Designing labor market institutions

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“Western Europe suffers from too many labor market rigidities, from excessively generous unemployment insurance to high employment protection, and to high minimum wages. It is essential that countries putting in place new institutions do not commit the same mistakes.”

The quote is made up. But it is, I believe, a fair representation of the opinions of many experts and many organizations, from The Economist to the OECD.

I am more skeptical, or at least, more open. The labor market is far from a textbook competitive market to start with. It is rife with information problems, with room for market power and for bargaining. It will not function well without proper institutions. And these institutions, from unemployment insurance to the minimum wage, came into being in response to clear market failures, from the exploitation of workers in the one-company towns in the 19th century, to the extreme suffering of the unemployed during the Great Depression.

That labor market institutions came in response to market failures surely does not imply that the institutions we have today are optimal in any sense: Their design may have been poor to start with. Circumstances and the

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economic environment surely have changed: What was needed or appropriate then may not be needed or appropriate today. Political economy considerations give institutions a life and a shape of their own: Employment protection creates a constituency for employment protection, and so on.

Still, it implies that simple slogans will not do. We, economists, owe Poland and other countries, a clear headed analysis of what institutions are needed today, and how they should be designed and existing institutions reformed.

This is a tough job. The labor market is a complex market. What I shall do today is present the state of my own reflections on the topic. These are largely the result of on-going research with Jean Tirole on the optimal design of labor market institutions. Take the remarks below for what they are: An attempt to identify the issues, and some preliminary insights as to the shape of the potential solutions and labor market institutions.

1 Some Facts

Let me start with some facts. Western European labor market institutions may not be best (let me not hedge here: they are surely not best), but their adverse effects are in fact not so easy to identify:

- For example: GDP per hour worked in the private sector is actually quite similar across both sides of the Atlantic. Here are some numbers for both the level and the recent growth rate of GDP per hour worked, using purchasing power parity adjusted measures of GDP:

PPP GDP per hour worked, private sector
<table>
<thead>
<tr>
<th>Country</th>
<th>US</th>
<th>Germany</th>
<th>France</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level, 2001</td>
<td>100</td>
<td>85</td>
<td>95</td>
</tr>
<tr>
<td>Growth rate, 1990s</td>
<td>1.6%</td>
<td>1.8%</td>
<td>1.8-2.0%</td>
</tr>
</tbody>
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France and Germany are clearly within sight of the US productivity level. And, for the 1990s, their growth performance, in terms of labor productivity growth, has actually been slightly higher than that for the US.

The point I am making here is partly rhetorical: Obviously, these numbers do not prove that labor market institutions have no adverse effect on efficiency and output. Maybe with different labor market institutions, Europe would be far ahead of the United States. But it is also more than rhetorical: Pictures of doom, either about the level or the growth rate of GDP, are simply inappropriate.

- What about unemployment? Unemployment increased a lot in Western Europe in the 1970s and the 1980s. It is still high today, around 8% for the European Union as a whole. But the high average number hides a diversity of experiences across countries. In 2001, the unemployment rate stood at 2.5% in the Netherlands, 4.7% in Sweden, 4% in Portugal, three countries that clearly have “European style” labor market institutions.

- Is this to say that different labor market institutions yield similar outcomes? The answer is no. If one looks not just at unemployment,
but at the flows of job creation and destruction, and at the flows of workers through the labor market, then clear differences emerge:

Reallocation is lower in Europe than in the United States. Even at the same unemployment rate, flows are lower in Europe than in the United States. The following numbers, taken from a research project I carried out comparing Portugal and the United States—two countries with roughly the same average unemployment rate over the last twenty years—makes the point:

<table>
<thead>
<tr>
<th>Country</th>
<th>Portugal</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jobs. quarterly creation</td>
<td>3.6%</td>
<td>5.4%</td>
</tr>
<tr>
<td>annual creation</td>
<td>11.1%</td>
<td>10.6%</td>
</tr>
<tr>
<td>Workers. quarterly inflows</td>
<td>4.1%</td>
<td>11.1-14.1%</td>
</tr>
</tbody>
</table>

