Labor Policies and Regulatory Regimes

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Introduction

1.1 Labor regulations can change the price of labor (by imposing minimum wages or subsidized employment schemes), its quantity (by prohibiting child labor or setting restrictions on cross-country worker mobility), and its quality (by establishing occupational certification and licensing or industrial health and safety standards). In addition, regulation can affect the way labor is exchanged in the market, through job security rules, trade union laws, and dispute resolution provisions. Labor exchange is also affected by other, non-labor market policies, such as social assistance that provides income support to the nonworking poor. Such policies alter the willingness of workers to supply labor by changing their reservation wage and can increase employer costs (depending on the way they are financed). Finally, industrial and trade policy affects the allocation of labor and wages both in specifically targeted and other sectors of the economy.

1.2 The objective of this paper is to discuss some of the main issues of labor regulation. The next chapter shows why labor is not a conventional commodity, how the unfettered workings of the labor market may fail to produce efficient outcomes, and why governments may wish to intervene to improve the allocative and distributive results. It also shows the different labor market outcomes that arise from freely negotiated contracts compared with regulated ones. The third chapter provides a typology of labor market interventions and examines specific labor market regulations in areas such as trade unions, dispute resolution, unemployment insurance, minimum wages, and job security. The fourth chapter examines the case of the dock industry in Britain as an illustration of the impact of regulation and deregulation on labor markets, discussed from a partial equilibrium perspective. The fifth chapter looks at economywide effects of labor market deregulation in the United Kingdom, the industrial country that experienced the most radical reform in industrial relations in recent years, and in developing countries that went through adjustment and trade liberalization in the 1980s. The final chapter summarizes the discussion.

1.3 The paper's two principal messages are, first, that there are neither easy answers nor hard-and-fast rules relating to the overall coverage and optimal degree of labor market regulation (that is, policy design). Similarly, it is far from trivial to assess the desirability and effects of economywide labor market deregulation. The range of potential labor market policies is wide
and their interactions with other markets complex. It is therefore difficult to anticipate or even assess the effects of regulation or deregulation amidst other interventions or market failures.

1.4 Second, the effects of policy reform in specific areas (in terms of industries, occupations, and so on) are more predictable because they can be assessed through partial equilibrium analysis. The change in the U.K. dock industry is a case in point. However, a partial equilibrium perspective may lead to outcomes that fall short of a global optimum.

1.5 For reasons of brevity the paper has been written mainly from the perspective of regulation—what, when, and how much to regulate. In short, it argues that there are conditions under which regulation is socially beneficial. Had it been written from the perspective of deregulation, the message would have been the same: When the conditions that originally justified an intervention either have changed or no longer apply, regulation should be amended or repealed.
Rationale for Labor Market Interventions

2.1 Government interventions in labor markets are precipitated by dissatisfaction with the technical, allocative, or distributional consequences of their unrestricted operation. Technical inefficiency arises when the economy is not at its production frontier (for example, because workers are underutilized in their current jobs due to information failure about more suitable jobs). Allocative inefficiency arises when the product mix (quantities) does not reflect societal preferences (relative prices), as in the case of monopoly or monopsony. A third kind of inefficiency, usually missing from the debate, arises when the initial distribution of endowments prevents the economy from maximizing social welfare. Thus, a reallocation of resources can improve society's welfare, as in the case of diverting resources to educate the poor.

2.2 The precise motivation behind, and objectives of, particular labor market regulation (and deregulation) episodes are in general complex because they reflect not only economic factors but also historical, political, social, and cultural elements. Governments may attempt to deregulate if the beneficiary effects of enhancing competition (such as structural adjustment policies) are hindered by imperfections in the labor market. Governments may introduce regulations as a means of achieving a more equitable pattern of distribution between individual members of, or groups within, society. Minimum wage legislation is perhaps the most widely implemented regulatory policy under this heading. The following situations, among others, may give rise to, and provide a rationale for, labor market intervention.

- *Regulation can rest on the belief that the market for labor, if left alone, will fail to function efficiently because of imperfections on either the demand or the supply side.* First, labor is a factor of production, and its demand is covered by Marshall's laws of derived demand (Marshall 1890). This means that labor's price (wage) and utilization (employment) depend on output demand (elasticity of demand for the final product), production technology (ease of substitution between labor and other factors), the availability of factors other than labor (their elasticity of supply), and the structure of costs (in particular, the share of labor in total costs). Thus, even competitive labor markets may not result in an efficient allocation of labor—the prime role they are envisaged to play—if there are imperfections elsewhere in the economy: The economy would not necessarily achieve higher allocative efficiency if interventions
corrected market failures in one market but not in others (see Lipsey and Lancaster 1956 on the theory of the second best).

Second, on the labor supply side and again with reference to Marshall, labor has four distinct peculiarities: Labor is not sold but only hired (the property right remains with the seller); its suppliers are at a disadvantage in bargaining; it cannot be stored; and investments in labor have a long gestation period. These peculiarities can lead to inefficient "spot" equilibria in the labor market due to the presence of monopoly or monopsony power, myopia (the inability of individuals to see far in the future), "irrationality" (short-run considerations may lead to discounting future costs and benefits at different rates than those that would maximize welfare in the long run), and credit market failure.

Expressed differently, labor markets work efficiently only when product markets, from which demand for labor is derived, operate in a competitive fashion (there are no monopolies); when employers do not collude (there is no monopsony power); when workers are concerned with themselves only (there are no unions); if the economy is an open one (a price taker in the world market); and if there is no economic rent to be appropriated by employers' coalitions or trade unions. Finally, labor is the most politicized factor of production, and labor transactions are more relational and conflictual than are voluntary exchanges between equals.

