Two internally consistent but opposing intuitions

Freeman’s “institutionalists” and “distortionists”

<table>
<thead>
<tr>
<th></th>
<th>Institutionalists</th>
<th>Distortionists</th>
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</thead>
<tbody>
<tr>
<td>Starting point</td>
<td>Institutions address power imbalances in LM and can help efficiency by reducing transaction costs and enhancing productivity</td>
<td>Institutions impede efficiency and create unintended consequences for targeted beneficiaries</td>
</tr>
<tr>
<td>Evidence</td>
<td>Often qualitative Multidisciplinary methods</td>
<td>Quantitative Econometric methods</td>
</tr>
<tr>
<td>Limitations</td>
<td>Downplays empirical evidence that challenges assumptions</td>
<td>Ahistorical and inadequate attention to social and political context</td>
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</table>
When theory uncertain, look at the evidence

- Review of quantitative evidence on impacts of labor market institutions
  - Minimum wages
  - Employment protection legislation
  - Unions and collective bargaining
  - Mandated benefits (parental leave)

- Based on findings of over 150 studies

- Particular features of review
  - Particular effort paid to studies of developing countries
  - Consider impacts beyond standard labor market outcomes
Methodology (1)

Some issues with the quantitative literature

• Identification
  • Isolating impact of institutions complicated (endogeneity, bundling, macro conditions)

• Measurement
  • Hard to characterize many institutions in a valid measure
  • Problems of capturing institutions as they operate “on the ground” rather than “on paper”

• Limitations of modelling and results interpretation
  • “Average” impacts can hide differential effects (e.g., identifying winners and losers)
  • Focus on short-term effects when important impacts may be long-term
  • Inadequate attention to magnitude of impacts (statistically significant but is it really significant?)
Methodology (2)
Linking to indicators of the WDR framework
Minimum wages (1)

• Focus on employment effects
• Lively debate about impacts
• Effects concentrated (though not exclusively) on lower part of the wage distribution so much of the analysis has focused on youth, women, less-skilled
• Measuring impacts in developing countries especially complicated by limited compliance
Minimum wages (2)

- Employment
  - Through 1980s, consensus view – 10% increase in MW reduced teenage employment by 1-3%
- Card-Krueger-Katz studies
  - Found positive (and sometimes substantial) effects on youth employment
  - Likely explanation -- non-competitive labor market models
- Overall, much less consensus among economists now than a generation ago
Minimum wages (3)

• Employment (con’t)
  • In developing countries, majority of studies find negative effects on employment – especially when isolated on youth and less skilled -- but not all and magnitude not usually large

• Why are effects so modest?
  1. Non-compliance, especially in developing countries
  2. Measurement problems
     • E.g., Effects might accumulate over time, and may be beyond scope of most studies
  3. Policy-makers understand risks and keep MW levels reasonable (generally assumed to be in neighborhood of 30-50% of median wages)
Minimum wages (4)

• Earnings
  • Almost all studies find that wages rise with increases in the minimum wage
    • Strongest effect around minimum, diminishing with movement up the wage distribution
    • Surprising finding of apparent minimum wage effect in informal sectors (“lighthouse effect”)
  • Consistent finding that MW compresses wage differentials, thus reducing wage inequality
  • Mixed evidence (from Latin America) about poverty effect (e.g., Lustig and McLeod vs. Neumark *et al.*)
Minimum wages (5)

- Very little work on impacts on productivity, none in developing countries

- Social cohesion
  - Defined to include inclusion, participation, active social relationships, and social order
  - Little, if any, direct research so links are inferred or even speculative
  - MW can contribute to “fairness” aspect by protecting workers vs. exploitative, unfair wages and by compressing wage differentials
  - But depends on coverage and enforcement
Employment protection legislation (1)

• Refers to rules governing hiring and firing
• Much debate about employment and productivity impacts
• Theory indeterminate on employment and productivity effects
• But measuring job security rules is complicated
  • Enforcement issue
  • EPL doesn’t easily reduce to a single measure
Employment protection (2)

• Employment

  • Impact on employment *levels* -- studies divided between those finding modest negative effect and no effect

  • Overall, results are fragile, depending a lot on model specification and treatment of data

  • Evidence more conclusive on employment *dynamics*

• EPL associated with longer durations in different labor market states and lower flows between them
Employment protection (3)

• Employment (con’t)
  • Some studies have found that strong EPL shifts employment to informal sector, but not a lot of evidence
  • Employment effects most positive for groups likely to be covered (e.g., prime-age males, higher skilled)
  • Lower hiring rates can have a negative effect on employment for youth, women, and the less-skilled
Employment protection (4)

• Productivity
  • Strict EPL should constrain allocative efficiency but because of commitment signals and expected tenure effects, it could increase worker effort and incentives to invest in human capital
  • Empirical evidence on overall effect on productivity levels limited, largely restricted to OECD countries, and mixed in terms of findings
Employment protection (5)

• Social cohesion
  • Here, too, any links need to be inferential
  • To the extent that job protections signal that firms are being socially responsible in difficult economic times, EPL can support social cohesion.
  • By lengthening job tenure, these rules can also make a positive contribution by promoting well-being and security.
  • However, when the effect of these rules is to deepen the “insider-outsider” divide, the opposite can occur (OECD, Social Cohesion study 2011).
So where does this leave us?

