 - Substitute in practice? Maybe to some extent but not striking
 - Could reflect that the greater the limits to UI, the more there is a case for *some form* of EPL as a complement

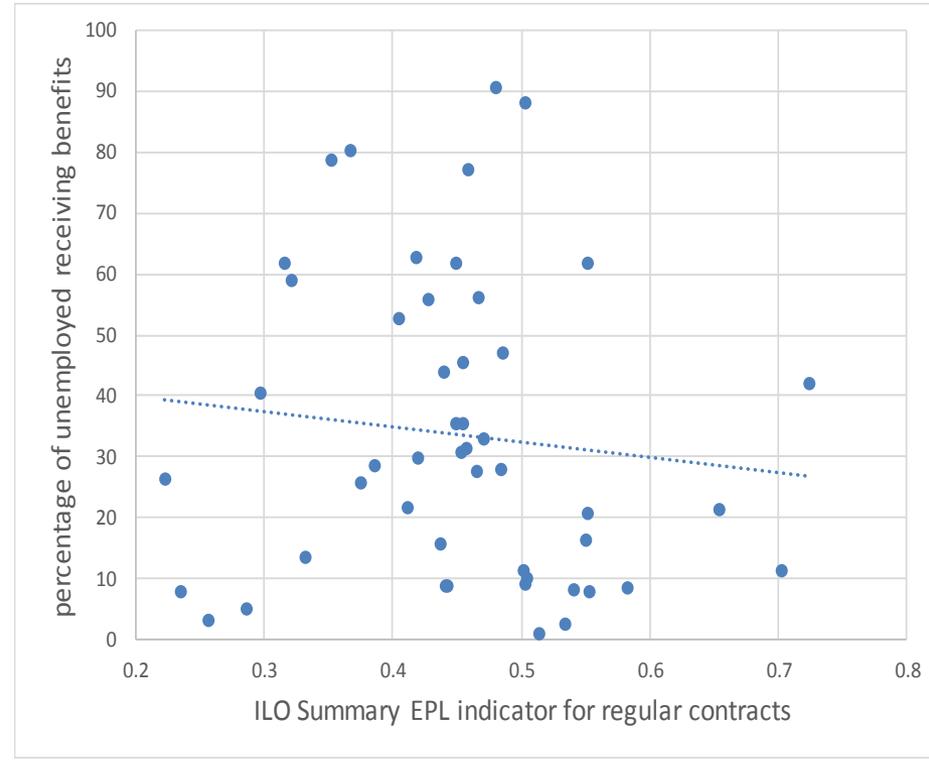


UI AND EPL: SUBSTITUTES?

UI coverage versus OECD EPL indicator



UI coverage versus ILO EPL indicator



Sources: International Labour Organization, 2014. “World Social Protection Report 2014/15: Building economic recovery, inclusive development and social justice”. International Labour Office - Geneva: ILO, 2014. EPLex summary indicators in the area of terminating regular contracts. Available at http://www.ilo.org/travail/areasofwork/WCMS_435450/lang-en/index.htm

OECD, 2015. OECD Indicators of Employment Protection Legislation, summary index for protection against individual and collective dismissals. Available at <http://www.oecd.org/els/emp/oecdindicatorsofemploymentprotection.htm>.

EPL: BASIC CHALLENGES

- Two main motives:
 - Non-economic: protection from abuse and discrimination
 - Economic: insurance against income loss risk (Pissarides 2001)
- Two components:
 - Transfer (e.g. severance pay): *not necessarily* distortive (Lazear 1990; Pissarides 2001) but only under strict conditions (Garibaldi-Violante 2005)
 - Tax (e.g. administrative procedures incl. uncertainties): distortive
- Nature of distortions of tax component:
 - Lower productivity (Autor-Kerr-Kugler 2007; Bassanini-Venn-Nunziata 2009; Eslava-Haltiwanger-Kugler-Kugler 2004), possibly more so in EMDEs where rule of law is weaker (Caballero-Cowan-Engel-Micco 2004)
 - Higher U duration (Bentolila and Bertola 1990; Pissarides 2000)
 - Dualism, incl. informality in EMDEs (BRA: Bosch-Esteban Pretel 2012, Bosch-Goni Pacchioni-Maloney 2012; IND: Besley-Burgess 2004)
 - Possibly employment in EMDEs (Botero et al. 2004; Fallon-Lucas 1991; Ahsan-Pages 2009; Heckman-Pages 2004)