Source: Blanchard and Portugal, AER, March 2001

Quarterly rates of job creation and job destruction are substantially lower in Portugal than in the US. The difference goes away when looking at annual rates (a finding in line with findings from other European countries). The fact that numbers look similar at annual or lower frequencies suggests that lower reallocation may not actually impede very much the churning process required by growth. What it seems to impede is the higher frequency reallocation, the ability of firms to quickly adjust their labor force in response to temporary shocks.

Flows of workers are substantially lower—less than half—in Portugal than in the United States (the replacement of a worker by another on a given job gives rise to a worker flow, but not to a job flow. This is
why measures of worker flows exceed measures of job flows). One interpre-
tation of this fact is that the matching of workers and jobs is less
efficient in Portugal than in the US: More workers stay in jobs they do
not like; more firms keep workers they are not very happy with. (This
is not the only interpretation. Another, less pessimistic interpretation,
is that European firms and workers are organized differently from US
firms and workers. They invest more in their employment relationship,
and so, having done the investment, tend to stay together longer).

If unemployment rates are similar, but flows of workers are lower, then
it follows that unemployment durations are longer in Europe. This is
indeed the case. For an individual, being unemployed means some-
thing very different on both sides of the Atlantic. In the US, it means
remaining unemployed for three months on average before finding an-
other job; in Europe it means remaining unemployed on average for
close to a year. For those who are unemployed, a group which often
disproportionately includes the young and the old in Europe, being un-
employed is likely to be much more traumatic on this side of the ocean
than on the other. A long unemployment spell is much more likely to
lead to a loss of skills, a loss of hope and self confidence; indeed these
effects have been well documented in Europe. Here, different labor
market institutions look very much like a potential culprit.

In much of my work on unemployment, I have explored how specific
labor market institutions may be responsible for these various aspects of the
labor market. Today instead, my approach will be normative. I shall ask:
If we started from scratch, which labor market institutions would we want
to put in place?
2 Unemployment insurance

I take it as nearly self evident that, left to itself, the labor market provides too little unemployment insurance (To be convinced, I think one only has to read about the fate of the unemployed in the Great Depression.) The question is why, and what can the state do that the private sector cannot?

- Self insurance, that is the accumulation of own funds for a rainy day, can only play a limited role. For many workers, unemployment comes too early in their working life to accumulate sufficient funds. Its duration may be too uncertain to be reasonably sure not to run out of funds. The state may and probably should give fiscal or other incentives for workers to commit and save more for such a contingency. Some countries have put such incentives in place; they are highly desirable as, as we shall see below, other solutions create their own problems. But it is unrealistic to expect self insurance to provide sufficient insurance for workers. So one has to look for insurance by others.

- Insurance by the firms themselves runs into a number of problems. First, there is the moral hazard problem often associated with insurance—not only unemployment insurance, but insurance of any kind. If they receive unemployment insurance, workers have less of an incentive to search and accept jobs. Monitoring the search effort of its laid off workers is extremely hard for an individual firm. Indeed, the firm may have a hard time simply finding out whether the worker is still unemployed or has taken another job. This sharply limits the amount of insurance it can offer.

Insurance by firms also runs into what economists refer to as “a lack of deep pockets”. Layoffs typically are high when a firm does poorly,
maybe when it goes bankrupt. The problem may then be the same as for self insurance: the funds will not be there when they are needed. Alternatively, the firm may be able to pay, but, as a consequence, suffer serious liquidity problems. This may lead in turn to inefficiently low investment and production.

