POLICY CHOICES AND INTERACTIONS WITH EXISTING INSTRUMENTS

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TABLE OF CONTENTS

INTRODUCTION

Policy interventions generally have both desirable and undesirable effects on the efficiency and/or equity of market allocations. The balance between the former and the latter depends importantly, for each instrument, on the scope and elasticity of market reactions to its introduction, which in turn depend on the pervasiveness and character of policy intervention along the margins where such reactions may take place. Thus, specific policy choices are difficult to evaluate or indeed rationalize in isolation. The general aims of labour-market policy intervention are pursued by different and often quite complex packages of interacting instruments. Each country's current and past choices of policy instruments reflect structural features of its labour market on the one hand, and political considerations as to the relative weight of each policy's desirable and undesirable effects on the other.

This paper briefly illustrates such a perspective on policy interactions in the context of the currently prevalent package of labour-market policies:

– Unemployment insurance (UI);

– Employment protection legislation (EPL);

– Training and job-matching facilities for the unemployed (ALMP);

– Wage compression (WE).

The perspective is then brought to bear on interactions of these and other policies with:

– Wage subsidies and in-work benefits for low-pay employment relationships (MWP);

whose implications may be more or less attractive depending on the same structural and politico-economic characteristics shaping current policies.

GOALS AND LIMITS OF LABOUR MARKET POLICY

In general, labour-market institutions aim at:

1. increasing net output; and/or

2. reducing *ex post* inequality of outcomes for *ex ante* similar individuals; and/or

3. redistributing resources across different individuals.

Job creation and unemployment reduction are means to these general ends, but may be pursued for their own sake if non-employment *per se* has negative effects on a person's social situation. It is also possible that pervasive non-employment may decrease output- and utility-based measures of economic well being (under headings 1 and 2) through political, social, and crime-related external effects (Phelps, 1998).

If labour-market interactions were perfectly competitive and could rely on complete information (and the same were true of all other economic arrangements) then *laissez faire* allocations would be efficient. No policy intervention could increase net output, and any distributional issues could and should be addressed by lump-sum redistribution. Unfortunately, real-life markets (and especially labour markets) are neither perfect nor complete. Hence, both the equity and efficiency of *laissez faire* outcomes can in principle be improved by taxes, subsidies, and regulatory constraints, and it is far from surprising to find that such policy interventions are pervasive in all industrialized countries' labour markets.

THE CASE OF UNEMPLOYMENT INSURANCE

The design and implementation of policy intervention, however, are confronted by problems similar to those that prevent *laissez faire* markets from achieving first-best outcomes. Information problems, in particular, plague both market interactions and collective intervention pursuing efficiency and equity. Obvious examples of this are found in the context of policies meant to provide insurance against the risk of becoming or remaining unemployed. Moral hazard and adverse selection problems curtail market supply of such insurance. Insured workers would not try so hard to avoid unemployment and find new jobs; if the price of insurance cannot be based on full information, private information by workers as to their own relatively high unemployment risk would either make the scheme unprofitable for insurance providers, or unattractive to workers with average risk.

Public unemployment compensation schemes are meant to address the market's inability to provide insurance. Mandatory participation in such schemes may address adverse selection problems. Moral hazard remains a problem, however, since workers have no less incentive to decrease their effort when covered by social instead of private insurance. As policy interventions are unable to achieve first-best outcomes, their desirability is challenged by their own effects on economic agents' behaviour along margins where they respond to equally imperfect market incentives.

The case for policy intervention must then rely on the fact that the information-gathering and enforcement facilities of collective agencies may well be superior to those of private insurance providers. Unemployment compensation reduces

187

incentives to exert search effort, but appropriately designed monitoring and incentive schemes can, in principle, be configured so as to ensure that any reduction of productive efficiency is more than offset by the benefits of smoother consumption patterns.

Unemployment compensation schemes, however, do not only provide valuable insurance (possibly at the expense of some productive efficiency), they also have *ex ante* redistributive effects, particularly when they are not uniformly available to all individuals. In particular, availability of non-employment benefits strengthens the bargaining position of workers and makes it possible for them to extract a larger share of producer surplus. When more generous benefits are financed by general taxation, the net income of factors other than labour is decreased.