EPL: DOMINATED BY WELL-FUNCTIONING UI

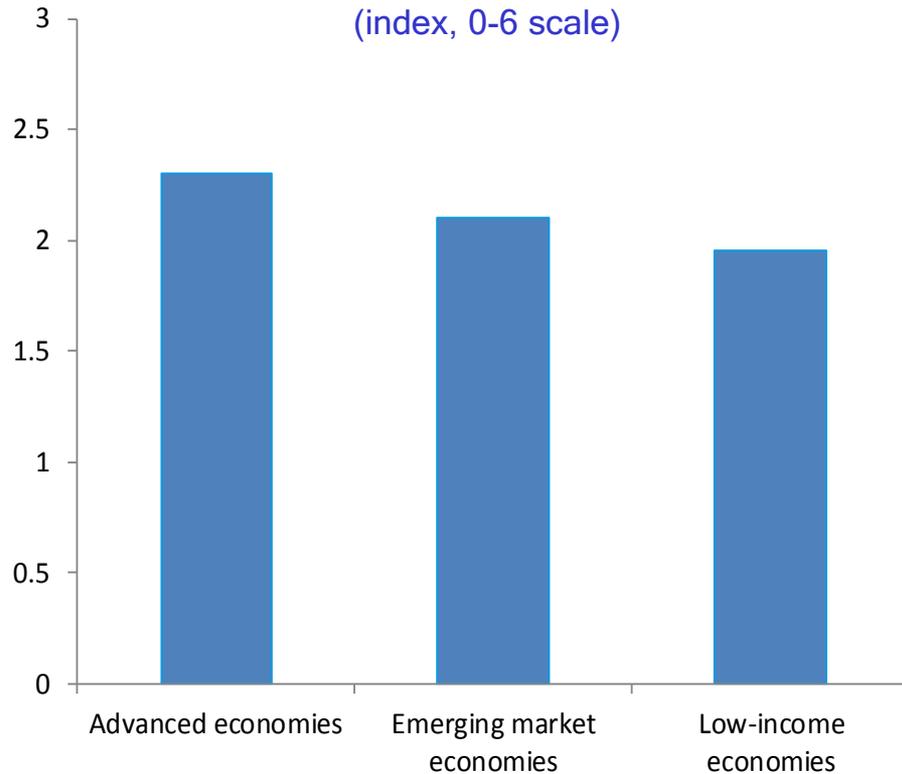
- Theory points to weak case for EPL under optimal UI:
 - No insurance against unemployment *duration* risk
 - No risk sharing across workers in different firms → risk of non-payment as the likelihood of dismissal correlated with that of bankruptcy
 - Only case for lay-off tax to correct UI externality (Blanchard-Tirole 2008)
- Changing world of labor further strengthens case for UI vis-à-vis EPL: need to protect workers rather than jobs through portable rights
- Practical issues further weaken case for tight EPL in EMDEs:
 - Weaker enforcement (weaknesses of administrative & judicial systems)
 - Litigation costs can be significant
 - Many workers do not qualify due to short tenure and informality
- But the stronger the limits to UI, the more there is some case for EPL:
 - Partly explains why EPL is rather tight in many EMDEs
 - A lot of scope for reform however



