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

Romain Duval
(Advisor, Research Department, IMF)

IMF-OCP policy Center-Brunel University
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* 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-Tirrole 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)

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


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)
  - 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)

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!