- **Interventions can also be introduced if the level of unemployment consistent with demand—supply equilibrium in the labor market is judged to be unacceptably high, and income support and re-employment assistance to the unemployed is deemed to be desirable.** The precise definition of what constitutes an "unacceptably high" level of unemployment varies and is partly determined by the socially acceptable living standards gap between the unemployed and the employed, and the willingness to publicly finance unemployment insurance. Interventions may also be desirable (for example, in the form of subsidized retraining) to ensure that society's human capital stock suffers minimum depreciation during the down-phase of the cycle and until recovery resumes. However, it is relevant to recognize here that labor market regulation is not the only (or necessarily the most efficient) means of achieving these particular objectives. When left to their own devices, employers and employees can arrive at implicit contracts addressing the problem of cyclical fluctuations in employment (Manning 1990). In essence, this solution involves the employer's taking on the role of an insurance company that provides the worker with coverage against the possibility of becoming unemployed at some future date, with the premium for this insurance taking the form of a somewhat lower wage than the employee would otherwise have earned. The important point here is that implicit contracts, although hard to be confirmed in practice due to their nature, represent a mechanism whereby labor market actors arrive themselves at a nonregulatory solution.
• **Missing markets provide a further reason for labor market regulation.** The fact that the market for information may be incomplete frequently prompts governments to provide both employers and workers with information, in many cases at little or no cost. An obvious example is the provision of information relating to job vacancies as a means of improving the efficiency of job searches.

• **In the presence of asymmetric information, insurance companies are unable to distinguish between good and bad risks.** The state can use its power to require all workers to buy unemployment, accident, and health insurance with a specific level of coverage (what is commonly described as a "pooling equilibrium"; Rothschild and Stiglitz 1976). This action can lead to the adoption of a premium rate that is the average of the fair rates for the different risk groups and can prevent the good risks from being driven out by the bad ones. Whether such a pooling equilibrium is better for the good risks than a separating equilibrium will depend on the circumstances. The good risks will pay a higher premium rate than is actuarially fair for them, but they will be able to buy more coverage in a pooling equilibrium than in a separating equilibrium. If bad risks are sufficiently risk-averse to care more about the extent of coverage than the higher premium rate, by contrast, they will pay a lower premium rate than is actuarially fair for them, and they will be unambiguously better off. The existence of adverse selection necessarily leads to some labor market inefficiency. The enforced pooling equilibrium implies that high-risk employment is being subsidized at the expense of low-risk employment. Also, the fixed level of coverage implies that some workers will have more insurance coverage than they want. Whether the effect of those with more coverage than they want (who will be attracted into riskier occupations) balances the effect of those with less coverage than they want (who will be attracted into less risky occupations) depends on the level of fixed coverage chosen.

• **Paternalism can correct for irrationality.** Some people do not make adequate provision for their retirement or for labor market risks such as unemployment and industrial injury. The state, therefore, may adopt the paternalistic policy of requiring individuals to purchase more insurance coverage than they would otherwise have chosen. This argument therefore complements that derived from considerations of adverse selection in supporting a compulsory system of labor market insurance. People who are forced to buy more insurance than they want, either because of paternalism or forced pooling equilibrium, will treat the additional insurance contributions as a tax and can therefore be expected to reduce their labor supply. This means that the advantage of financing benefits from compulsory earmarked contributions is reduced by the presence of involuntary participants.

• **Labor market regulation may be a necessary component for the achievement of wider social objectives.** The Charter of the Fundamental Social Rights of Workers (the "Social Charter" adopted in December 1989 by all members of the European Union except the United Kingdom) is a case in point. The implementation of this charter
was seen by many as a logical extension of the European Single Market initiative, designed to prevent unfair competition and "social dumping" between member countries and to promote social integration throughout the European Union. Although concerned with wider issues relating to social policy, this charter lays down regulations covering a host of issues including workplace health and safety, maximum hours of work, the rights of part-time and subcontracted workers, training entitlements, and consultation requirements.

By their very nature, social contracts such as the charter (especially if the benefits are heavily weighted to those with full-time or permanent employment) raise potential conflicts between the gainers in society and those who either gain less (for example, part-time workers and the unemployed) or those who meet the costs of the provisions, the taxpayers at large.

- **Individually negotiated contracts can lead to inefficiency compared with regulated contracts.** The difference between individual and regulated contracts can be illustrated by the right of employers to terminate freely a worker's employment even without cause—a practice that in the United States has been labeled "employment at will." According to this principle, the firm could at any time and at will dismiss a worker "for good cause, for bad cause, or even for cause morally wrong" (Dertouzos and Karoly 1992). The freedom of U.S. employers to dismiss workers has been gradually curtailed since the 1980s with the introduction of restrictions on employers' ability to dismiss without showing just cause. In theory, the shift away from the employment-at-will principle should reduce flexibility and induce inefficiency. However, employment-at-will can be efficient only if the following conditions hold: agents are infinitely rational; wages are not affected by norms of fairness; contracting costs are low; dismissal policies of one firm do not have an effect on other firms; there are no other externalities of dismissals (for example, in the form of unemployment benefits paid by the rest of the society); and possible injustices involved in dismissals are of no concern to society. If these conditions do not hold, then it is employment-at-will, not an appropriately designed just-cause policy, that would lead to inefficiency (Levine 1991).

Labor regulation that restricts individual contracting can also increase efficiency by reducing uncertainty. For example, in the case of employment-at-will, regulation can reduce the employer's ability to engage in capricious behavior, enabling management and labor to develop a long-run employment relationship and reap the mutual benefits of this cooperation. Against this benefit, one must examine the costs of reducing employers' ability to freely adjust their work force.