INTERACTIONS WITHIN THE STANDARD INSTRUMENT PACKAGE

In the simple framework outlined above, unemployment compensation schemes not only have both desirable and undesirable effects for society as a whole from an *ex ante* point of view. They also affect relative welfare across individual agents or groups of agents who may *ex ante* or *ex post* gain or lose from any given configuration of taxes, subsidies, and regulatory constraints.

A similar perspective is applicable to other policy instruments. Each policy instrument's effects, however, depend on the character and elasticity of behavioural responses (by workers, employers, and markets) along margins where they are indeed free to react. Other policy instruments can alter the scope of such reactions, and may in fact be intended to prevent market interactions from circumventing policy interventions and (partly) restoring the undesirable features of *laissez faire* outcomes targeted by each policy.

Possible effects of **unemployment insurance** (UI) in isolation have already been outlined above. If employers (as stockholders) have better access to financial markets than workers, then **employment protection legislation** (EPL) may shift the costs of adjustment to employers, and reduce or eliminate the adverse consequences of job loss for uninsured workers.

From this perspective, UI and EPL address similar problems, and are to some extent substitutable to each other. Protection from job loss is less needed when generous unemployment benefits are available and, in turn, the need for such benefits is more pressing in conditions of job insecurity.

As to undesirable or "side" effects, both policies tend to reduce productive efficiency. To the extent that UI reduces search intensity and increases workers' reservation wages, it implies a slower exit rate of labour units from unemployment

at the same time as it smooths workers' consumption patterns. EPL also tends to reduce productive efficiency, as it prevents destruction of relatively less productive jobs and slows down creation of more productive employment opportunities, as employers aim to reduce the cost of future employment reduction by hiring fewer workers during cyclical upturns. As it reduces both job destruction and job creation rates, EPL should not have first-order effects on overall employment.[1] It tends, however, to be associated with long-term unemployment, and with high unemployment rates among workers other than prime-age males. Further, by preventing the reallocation of employed workers from less to more productive jobs, EPL should reduce the overall productive efficiency in the face of local or sectoral shocks.

Despite their tendency to under-employ labour by allocating workers to unemployment or relatively unproductive jobs, UI and EPL may actually increase productive efficiency in the presence of distortions other than a missing market for job-loss insurance. UI, while decreasing search intensity per unit of time, can increase the overall amount of search when workers would inefficiently cut off search time in its absence. Similarly, EPL can induce employers to retrain workers rather than fire them, and this may increase labour productivity (net of retraining costs) when financial market imperfections would otherwise prevent workers from financing their own retraining. To the extent that EPL specifies payments to workers directly (rather than administrative procedures representing dead-weight costs from the point of view of employers and employees), it may facilitate reallocation of displaced workers who would be liquidity constrained in the absence of redundancy payments.

Again, UI and EPL are broadly substitutable rather than complementary in these respects. In an important respect, however, UI and EPL are complementary: by reducing the intensity of labour market flows, EPL makes it harder to find a job for those who are unemployed. Thus, long-term unemployment benefits (or invalidity pensions and early-retirement provisions) are all the more appealing for workers when EPL is stringent.

The possibility that UI and EPL may improve efficiency as well as "equity" depends on imperfect market provision of reallocation-oriented and skill-improving investments. In general, poor *laissez faire* opportunities for financing workers' retraining and relocation may depend on a variety of features of the economic environment. In particular, they may in turn be addressed directly by other policy instruments, namely public **training and job-matching facilities for the unemployed** (ALMP). These policies combine forms of income support with "active" measures meant to ensure that labour is not idle (as it might under a pure UI scheme) or employed in low-productivity jobs (as EPL tends to imply), but is retrained and reallocated so as to ensure that it is used efficiently.

189

Such schemes are clearly attractive if public agencies can fund them more efficiently than financial markets, again as a result of a superior information-processing and enforcement capacity. Creation of public jobs may also be beneficial under the same circumstances, *i.e.* if the government is better able than *laissez faire* markets to make use of labour services. In practice, however, ALMP may prove to be expensive (Martin, 1998) when proper account is taken of fund-raising costs, which of course depend in turn on the structure of the relevant tax system.

Further interactions can be identified between each of the policies discussed above and the extent and character of institutions leading to **wage compression** (WE) across jobs, namely *centrally bargained wage schedules* (with administrative extension at the sectoral, regional, or even national level) and *statutory minimum wages*.