EPL STANCE: COMPARABLE TO ADVANCED ECONOMIES

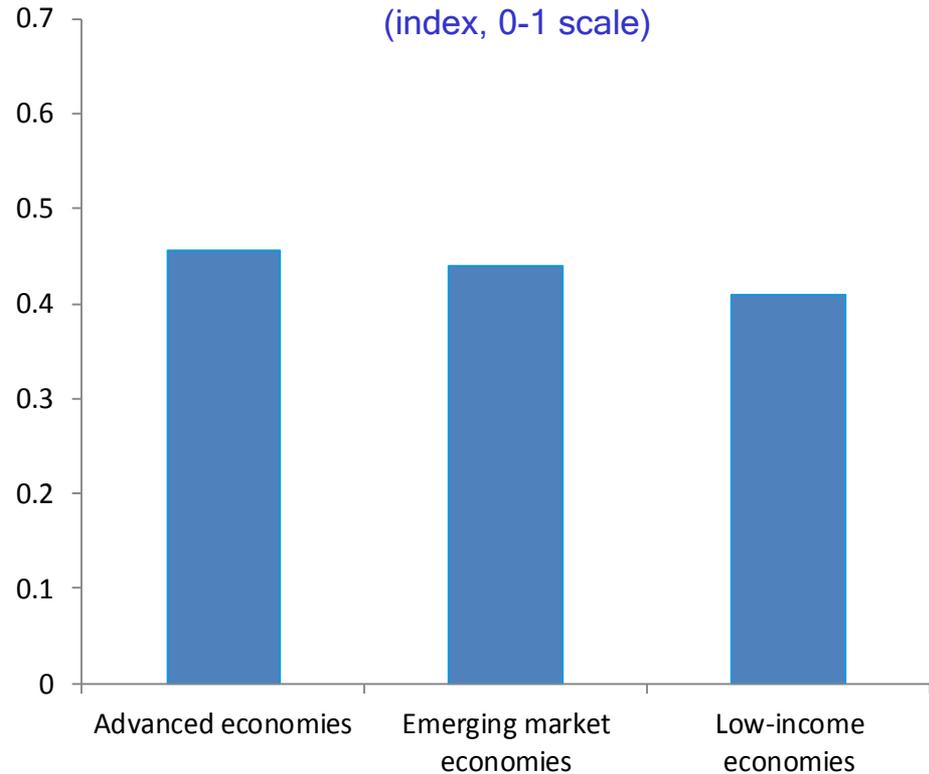
OECD summary index of protection of regular workers against dismissal

(index, 0-6 scale)



ILO summary index of protection of regular workers against dismissal

(index, 0-1 scale)



Sources: OECD, 2015. OECD Indicators of Employment Protection Legislation, summary index for protection against individual and collective dismissals. Available at <http://www.oecd.org/els/emp/oecdindicatorsofemploymentprotection.htm>. International Labour Organization. EPLex summary indicators in the area of terminating regular contracts. Available at http://www.ilo.org/travail/areasofwork/WCMS_435450/lang--en/index.htm



EPL AND DUALISM

- Poorly-designed EPL can encourage labor market dualism of 2 types:
 - Between regular and non-regular contracts (dominant in AEs)
 - Between formal and informal workers (dominant in EMDEs)
- Dualism can be detrimental to both efficiency and equity:
 - Inefficiently high labor turnover (temporary contracts) and informality
 - Slower (on-the-job) human capital accumulation
 - Static/dynamic wage inequality between otherwise comparable workers
- Suggests EPL should be neither too strict nor too asymmetric + EMDEs can learn from AEs' experience with partial reforms

CONCLUDING THOUGHTS

- Too much reliance on EPL and too little on UI to provide income loss insurance in EMDEs...
- ...partly for understandable reasons—hard to build well-functioning UI system under pervasive informality and weak administrative capacity...
- ...but also partly for bad reasons
 - EPL not only tight but often poorly designed and enforced
 - Scope for smart UI design combining individual saving and risk pooling
- Gradually rebalancing away from EPL toward UI along development path:
 - Can start now—lot of scope for reform even under current constraints
 - Amplify as informality declines and administrative capacity improves
 - And consider carefully complementary policies: ALMPs, financing (general taxation vs. labor taxation)

Thank you!