- **Regulation can create equal opportunities, ensure equal treatment, and reduce discrimination, thereby increasing the allocative and distributional efficiency of markets.** Regulation can prescribe not only "general" rights for individual workers but also "specific" rights for certain groups. The case of general versus specific rights
can be clarified with reference to female workers. Many countries have laws that establish the general right of women to be treated in the same way as equally qualified men. The objective of such legislation is to remove discrimination on the demand side of the labor market (Zabalza and Tzannatos 1985). However, granting women the same general rights as men may not be sufficient to ensure that women attain the same labor market outcomes as men. Women face the additional sex-specific constraints on the labor supply side arising from childbearing and, more generally, reproduction. Thus, women are granted (to various degrees) special rights through maternity legislation—such as leave during pregnancy and around the time of birth, which can be accompanied by guaranteed reentry to their previous job. In some cases legislation may not only afford women equality in opportunity but also aim at achieving equal (or more equal) outcomes through affirmative action provisions (Faundez 1994).
3

A Typology of Labor Market Interventions

3.1 There is no generally agreed categorization of labor market interventions. Some interventions affect the institutional process of labor exchange, whereas others more directly affect labor demand or labor supply. Another way to look at interventions is by examining their impact on efficiency or equity. Finally, a popular distinction of labor market policies has been between "active" and "passive" policies (sometimes called "proactive" or "reactive"; OECD 1992). Although there are no precise criteria for including a particular policy under either of these descriptive titles, active policies typically include measures that enhance the allocative role of the labor market (such as information gathering and dissemination, retraining, placement of retrenched workers, and so on); passive policies aim primarily at reducing hardship to workers (such as the payment of unemployment benefits). However, the distinction is not at all clear. For example, benefit payments can increase efficiency to the extent that the unemployed can afford to search longer for better-paying (higher-productivity) jobs, and public works combine income support with the creation of useful infrastructure.

3.2 The following list, though neither exhaustive nor mutually exclusive, indicates the main areas that have been subject to regulatory control:

- Labor rights and standards. The asymmetry in bargaining between buyers and sellers has been addressed by governments through establishing some minimum protection for individual or groups of workers. Such asymmetry is typically seen in terms of an unequal balance of bargaining power between the buyers and sellers of labor. To redress these asymmetries, legislation can establish minimum labor rights with respect to the freedom of association, organization, and collective bargaining. In many instances, national legislation is supplemented by international (International Labor Organization) conventions on labor standards such as the minimum age for work, especially in certain activities; prohibition of forced labor; maximum hours of work in a day or week; minimum health and safety standards, and so on. The extent of rights and level of standards are not rigidly defined in the international conventions, whereas the relevant provisions and enforcement vary between countries and also within countries at different points in time. For example, international conventions do not make clear whether the right to organize refers to secret ballots or secondary
picketing, whether the requirement for majority-based decisions means the total work force or simply the workers who happened to vote in that particular occasion, or whether the cutoff age for child labor is 10 or 15 years of age.

- **Conflict resolution, intermediation, and information.** The government can create and enforce rules within which conflicts between employers and workers should be solved by direct mediation in labor disputes or by providing services to improve information flow between the affected parties. It can also offer job placement services for workers. Of course, there are equally valid counterarguments to such activities: Each can be undertaken voluntarily, market failures can have less damaging effects than government failures, and there is no reason why information is more efficiently or better supplied by the government than by the affected agents and parties.

- **Direct wage and benefit interventions.** Minimum wages, wage subsidies, and payroll taxes are prime examples of wage interventions. Benefits can include bonuses, supplements, family or housing allowances, and training and education entitlements.

- **Job security legislation.** This refers to a host of provisions that protect the worker's employment status either directly (for example, by prohibiting termination of employment or reassignment) or indirectly (by imposing penalties on employers that increase the costs of termination and thus reduce the "demand" for employment changes). Regulation includes measures such as severance pay and advance notice for dismissal. Again, the range of job security legislation varies, from the constitutional provision of the right to work in the formerly planned economies to (employers') employment at will in the United States.

- **Social insurance and assistance.** This includes insurance for old age (workers' pensions), disability (temporary and permanent), unemployment (benefits paid while out of work), workers' accidents (compensation for industrial injuries and occupational hazards), health (to workers and their families), and maternity.

3.3 Underlying these areas of regulation is a wide range of specific policies and provisions. For example, with reference to social insurance and assistance policies, workers' pensions can be individually or pay-as-you-go funded, privately or publicly managed, benefit- or contribution-defined, awarded at the age of 55 or 65, and so on (World Bank 1994). Which "regulation" is best is hard to tell without taking into account prevailing norms (should all people above some threshold age be entitled to income support irrespective of whether they have paid any contributions?), social factors (are families altruistic or, in fact, relevant for intrahousehold transfers to any significant extent?), and political considerations.

3.4 The remaining part of this chapter examines selected areas of labor market regulation that include trade unions, whose objective to secure (additional) pay and employment can benefit their members but affects the general allocation of labor in the economy; dispute resolution, which affects unions as well as labor market outcomes; and wage coordination mechanisms. The discussion then moves to unemployment benefits, which operate through the supply side of the labor market; minimum wages, which affect labor demand as well as pay and employment
outcomes for workers at the low end of the skills distribution and thus have a bearing on social considerations; and job security regulations, which affect labor demand and have elements of protecting the segment of the labor force that is prone to employment fluctuations. The concluding chapter draws attention to the fact that regulation, whose enforcement is typically confined within national boundaries, can increasingly become outdated with globalization and should be either amended to take into account international aspects of production (such as imports or migration) or coordinated at the international level.