- Even with expansion of empirical work and introduction of new data and methods, many impacts of labor market regulations still not clear

- Headline message: Clear distributional effects but unclear efficiency effects

- Very little direct research on social cohesion effects, but these are likely to be important
**The WDR’s “plateau and cliffs”**

- Review suggests that, in many countries, labor regulations and institutions within a zone where positive and negative efficiency effects operate side by side – this is the “plateau” and dominant impact is distributional.
- But being off the plateau and on a “cliff” can be costly, with the nature of the costs being determined by which cliff country is on.
- The familiar cliff where regulations and institutions can interfere too much with functioning of LM creating negative employment and productivity effects.
- But problems also are created when regulation is too minimal and institutions for voice are weak.
Regulations and institutions don’t address imperfections or provide adequate voice.

Regulations and institutions exacerbate imperfections or create new ones.
Some practical questions

- What kinds of analysis can determine if a country is on the plateau, or on a cliff? What kinds of data are needed?
- Is there an overall determination, or can a country be on the plateau with respect to one labor institution and on a cliff with another?
- If a country is on a cliff, is it a binding constraint to job creation?
- If so, what are the remedies?
## Minimum wage summary

<table>
<thead>
<tr>
<th>Dimension</th>
<th>Indicator</th>
<th>Findings</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Living standards</strong></td>
<td>Aggregate employment</td>
<td>Either modest negative or no impact.</td>
<td>Both developed and developing countries. Some studies show positive employment effect.</td>
</tr>
<tr>
<td></td>
<td>Employment for particular groups</td>
<td>Groups most likely to have negative impact are youth and low-skilled.</td>
<td></td>
</tr>
<tr>
<td><strong>Wages</strong></td>
<td></td>
<td>Positive effect on wages.</td>
<td>Effect strongest around minimum. Some evidence of positive effect in informal sector.</td>
</tr>
<tr>
<td><strong>Wage distribution</strong></td>
<td></td>
<td>Reduces wage inequality.</td>
<td></td>
</tr>
<tr>
<td><strong>Poverty</strong></td>
<td></td>
<td>Unclear</td>
<td>Few studies</td>
</tr>
<tr>
<td><strong>Productivity</strong></td>
<td>Labor and multifactor productivity</td>
<td>Unclear</td>
<td>Positive effect in only study of OECD countries.</td>
</tr>
<tr>
<td><strong>Social cohesion</strong></td>
<td>Fairness</td>
<td>Provides “decent” wage.</td>
<td>Depends on enforcement and coverage.</td>
</tr>
<tr>
<td></td>
<td>Social dialogue</td>
<td>Weaker where state regulates minimum wage.</td>
<td>Based on one study. Direction of relationship unclear.</td>
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</tbody>
</table>
## Employment protection summary

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<td><strong>Living standards</strong></td>
<td>Aggregate employment</td>
<td>Either no impact or modest negative impact.</td>
<td>Both developed and developing countries. Effects weaker on unemployment than employment</td>
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<tr>
<td></td>
<td>Employment dynamics</td>
<td>Reduces flows.</td>
<td></td>
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<td></td>
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<td>Can moderate initial effects of a shock, but then can contribute to their persistence.</td>
<td></td>
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<td>Employment for particular groups</td>
<td>Groups most likely to benefit are prime-age men and skilled. Negative impact most likely for youth and low-skilled.</td>
<td></td>
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<td>Wage distribution</td>
<td>Reduces wage inequality.</td>
<td></td>
</tr>
<tr>
<td><strong>Productivity</strong></td>
<td>Labor and multifactor productivity</td>
<td>Mixed results.</td>
<td>Positive training effect, but negative effect on reallocation of labor.</td>
</tr>
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<td><strong>Social cohesion</strong></td>
<td>Social responsibility</td>
<td>Signals commitment</td>
<td>Depends on coverage.</td>
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<tr>
<td></td>
<td>Security</td>
<td>Greater tenure enhances security</td>
<td>Depends on coverage.</td>
</tr>
<tr>
<td></td>
<td>Income equality</td>
<td>Modest equalizing effect</td>
<td>OECD countries</td>
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