A compressed wage distribution is a natural by-product of UI: as workers have small incentives to accept low-wage employment when generous unemployment benefits are available to them, the low end of *laissez faire* wage rates is truncated by high reservation wages. Minimum wages and centrally bargained wage schedules have similar and more obvious effects on the dispersion of wages across employment opportunities and across workers with different characteristics. When individual wage bargaining is constrained by such institutional features, workers located in low-demand segments of the labour market may not obtain employment by accepting low wage offers (and bidding down the wage of their employed counterparts). Hence, UI and WE are complementary: the former reduces incentives to engage in low-wage bidding (perhaps in an unregulated segment of the labour market); the latter, by preventing low-wage employment, makes non-employment benefits more valuable to workers.

WE policies are also complementary to stringent EPL. Turnover costs, in fact, induce firms to hoard labour during cyclical downswings, and to restrain hiring during cyclical upswings. This increases the volatility of labour's marginal productivity, and of employers' profits. Firms attempt, of course, to reduce such volatility by any means available to them, for example by varying work-time when this is possible. If wage determination were left to market forces, their volatility would also increase, and institutional constraints on labour shedding by firms might well do little to reduce the volatility of individual labour incomes. In the extreme case where workers have no bargaining power, wages could respond to the labour demand shocks that EPL are meant to protect workers so strongly as to restore equality of wages and marginal productivity. Wage stability over time is then a natural complement to EPL: and it generally results in cross-sectional WE since most labour demand shocks occur at sectoral, regional, or firm levels rather than at the aggregate level.

This brief review of policy interactions was focused on the trade-off between productive efficiency (brought about by high employment, especially at high-productivity employment opportunities) and *ex post* inequality (as may be

generated by the inability of *laissez faire* markets to provide adequate insurance in the face of labour-market shocks). As noted above, however, policies and institutions may also be motivated by *ex ante* distributional goals, the pursuit of which typically entails efficiency losses in the realistic absence of lump-sum instruments. In particular, it is easier for organized labour to obtain a larger share of producer surplus not only when unemployment benefits provide a credible outside option in wage negotiations, but also when competitive wage underbidding is made difficult by minimum wages or by administrative extension of centrally negotiated wage rates. EPL *per se* need not affect average employment at given wages, nor need it increase workers' bargaining power in otherwise unconstrained wage-setting processes. In combination with WE, however, it may imply that workers who are employed (chiefly prime-age males) enjoy not only job security and wage stability, but also high wage rates.

"MAKING WORK PAY" AND EXISTING POLICY PACKAGES

Labour market policies aim at "protecting" workers against low and volatile labour incomes, at the likely cost of low employment rates or otherwise reduced productive efficiency. Countries and labour markets differ not only in the overall level of such protection delivered by politico-economic interactions, but also in the combination of policies meant to implement the desired combination of worker protection and productive efficiency.

In light of the interactions outlined above, each policy instrument generally calls for other instruments to be used. If only a minimum wage were imposed on an otherwise unregulated labour market, low-productivity workers would not be employed: their standard of living would come to depend on non-employment benefits, or training subsidies could be used to make them employable. Clearly, the chain of policy interactions could start from the other instruments rather than from minimum wages, and the final configuration of policy and market interactions may or may not be preferable to *laissez faire*. Both the costs and benefits of labour market policy depend on subtle features of the economic environment in which it is implemented. Policy interventions appear more desirable in situations where *laissez faire* markets feature more inequality and/or insecurity, but their shortcomings also become more apparent (though with different prominence to different eyes) in those same situations. Thus, the details of policy reforms should depend on the relative importance of the various possible reasons of the current configuration's poor performance.[2]

In light of the complementary or substitutable nature of policy interactions, it is not surprising that policies implemented in different countries and different labour markets are clustered in well-defined "policy models". For example,

191

Anglo-Saxon countries largely rely on UI, and feature relatively high mobility into and out of unemployment and wage dispersion among those employed. EPL is a more important policy instrument in the larger Continental European countries, which feature low employment rates for non-primary workers and wage compression. Scandinavian and other small European countries implement ALMP financed by general taxation, combined with centrally bargained and highly compressed wages.

The introduction of low-wage employment subsidies (MWP) alongside and/or instead of more traditional policy instruments cannot have the same effects all over the varied landscape of current labour market configurations. Institutional differences often matter in relatively obvious, rather mechanical ways. For example, payroll reductions for low-wage employers and employment-conditional income supplements for low-wage employees have similar theoretical implications when pre-tax wages can adjust freely to market pressures and institutional influences, but have very different implications in the presence of binding minimum wages.