Unions

3.5 Unions arise from the asymmetry in contracting between individual workers and employers, the concern for basic labor rights, and the different perceptions about the merits of employment relations governed by individual contracts or collective agreements. The basic question to be answered is: Are unions good or bad, and should they be encouraged or discouraged?

3.6 Economic analysis usually assumes that the alternative to a unionized labor market is one characterized by the atomistic, perfectly competitive structure that ensures that markets clear, with individual workers choosing whether to work by comparing the given, perfectly competitive wage with the marginal utility of leisure (nonmarket activity). However, the removal of unions may reveal market imperfections on the labor demand side in the form of monopsony. Hence, policy decisions that have as their central objective the "return" to a perfectly competitive labor market (with all its well-known potential benefits) can succeed only if they are accompanied by policies designed to free up the demand side of the market. Indeed, the presence of unions in such circumstances may offer a second-best alternative to free competition. In this case, the countervailing influence of unions may result in a set of outcomes closer to the competitive equilibrium than that offered by competition on the supply side of the labor market and monopsony on the demand side.

3.7 The potential benefits associated with the presence of unions in the form of "voice" (empowerment) as opposed to "exit" (separation) effects should be seen against their costs (in the form of welfare losses due to misallocation of resources). In general, these effects have been found to be small and of comparable magnitude to the deadweight loss arising from monopsonies in product markets, which is typically less than 1 percent of total product (Rees 1963; Johnson and Mieszkowski 1970; DeFina 1983; Freeman and Medoff 1984; Pencavel 1991). However, even these low estimates may overstate the allocative loss from unions because they assume that employment is determined by a static demand curve of labor. It is nonetheless possible that labor contracts are not on the demand curve but on the firm's iso-profit curve (as suggested by the efficient bargaining models; McDonald and Solow 1981), and that unions and collective bargaining in general can have beneficial effects on the productivity of their members (the so-called second face of unionism; Freeman and Medoff 1979).
Dispute Resolution

3.8 The breakdown of negotiations between individual workers and their employers can take various forms ranging from poor relations at the workplace (with potential costs including decreased levels of labor productivity) to labor turnover (with the potential loss to the employer of past investments in workers' human capital). At the level of collective contracting, the stakes are arguably much higher for workers, their unions, and employers, with the ultimate cost of a negotiation breakdown being lost incomes to workers and lost profits to employers. Given the potential cost to both of the contracting parties, it is likely that workers and employers have a strong incentive to achieve a solution, in preference to conflict. Like all good threats, the employer's threat of a lockout and the union's of a strike are best if they ensure that an agreement is reached while remaining unused.

3.9 In real life, collective bargaining sometimes breaks down, and production, labor earnings, and profits are lost. It is simply not known whether these costs to society are greater or less than those that would arise from breakdowns in individual employer-employee pay negotiations. Indeed, given economies of scale in the production and dissemination of information, it is possible that a system of collective agreements, through its ability to resolve disputes, may be a less costly option from a social point of view than individual contracting.

3.10 There is a strong body of empirical evidence in Australia, Canada, Japan, New Zealand, the United Kingdom, and the United States to suggest that the cause of disputes under collective bargaining is asymmetries in the information possessed by the involved parties (Hicks 1932; Walsh 1975; Hazledine and others 1977; Mauro 1982; Hayes 1984; Tracy 1987; Booth and Cressy 1987). A common case is when the trade union misjudges the maximum wage the employer is willing or able to pay. In such circumstances, regulation through its information-gathering and disseminating roles can prove decisive in resolving disputes.

3.11 To understand the process, it is important to recognize the distinction between the union proper (sometimes called the official union) and its rank-and-file membership. This distinction results in a tripartite framework where the official union (often a well-informed professional body) acts as an intermediary between the union membership and the employer, reconciling the aspirations of the former against what it judges (on the basis of its more complete knowledge of the overall situation) that the employer would agree to pay. This reconciliation between worker aspirations and labor market realities may be achieved without either party having to resort to its "no-trade" sanction. Should negotiations break down and a dispute occur, the role of the official union as a purveyor of information continues: The union passes information in both directions about concessions acceptable to each side and any other relevant issues that materialize as the dispute progresses. Information is transmitted until demands fall into balance with offers, at which time a settlement is achieved.

3.12 Viewing trade unions in this way—as an information-gathering and spreading body—suggests that policies might be targeted at increasing the efficacy with which unions fill this role. The introduction of cooling-off periods, during which all parties take time out to reassess the situation before implementing no-trade strategies, is one such example. Another example is the
requirement that the employer (generally seen as the party in possession of more complete information) divulge to the union and its members certain types of information to minimize the possibility that disputes arise because workers have incorrectly estimated the employer's ability to pay.

3.13 Some degree of conflict is inevitable when wages and other employment conditions are set by negotiation (either collective or individual) as opposed to the invisible hand of the market. Recognizing this, there are grounds for believing that a centralized, union-based system of wage bargaining may be less costly to society than an individual-based negotiating system in terms of both total transactions costs and dispute costs. It may therefore be more appropriate to devise policies that seek not to remove unions but rather to increase the efficiency with which they perform these tasks.

Wage Coordination Schemes

3.14 Collective bargaining and dispute resolution mechanisms are potentially a powerful means to facilitate wage coordination, an influential determinant of labor market and macroeconomic performance. For example, the Japanese system of wage setting is decentralized (firm-based) but coordinated in the sense that it follows company rules based on seniority (hence, they are transparent) rather than individual contracting. Germany and the Netherlands have also coordinated systems through strong employer organizations between large companies and across industries, as well as between unions. Some coordination in France is accomplished through the significant shareholding of government in production in the form of public services, utilities, and large nationalized industries. In Italy there is informal employer coordination through the large firms, regional employers associations, and union confederations. Finally, Sweden has a centralized employers organization as well as union confederations.