- What about insurance by private insurance companies? The deep pockets problem will be less severe: Only in the case of large aggregate shocks may insurance companies not be able to pay. The monitoring problem may also be alleviated: Economies of scale may allow the insurance companies to do a better job than individual firms. But a new problem emerges: Monitoring of firms and workers. Layoffs trigger payments from the insurance company: This in turn increases the incentives to layoff.

- Is there then a role for the state to provide unemployment insurance? The answer is yes. For two reasons. Because it has an administrative infrastructure which already covers the country, it can monitor workers’ status, if not search effort, more easily. And it has deeper pockets than the private insurance companies. Even in the event of an economy–wide recession, workers do not have to worry about receiving their unemployment benefit checks.

3 Negative income taxes

There is however a problem the state cannot solve, that of fully monitoring the search effort of the unemployed. Here, recent reforms (the Blair reforms in England, the PARE in France), which typically offer more generous benefits, but reduce or end them if workers keep turning down jobs for which
they qualify—suggest that one can substantially improve upon traditional unemployment insurance systems, in terms of both incentives and insurance.

But, even in the best designed system, monitoring is likely to remain far from perfect. And this is all the more relevant for low-skill workers. Their marginal product and their wage may be barely above what is considered a minimum socially acceptable standard of living. If unemployment insurance is to provide that minimum, what incentive do they have to look for work?

The solution there is clearly not to increase the minimum wage. On this, basic economic theory must be right: This will simply eliminate low skill jobs. Nor can the solution be to pay unemployment payments below the minimum standard of living: This would clearly destroy its purpose. There is therefore only one solution: One which increases the take home pay of low skill workers so they have an incentive to work, without increasing their cost to firms. This is a negative income tax. How generous it must be depends on the relation between the productivity of the lowest skilled workers to what is perceived to be the socially acceptable minimum standard of living. This is likely to vary across countries.

4 Severance payments and employment protection

The other problem faced by any third party provider of unemployment benefits, be it private companies or the state, is the effect it has on the decision to layoff.

Assuming that the decision to layoff is privately efficient, layoffs will occur when the productivity of the worker is less than his reservation wage (the wage which would make the worker indifferent between working and not working). The reservation wage is clearly an increasing function of unemployment benefits. This implies that the provision of unemployment benefits
will lead, from a social point of view, to too many layoffs: Some workers, who would have had low but positive productivity will be unemployed, and thus producing nothing at all.

The solution, from both a conceptual and practical point of view, is then to undo that distortion by a tax paid by firms when they layoff a worker. How large should the tax be? The answer is straightforward: It should be equal to the expected value of unemployment benefits which will be paid by the worker. In this case, the tax will exactly offset the subsidy to layoffs implicit in the payment of unemployment benefits to the worker, and lead to a socially optimal layoff decision.

This result actually looks like a happy coincidence from a fiscal viewpoint: The payments from the firms to the state will be equal to the expected value of unemployment benefits. The payments from the state to the workers will be equal to the actual value of unemployment benefits. Given the law of large numbers, the state should roughly balance its accounts.

But this argument is not quite right. One of the arguments we gave earlier for why firms did not provide insurance is their lack of deep pockets. But this implies that some firms will not be able to make those tax payments either. Thus, the unemployment insurance system is likely to—and should—run a deficit. How large a deficit? Most layoffs are not associated with bankruptcies, but take place in firms which are on-going, and thus can pay the tax. This suggests that the deficit is likely to be small. (One caveat. If bankruptcy allows firms to avoid paying layoff taxes, large firms will have an incentive to subdivide, so as to escape the tax as often as possible by invoking bankruptcy of the subsidiary. This in turn will make the deficit larger. My guess is that this induced effect is unlikely to be large.)

What I have described is a system in which the state runs the unem-
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employment insurance system, and collects taxes from firms when they layoff workers. But there are many alternative ways of achieving the same—or nearly the same—result. While they may look different, they have essentially the same properties:

- For example, firms may pay these taxes not when they layoff workers, but each month, at a rate corresponding to the probability that they layoff workers—more realistically, at a rate corresponding to the historical layoff rate of the firm (a system not unlike the US system, except for the cap on contributions by firms in the US). The implications and caveats will be very similar.