At a deeper level, however, the attractiveness of these and other MWP instruments depends on the same structural and distributional features of each economy that may rationalize minimum-wage provisions in the first place. Consider again the economic and distributional role of minimum wage provisions (Gregg, 1999). Binding wage floors tend to reduce the intensity of wage competition, and may or may not decrease employment, depending on the structure of labour markets. Their effects on the composition of employment and unemployment, however, are relatively clear-cut: on both theoretical and empirical grounds, high minimum wages tend to decrease employment opportunities for young labour-market entrants. From this perspective, the different stringency of minimum-wage provisions, like other elements of different countries' labour market institutions, presumably reflects the intensity and social relevance of such effects, and depend in turn on different economic and social circumstances as regards family structures, the size and volatility of productivity shocks, and product-market competition within and across the boundaries of labour markets.

This general perspective may be useful when evaluating the effects of low-wage employment subsidies on efficiency, insurance, redistribution, and fiscal costs. A reconfiguration of policy packages to include more extensive use of MWP instruments can possibly improve labour market performance along all these dimensions, but it may also privilege one at the expense of others. Since each policy instrument has both desirable and undesirable effects, and in light of the redistributive character of many existing policies, it would indeed be surprising if MWP policy interventions were not undesirable (at least in some individuals' eyes). The remainder of this paper proposes for discussion a few potentially important dimensions of interaction within this complex framework of analysis.

Can MWP policies reduce desirability of UI?

From a static perspective, it may well be desirable to replace unemployment benefits with in-work benefits paid to workers or to employers. A given worker's productivity may be permanently low, but positive and higher than his or her valuation of leisure (taking into account possible external effects). Then schemes that condition benefits on *not* working inefficiently decrease work incentives, and are inferior to unconditional income support measures with similar redistributive properties.

Unemployment assistance schemes do impose more or less stringent eligibility conditions aimed at increasing incentives to accept available employment opportunities (Grubb, 1999; Atkinson, 1999, Chapter 4). Of course, tighter eligibility requirements reduce the effective degree of income support for unemployed individuals at the same time as they increase their incentives to accept employment. In the limit case where benefit conditionality is so strict as to make unemployment with benefits just as unpleasant as unemployment without benefits, the scheme would not have adverse employment implications, but would also fail to reduce welfare inequality across employed and unemployed individuals. To prevent inequitable outcomes appropriate targeting of eligibility conditions, such as exemptions based on family and health conditions might be needed. For brevity, this paper does not examine further these and other obvious interactions between MWP instruments and social-assistance measures. It should be noted, however, that work-contingent benefits may be a suitable policy instrument when ability to work is unobservable, but do tend to produce higher welfare inequality relative to unconditional income support (Besley and Coate, 1992).

Common views on UI desirability, however, are based on explicitly dynamic considerations. If unemployment and low productivity are temporary (rather than permanent), then availability of insurance in job-loss contingencies improves workers' welfare *ex ante*, and makes it easier *ex post* to reallocate labour from low to high productivity employment opportunities. From this perspective, a given worker's productivity and wage offers are not permanently low, but may be improved by search activity. By inducing workers to accept low-wage employment opportunities, MWP policies may prevent a more productive allocation of labour through more extensive search. Evidence on the strength of such reservation-wage effects (Greenwood and Boyer, 1999) as well as on the relative importance of lifetime and temporary dimensions of earnings inequality in various countries can be brought to bear on the relative desirability of MWP instruments (which tend to employ workers in their current job market segment) and UI instruments (which may reduce incentives to accept employment, but also increase the likelihood of sufficiently high wage offers).

In what respects are MWP policies substitutable to ALMP?

A worker's productivity when employed depends not only on chance matching with suitable and possibly unstable employment opportunities, but also on worker characteristics which are also not permanently given, but may be changed by costly training and relocation activity. UI benefits reduce incentives to engage in training but, besides easing labour reallocation, may also provide workers with the financial means to obtain additional skills while searching for jobs; MWP benefits, conversely, are contingent on low productivity, hence reduce market incentives for both workers and employers to improve productivity. Of course, however, nothing guarantees that workers would take advantage of the opportunities for productivity growth made possible by UI income support.