3.15 The economies in which these employer—worker coordination mechanisms serve as an alternative to individual contracting have performed satisfactorily. Evidence (OECD 1994) suggests the apparent superior macroeconomic performance of nine countries that have coordinated wage mechanisms—Australia, Belgium, Finland, France, the Netherlands, Norway, Portugal, Spain, and Sweden—which had on average 17 percent cumulative real wage growth and a 7 percent annual inflation rate between 1980 and 1993. Austria, Germany, and Japan ranked at the top of the league, with 31 percent wage growth and inflation of only 3 percent. By contrast, the apparently flexible labor markets in which bargaining is uncoordinated and negotiations take place at the plant or company level (Britain, Canada, New Zealand, Switzerland, and the United States) had 2.5 percent cumulative real wage growth and a 6 percent inflation rate in the same period. Thus, centralized pay setting may not be associated with the typical effects of wage inflexibility that conventional theory postulates. The relationship between the degree of centralization in wage setting and macroeconomic performance may not, however, be linear. Comparative studies across a sample of industrial economies point to a U-shaped relationship: low and high levels of centralization improve macroeconomic outcomes (Calmfors and Driffil 1988).
3.16 In most economies, coordination evolved gradually through piecemeal legislation over the course of decades rather than as a massive policy intervention at one point in time. Although some policies may have created insiders and outsiders in the labor market, policies have usually blended the social concerns with the economic realities of the time. Most countries with coordinated systems, especially those in Europe, are in a process of change, partly because of their exposure to external competition and their failure to take account of their countries' international trade performance, and partly because of the declining trend in manufacturing, in which collective bargaining is more common than in white-collar sectors.

**Unemployment Benefits**

3.17 Unemployment deprives workers (and their families) of labor income and decreases their current consumption and welfare. An added concern is that workers seeking to escape unemployment may accept jobs that undercompensate them for their skills and thereby lower their contribution to output.

3.18 Four arguments can be given to justify some income support to the unemployed. First, according to the deadweight loss argument, the variability of workers' income and their families' welfare cannot be fully offset by precautionary savings due to reasons of myopia. Benefits are seen as a way to reduce this variability. Second, the poverty argument assumes that the unemployed are among the poorest and that benefits can prevent consumption from dropping below some critical level. However, evidence from industrial countries suggests that unemployment benefits are paid mainly to those at somewhat below the median income, whereas those in the bottom two income deciles get little (Hamermesh 1992). Third, in the efficiency argument, benefits can improve the allocation of labor by enabling the worker to hold out for higher-wage offers (Ehrenberg and Oaxaca 1976). Finally, the political economic argument holds that in the specific case of massive layoffs during adjustment or transition, some form of unemployment benefits can reduce workers' resistance to costs due to restructuring and facilitate transition. However, none of these reasons by itself justifies public involvement in unemployment insurance. An additional argument is required: that private schemes cannot insure against the common risk of widespread recession.

3.19 Unemployment benefits are perhaps the most controversial of social policies. Arguments against such benefits include, first, the fact that unemployment is not harmful in itself (compared, for example, with injury or disability). Second, that unemployment is preventable in the sense that particular individuals can avoid it by lowering their reservation wages (that is, the wage below which an individual is unwilling to work). Finally, unemployment benefits may simply crowd out private savings. It can therefore be argued that unemployment benefits make the economy suffer a deadweight loss because taxes must be raised to finance them, while the welfare of workers receiving these benefits is unchanged.

3.20 Empirical evidence confirms the positive relationship between the generosity of benefits, in terms of levels and eligibility, and the unemployment rate (Layard, Nickell, and Jackman 1991). This effect comes primarily through an increase in the duration of
unemployment rather than the incidence of unemployment. That is, the availability of benefits reduces the pressure for re-employment. However, the adverse effect of unemployment benefits on work incentives, although statistically significant and positive, is usually small and dependent on overall macroeconomic conditions.

3.21 In general, the generosity of unemployment benefits has decreased in most countries during the last decade with no immediate impact on unemployment. In Germany during the 1980s, the unemployment rate was rising at the same time benefits were falling, and the same was true for the United Kingdom. Generous benefits may have a greater effect on search behavior during tight labor market conditions (Burdaless 1990). In fact, the rise of unemployment benefits in many countries during the mid- to late 1960s was justified precisely on efficiency grounds: At that time of low unemployment, it was deemed beneficial to the economy to increase benefits for unemployed workers so they could spend more time on job search, and ultimately find more productive, higher-paying jobs than they would have found if they had been pressured by income constraints.

3.22 There are several considerations to be taken into account in the design of unemployment insurance. First, although unemployment insurance should help the unemployed and their families to maintain a socially defined level of consumption (the benefit adequacy principle), the level set must not create an undue disincentive to work. This generally requires benefits to be low (for example, below the minimum wage but equal to some agreed poverty line). The correct balance is hard to determine. For example, the United Kingdom is still struggling to find the right balance between wages and benefits and reduce the poverty trap (the rate at which benefits are withdrawn when earned income increases) even after its sizable reforms of the 1980s (see the discussion of the British reforms in Chapter 5 of this paper). The current structure of taxes and benefits in the United Kingdom is such that the net weekly income of a couple with two children would rise by less than £50 if their gross earnings rose from £50 to £300 a week (The Economist 1994).