- Or the state may just play the role of monitor, and delegate the running of the system to private insurance companies or other private entities, which then collect contributions from firms and pay benefits to the unemployed as the state would. The state may still have to come in in case of aggregate shocks, and to finance the deficit.

- Or the system can be run with a combination of unemployment benefits and severance payments. Part of the present value of benefits may be given to laid off workers directly by firms in the form of severance payments. The rest, including the insurance component, can then be provided by a scaled down unemployment insurance system run by the state, with smaller contributions from firms, and smaller unemployment benefits going to workers. Workers in firms which go bankrupt and cannot pay will be worse off (they will not receive severance payments, and will receive the same unemployment benefits as workers who receive severance payments), but otherwise the system will very much resemble our original system.
This last description suggests a justification for employment protection in the form of severance payments. It does not provide a justification for the administrative and judicial steps which typically characterize employment protection in most continental Western European countries, and are seen by firms as the major cost of employment protection legislation. Given the rules on severance payments, the decision should be left to the firm, and there is no reason for a judge to look and intervene.

Can one think of an economic rationale for such administrative and judicial interventions, in addition to severance payments? The argument I have developed suggests one potential rationale. Instead of using a tax in order to reduce the layoff rate to its efficient level, one can imagine this role being played by a smart and fully informed judge, who would make sure that only those layoffs which are socially efficient are allowed to take place. Stating the argument shows its logic, but also, I believe, its dangers. Judges are unlikely to know much about the firm, and, given their discretionary powers, have many reasons to achieve objectives other than efficient layoffs. Taxes, or a combination of taxes and severance payments, are clearly the better way to go.

5 Job destruction versus job creation

One would hope that the provision of insurance benefits by firms, either directly or indirectly through the state system, would lead workers to accept lower wages while employed. Indeed, one might argue, the very provision of insurance, and thus the decrease in the risk faced by workers should lead to a decrease in overall labor costs, including not only wages but also the payment of unemployment contributions and severance payments by firms.

In fact, just the opposite is likely to happen. Both the provision of
unemployment insurance, and the taxes associated with layoffs are likely to increase the wage, thus leading to both a direct (through the payment of taxes and severance pay), and indirect (through the higher wage) increase in labor costs for firms.

This is because wages in the labor market reflect the relative bargaining power of firms and workers. And both unemployment benefits and layoff taxes or severance payments improve the bargaining position of workers.

Think of the wage as a weighted average of what the worker is worth to the firm (the marginal product of the worker) and the reservation wage of the worker (the wage at which the worker is indifferent between working in the firm or becoming unemployed), with the weights reflecting the relative bargaining power of both sides.

Then, higher unemployment benefits clearly increase the reservation wage of workers (as they can now more easily survive unemployment), and so increases the wage. Higher severance payments have the same effect: In thinking about whether to keep a worker or lay him off and replace him by another, the firm now has to take into account the cost of severance payments to be paid to the first worker; this in turn strengthens the position of the worker in bargaining, and so again increases the wage.

The implication: The presence of unemployment insurance, and its associated financing, are likely to increase labor costs, and in so doing, decrease job creation.

Can this adverse effect be avoided? The straightforward solution, at least conceptually, would be for the state to give subsidies to firms, so as to offset the increase in labor costs. But the limits of such a solution are obvious: The subsidies may induce the creation of flight–by–night firms, collecting the subsidies, and then declaring bankruptcy to avoid paying layoff taxes or severance payments. The subsidies have to be substantial, as they have to
cover not only the direct but the indirect increase in cost to firms. And for the state to finance them requires raising revenues and presumably creating distortions elsewhere in the economy.