ALMP instruments are meant to ensure that, despite possibly insufficient individual incentives, workers obtain appropriate training and placement assistance from public employment services. MWP instruments can also pursue similar objectives – *i.e.* aim at increasing the endogenous, potentially time-varying component of individual productivity. This is the case if productivity is more easily increased by on-the-job experience and development of individual responsibility (Phelps, 1998) than by off-the-job training and placement services.

Interestingly, this perspective on MWP policies' benefits and that which under-lies traditional rationalizations of ALMP policies are based on very different views of endogenous sources of individual productivity. While proponents of MWP policies believe that market employment is itself a powerful source of improvement in an individual's employment and wage opportunities, advocates of ALMP instruments prefer to rely on education, training, and collective employment services.

In practice, of course, the two sets of policies both may be desirable, and need not be incompatible. ALMP as implemented may result in cycles of disguised unemployment and subsidized employment, so that its effects may be similar to those of in-work benefits. And ALMP instruments may be complementary to in-work subsidies if they can offset the latter's tendency to reduce training expenditures by workers and/or employers. Since public resources are limited, however, policy-makers need to evaluate carefully the productivity-enhancement potential of the two sets of policies. Evidence on the limited effectiveness of public training and placement programmes (Martin, 1998) should be brought to bear on the issue alongside new evidence on the on-the-job wage growth potential of low-wage jobs (Greenwood and Voyer, 1999).

Are MWP policies attractive in EPL-based labour market configurations?

EPL tends to generate wider fluctuations and cross-sectional variation of labour productivity, as firms engage in extensive labour hoarding. To the extent that

MWP instruments subsidize low-productivity employment, they may tend to amplify such effects and, by increasing employment in depressed sectors or regions, further decrease overall productivity of those employed. From this perspective, MWP policies may be somewhat similar to industrial-policy instruments used to subsidize declining sectors and regions, in extreme cases through nationalization, in very rigid labour markets such as Italy's.[3]

Further important interactions between MWP instruments and EPL-based labour markets can be identified recalling that the same markets also tend to feature compressed wage distributions (WE), for the reasons outlined above. Thus, low-wage employment hardly exists in such labour markets, where wages are simply not allowed fully to reflect workers' and jobs' productivity at a given point in time, and may only do so on average through endogenous adaptation of workers' and employers' behaviour. As mentioned above, WE not only contributes to stability of labour incomes, but also ensures that high-wage configurations are not challenged by wage competition. In practice, many EPL-based labour markets feature high employment and high wages for high-productivity workers (prime-age males), and high and persistent unemployment (or non-employment) among other workers. Employing low-productivity workers may well reduce employment and earning opportunities for high-productivity workers: this may be a desirable outcome on distributional grounds, but need not satisfy the set of political concerns that motivate the current configuration of those labour markets.

A useful perspective on the interaction of MWP with existing institutions may be based on the observation that, in many European countries, unemployment is strongly regionally concentrated (Mauro *et al.*, 1999) because WE and UI prevent wages from adjusting to local labour market conditions. As shown by Spilimbergo (1999), the existing configuration of labour market institutions may be the preferred one by workers in relatively more productive regions, whose wages and employment opportunities would be challenged if migration were not prevented by labour market institutions. In this context, MWP instruments would feature important interactions with regional, industrial, and trade policy aspects, and may or may not be politically acceptable in countries where labour-market institutions emphasize WE and EPL.

NOTES

1. The empirical relevance of this simple insight, illustrated in Bertola (1999) and its references, is broadly confirmed by OECD (1999).

2. These include increased opportunism and reduced stigma (Lindbeck, 1997); changes in the demographic structure of the population, especially as regards birth rates and marriage patterns (Esping-Andersen, 1999); regime shifts in aggregate productivity dynamics (Blanchard and Wolfers, 1999); skill-biased changes in relative productivity within the labour force (*e.g.*, Nickell and Bell, 1995), which may in turn result from increased competition by developing country workers or from technological changes. Economic integration also affects the costs and benefits of labour market and social policies by increasing the tax elasticity of labour supply, since high-earning workers may react to high tax rates by moving to less onerous constituencies rather than witholding their labour supply altogether (Bertola *et al*, 1999). Such considerations may be particularly relevant for the evaluation of MWP instruments, which unavoidably increase the progressivity of labour taxation.

3. Interestingly, such policies are now challenged by European authorities: low-wage subsidies, unlike low wages, are a source of unfair competitiveness in an integrated economy.

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