3.23 Second, unemployment programs can incorporate longer waiting periods, for example, benefits may not be paid during the first few weeks of unemployment. Third, eligibility can be reduced by including disqualification clauses (for instance, because of employee fault). Similar arguments apply with respect to the duration of benefits which can be limited to, say, six or nine months. Fourth, when the objective of unemployment benefits is to increase the acceptability of reforms by reducing worker resistance to retrenchment in the short run, their costs and benefits should be examined against their fiscal implications and effects on poverty. In this case, alternative policy instruments should be considered (such as severance awards, means-tested social assistance, family and child benefits, and other public social spending on education and health).

3.24 Even if the right combination of policy characteristics could be determined, the question of whether an unemployment insurance program should be introduced remains unanswered. In general, informal insurance mechanisms will be relatively more important (compared with government-mandated schemes) in the least-developed countries, where
unemployment is hardly a meaningful concept amidst predominantly subsistence activities, the formal sector is small, the tax base is lacking, and "social" security takes the "private" form of extended family networks.

3.25 In countries with more mature economies, the following questions must be answered: Should benefits be financed from workers' pay, employers' payroll taxes, or general taxes? Should contributions be set at a flat rate or be earnings-related? Who should be covered? Should unions or the government administer the unemployment insurance scheme? How should the formal and informal sectors be treated? What other mechanisms are in place that affect incentives, welfare, and savings?

**Minimum Wages**

3.26 Minimum wage legislation has been widely adopted at various times by both industrial and developing economies. Although in practice minimum wages are commonly evaded in informal sector activities, especially in developing countries, they have the potential to induce large distortions by holding wages above their market clearing levels. This wage rigidity leads to an excess supply of labor at the prevailing minimum wage, which can manifest itself in the form of (increased) unemployment or lower wages in the unprotected or evading sectors.

3.27 A serious methodological issue exists in assessing the effects of minimum wages: There does not exist an indisputable counterfactual against which to judge the consequences of minimum wage legislation. The labor market may not assume a perfectly competitive structure when minimum wage legislation is abandoned. The relevant counterfactual may instead assume an employers' tacit agreement not to raise wages above an agreed level (a fact mentioned, not surprisingly, by Adam Smith). In this case, which can be put more formally in a monopsonistic context, minimum wage legislation can potentially lead to a reduction in distortion relative to the situation that would prevail in its absence. This case has been verified in Morocco, where agricultural workers' restricted geographical mobility across the large estates provides employers with some monopsonistic power (Table 3.1).

3.28 Empirical evidence on the employment effects of minimum wages is rather diverse. Some studies have indeed produced estimates that appear to be consistent with the prediction that minimum wages lead to increased unemployment for the United States, although the effect can be small (Ehrenberg and Smith 1991). A more recent study of the United States found an elasticity of employment to minimum wages for teens and young adults of only -0.1 to -0.2 (Neumark and Wascher 1992). Some studies have found that minimum wages have no adverse employment effect, and some have even found positive effects (Wellington 1991; Card, Katz, and Krueger 1993).

3.29 With respect to other countries, recent reviews of the employment effects of minimum wage legislation in the United Kingdom and other OECD economies have concluded that this legislation does not result in increased unemployment (Callaghan and Jones 1993). In a study of the minimum wage in France, Fitoussi (1994) concluded that there was no significant evidence to support the correlation between minimum wages and overall unemployment. Evidence on a
direct link between minimum wages and unemployment in other European countries is lacking as well (Gregory and Sandoval 1994).

3.30 Another effect of minimum wages that may dampen the adverse effect on employment can come from reductions in the duration of job search of low-paid workers. Such workers will accept the first job they are offered to the extent that the minimum wage exceeds their reservation wage. Also, efficiency wage theory suggests the existence of a positive association between the wage paid to workers and the level of labor productivity, with the consequence that minimum wage legislation can, in principle, result in output and welfare gains as opposed to losses (see Table 3.1). Recent empirical evidence reported by Machin and Manning (1992) suggests a positive correlation between minimum wages and employment in Britain, an effect (apparently attributed to monopsonistic behavior) that was particularly strong in the catering sector. Similarly, a recent U.S. study found that fast-food restaurants in New Jersey hired more workers after that state increased its minimum wage by 19 percent in 1992 (Card and Krueger 1993).

3.31 The effects of minimum wages on the distribution of earnings are ambiguous. One might think that the imposition of minimum wages would narrow the distribution of earnings by increasing the pay of the mainly unskilled workers who previously were employed at lower wages. However, the pay of semiskilled workers might also increase either through substitution of the unskilled by the semiskilled (the slope of the supply curve of the semiskilled is positive) or because of the ripple effect on the semiskilled, whose pay will increase to preserve their relative status (Grossman 1983). The increase in the pay of the unskilled and semiskilled is unlikely to extend to high-paid supervisory and managerial staff for two reasons. First, they are not substitutes in production to the other two groups. Second, because of higher wages at the lower end of the distribution, the firm will be able to screen and hire more productive unskilled and semiskilled workers requiring less supervision, thereby reducing the number and earnings of supervisors and managers (Calvo and Wellisz 1979).

3.32 Other forces are also at work. First, if demand contraction takes the form of retrenchment of workers in the covered sector, labor supply to the uncovered sectors will increase, thereby decreasing the wages of workers in those sectors. Second, the dispersion of earnings could increase if firms reduced the hours worked by minimum wage workers proportionately more than the difference between the competitive and minimum wages. Thus, the net effect of minimum wages on the distribution of earnings, a prime concern of the policy, is not clear beforehand.