So, it may be more realistic, in thinking about the design of labor market institutions, to simply rule out such subsidies. In this case, we are confronted with a clear trade off: the provision and financing of unemployment insurance is likely to affect job creation adversely, and thus to increase unemployment.

There is then no clean or elegant solution. The state must do the best it can subject to this constraint. This implies that it provide a bit less unemployment insurance than it would otherwise, that it reduce unemployment contributions/severance payments by firms, and that it accept some increase in unemployment. How much of each depends on many factors (and this is where a more formal and quantitative approach is needed): The degree of self insurance of the unemployed, the characteristics of the process of job destruction and job creation, their elasticity to the cost of labor, and so on. This suggests that different countries may want to choose different combinations of labor market institutions. (One fascinating fact about Continental Europe is the inverse relation one observes between the degree of employment protection and the generosity of the state unemployment insurance system across countries. One potential explanation is that these may two different ways of addressing the same failures, each one more appropriate to the circumstances of the country. Another is that one system (high unemployment benefits, and low employment protection) is much less distortionary than the other, but the existence of the other is explained by political economy considerations: more demand for employment protection if unemployment benefits are low)
6 Ex post bargaining, and the minimum wage

The fact that wages are likely to reflect the relative bargaining power of firms and workers has implications that go far beyond the effect we just discussed. At times, firms or workers may find themselves with overwhelming bargaining power. This may lead to very low or very high wages, with both distributional and efficiency implications.

How to design labor market institutions so as to avoid such extreme outcomes raises a whole new set of issues. For the most part, there is not a lot the state can do (except for setting rules on collective bargaining, an important set of issues, but one I do not want to take on here). I want however to focus on a case where it can do something. This is the case where the firm holds most of the bargaining power. The standard example is that of 19th century one-company towns, where workers had no alternative and thus could be forced to accept very low wages. But, short of this extreme case, there are clearly circumstances where firms may be in a position to pay a very low wage: Few other jobs may be available in the immediate proximity, moving costs may rule out the option of relocating elsewhere. In this case, what is to prevent the firm to pay a very low wage, in the limit no wage at all?

One constraint we just discussed is the level of unemployment benefits. No worker will accept to work at a wage below his reservation wage. Clearly unemployment benefits put a floor on how low the wage can be.

But this level may still be very low, or the worker may not qualify for benefits. And this is where there is a case for a minimum wage. This in effect puts a floor on the wage that firms can offer. It is a rough instrument. Ideally, its object is to push the wage closer to—but not above—the marginal product, to reduce the rents going to the firm without making the worker
unprofitable for the firm. In practice, any minimum wage is likely to have some employment cost. The important point is that it should be used to eliminate the worst cases of exploitation of workers by firms, not to reshape the wage and the income distributions. For that reason, it is essential that it be set low, probably lower than most minimum wages are today in Western Europe. If it is too low to live on, then, again, the right tool is the negative income tax, not the minimum wage.

7 Tentative conclusions

My purpose in those remarks was to identify the central imperfections which characterize the labor market, and think about the proper institutions.

From this analysis emerges the picture of a set of institutions, organized around a mix of tax incentives for self-insurance together with a state-provided unemployment insurance system, a mix of layoff taxes or unemployment contributions by firms, together with severance payments to workers, a negative income tax, and a low minimum wage.

Much remains to be done. Surely much remains to be done by us (Jean Tirole and I), in characterizing the exact menu of institutions, and how the menu might vary across countries. And even if we were to get the general conceptual structure and the general menu right, the devil is, as many reforms have shown, likely to be largely in the details.

But also much remains to be done to improve the political dialogue on these issues. It is time to go beyond the slogans, to avoid blaming “labor market rigidities” wholesale for the ills of our economies (I would gladly get rid of the term altogether). Starting from the position that these institutions are in fact needed, but probably need to be reformed, is likely to both facilitate as well as improve the dialogue among social partners, be
it business organizations, unions, or the state.