3.33 Of course, specific cases exist in which minimum wages have rather clear effects. High minimum wages for male workers in the export-processing zones of Mauritius used to discourage male employment, and low minimum wages for women induced an excess demand for female workers. After the minimum wage for male workers was eliminated in December 1984, 95 percent of new recruits for the following year were men who were paid less than the former minimum wage (Robinson 1994).
### Table 3.1: Effects of Minimum Wages

<table>
<thead>
<tr>
<th>Country</th>
<th>Period</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mexico</td>
<td>(1980s)</td>
<td>Significant noncompliance. The real value of minimum wages was eroded by inflation, and even the lowest market wages rose above the minimum. No noticeable impact on employment (Bell 1994).</td>
</tr>
<tr>
<td>Puerto Rico</td>
<td>(1960s-1980s)</td>
<td>Enforcement of minimum wages has been rigorous and affected both low wages and the distribution of wages. Negative effects on employment and positive on unemployment (Reynolds 1965; Santiago 1989).</td>
</tr>
<tr>
<td>Colombia</td>
<td>(1980s)</td>
<td>Substantial negative effects on employment (Bell 1994).</td>
</tr>
<tr>
<td>Kenya</td>
<td>(1960s-1970s)</td>
<td>An increase in the minimum wage following independence induced an expansion of the private demand for education (Collier and Lal 1986; Azam 1994b).</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>(1980s)</td>
<td>Significant negative employment effect on skilled workers and significant positive effect on wages for unskilled labor (Anderson et al., 1991); nonsignificant impact on privately operated industrial sectors, but it could not be determined whether low levels of minimum wages or massive evasion were the cause (Azam 1994c).</td>
</tr>
<tr>
<td>Morocco</td>
<td>(1980s)</td>
<td>Minimum wages have probably reduced employers’ rent in large agricultural holdings and augmented the incomes of the poorest families; no adverse effect on employment (Pascon and Ennaji 1986; Azam 1994a).</td>
</tr>
<tr>
<td>Chile</td>
<td>(1970s-1980s)</td>
<td>Real industrial wages fell by only 20 percent whereas minimum wages in industry fell by 50 percent; still minimum wages are found to affect (&quot;Granger-cause&quot;) real wages (Paldam and Riveros 1986; Azam 1994c).</td>
</tr>
</tbody>
</table>

**GENERAL**

<table>
<thead>
<tr>
<th>Effect</th>
<th>Remarks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Second—order effects</td>
<td>Minimum wages do not generally prevent downward adjustment of real wages because other dynamic adjustments usually take place in response to macroeconomic shocks (Freeman 1992).</td>
</tr>
<tr>
<td>Efficiency-wage consider</td>
<td>In Africa minimum wages in urban areas may have attracted better migrants from rural areas and increased their productivity (Mazumdar 1989, 1994).</td>
</tr>
<tr>
<td>Political considerations</td>
<td>Studies based on simple static examination of minimum wages are uninformative; minimum wages play different roles in different countries; the political economy aspects of minimum wages on costs and benefits must be identified (Tabellini and Rama 1994; Azam 1994c).</td>
</tr>
</tbody>
</table>

In conclusion, the effects of minimum wages on employment and the distribution of earnings and poverty are usually found to be country-specific and variable. Fiscal instruments or
a combination of labor market and fiscal policies might better serve the objective of poverty reduction because the low paid are not necessarily the poor. Many low-paid workers are so-called secondary workers (that is, second-income earners within the family, such as adolescents or spouses). Thus, although such workers are paid little, their household incomes are not necessarily below the poverty line. Also, in many countries the poor do not work at all. For example, in Britain only 1 percent of women whose husbands are out of work and who have dependent children are employed themselves, and also, fewer than half of all single mothers work. Finally, many of the working poor are poor because of personal circumstances (for example, a large family or incapacitated members). In such cases it would be preferable to address poverty through the social security system and general taxes rather than through minimum wages.

**Job Security Regulation**

3.35 Job security can arise from free contracting between workers and employers. Lifetime employment in Japan, for example, is basically a postwar phenomenon that became relatively widespread, especially after the onset of rapid economic growth when rapid technological change increased training requirements (Taira 1970; Johnson 1982; Seike and Tan 1992). Legislation can extend the benefits of longer-lasting employment relationships to workers and companies unable to strike optimal contracts.

3.36 Job security regulations include restrictions on individual dismissals and on collective layoffs, and mandatory severance payments in the case of separation. Job protection is usually not extended to those who perform their duties in a careless way leading to employer losses, pass trade secrets to competitors, are chronically absent from work, suffer from substance abuse, or are convicted of a felony. Regulations also can control collective dismissals when massive layoffs are expected to create negative externalities in workers' communities. Such regulations can take the form of a minimum notice requirement (three or six months' notice is common), prior approval by the government, a ceiling on dismissals (for example, no more than 50 layoffs per month), or a restriction on the percentage of the firm's work force that can be affected (for example, no more than 2 percent of workers per month). Severance payments are usually based on the worker's tenure with the employer.

3.37 Job security regulations can affect both the level of employment and the speed and extent of industrial restructuring during an economic downturn, especially a prolonged recession. Mandated job security legislation may lower the level of employment prior to adjustment by making employers cautious about hiring permanent workers. Sluggish job creation and low employment levels in the formal sector in countries as diverse as India, the United Kingdom, and Zimbabwe have been partly attributed to job security provisions (Nickell 1982; Fallon and Lucas 1991), although there is some evidence to suggest that job security laws had no impact on employment levels in Malaysia (Standing 1989). Fallon and Riveros (1989) estimated that, on average, job security regulations reduced formal employment in 35 Indian industries by 18
percent and in 29 industries in Zimbabwe by 25 percent. However, they concluded that job security did not slow employment adjustment in India or in Zimbabwe.

3.38 The case for eliminating job security regulation is far from conclusive, for many reasons. First, when dismissal becomes relatively difficult the firm has an additional incentive to increase or at least prevent a decline in worker productivity. This incentive can result in more training and an increase in productivity both by creating additional skills and by making workers more willing to accept reassignments within the firm because of their employment security (Paredes 1993). In this case the adverse effect of restricting layoffs on flexibility should be considered against the benefits of greater productivity and lower social costs arising from a more gradual restructuring of the labor force through attrition. This argument assumes that worker effort does not drop as a result of job security. If it does, then firms will not provide more training but will increase the capital-labor ratio and reduce employment.

3.39 Second, although job security imposes a cost on employers, this cost may eventually be passed to workers. For example, workers may be willing to accept lower wages or greater within-firm flexibility in return for greater job security. Some empirical studies have shown that the costs of mandates are largely shifted to wages with little effect on employment (Gruber and Kruger 1991). For this to happen, wages should be flexible. Other studies have arrived at less clear-cut conclusions, with no evidence that wages per hour are systematically affected by the introduction of job security regulation (Fallon and Lucas 1991). The ambiguity rests on the fact that there are many forces at work whose net effect is unclear a priori. They include compensating differentials that, in a competitive labor market, should reduce wages in protected sectors; increase wage bargaining, which can push up wages; or reduce worker motivation, which can raise wages per unit effort. All this suggests that the behavior and treatment of other aspects of employment and pay are crucial in determining what the eventual effect of job security legislation can be.

3.40 Third, advance notice requirements, one of the main elements of job security regulation, may reduce the duration of unemployment to the extent that they afford workers more time for job search. Consequently, such notices may have both an employment and an efficiency effect. Empirical evidence suggests that job security legislation negatively affects the incidence of unemployment though it does not reduce a spell of unemployment (Podgursky and Swain 1987; Ehrenberg and Jacobson 1988). In terms of efficiency, pay in a new job (replacement earnings) among workers who receive advance notice of termination is higher than that of workers whose employment is terminated suddenly (Ruhm 1992).

3.41 This discussion of job security legislation and the preceding section on minimum wages both speak of flexibility in the labor market. Flexibility typically refers to the ease with which employment and wages adjust, usually downward. Numerical flexibility refers to the adjustment in employment and hours of work and financial flexibility to the pay adjustment in response to changes in product markets and profitability. Other types of flexibility can enable the economy to adjust, sometimes more efficiently than through prices (wages) and quantities (employment). Functional flexibility, the reassignment of workers to other jobs within the firm,
is common among permanent workers in firms in Germany and Japan. Neither country has much reason to envy the (narrowly defined) more flexible economies of the United States or the United Kingdom. Finally, certain attitudes toward entrepreneurship and management are important determinants of labor market outcomes, giving rise to managerial flexibility and distancing strategies (such as subcontracting) on the employer side. The design of job security regulation should, therefore, take into account aspects of flexibility beyond the conventional "wage cum employment reduction" view.

Labor Regulation and International Trade

3.42 The discussion so far has focused on labor reforms from a national perspective, bypassing an important consideration: the integration of the world economy through international trade, advances in technology, and the globalization of production. When labor rights and labor standards differ among countries, such differences can give a cost advantage in internationally traded goods to some countries. Along with international trade, technology has enabled labor services to be subcontracted directly to workers in developing countries. For example, Caribbean workers perform data entry procedures and transmit their work electronically to U.S.-based companies. Skilled Indian engineers receive initial drawings by satellite and send the final products to the United States in the same way. Regulation therefore can no longer be concerned with only the working of the national labor market but must take into account conditions in overseas markets as well.

3.43 Two broad views on this issue exist. The first holds that labor regulation reduces economic efficiency and growth, especially in countries with a high incidence of poverty (Herzenberg 1990). The second view holds that differences in labor regulation among countries tend to discriminate against those countries with higher standards and greater respect for workers' rights, typically industrial countries. It is within this latter perspective that the United States considers the violation of basic worker rights and minimum labor standards as unfair trade practices. It has adopted legislation to this effect (such as the Omnibus Trade and Competitiveness Act of 1988) that restricts trade and investment guarantees in countries that either do not enforce or violate labor rights and standards. One policy issue in a world trade context is whether countries can agree on some level of labor rights and standards that would punish neither the more "principled" (industrial) economies nor those with surplus labor (the developing ones).

3.44 Labor regulation is also important from another international perspective: migration. Although there is a general consensus that flows of capital and goods should be free, there is no such agreement about the movement of people (Russell and Teitelbaum 1992). In general, labor regulation should make labor exchange possible at least through temporary relocation of labor (Bhagwati 1987). The services that have a strong provider-relocation requirement (such as construction and engineering) call for more permanent provisions (OECD 1989).

3.45 The removal of restrictions on migration is necessary for increasing the mobility of workers between countries, but it may not be sufficient. Complementary actions are often
required, as illustrated by the European Union's principle on the free movement of citizens of member states. The adoption of this principle required additional "regulation" in the areas of educational qualifications, certification, and licensing. Had national medical councils and engineering associations continued to place restrictions on the employment of doctors and engineers qualified in another member state, they would have violated the principle of free mobility of workers within the European Union. Thus, regulation (in the form of mutual recognition of credentials) was necessary, as well as the provision entitling workers who can legally practice a profession in one member state to practice that profession in all other member states.
A Case Study: The Dock Industry in Britain

4.1 This chapter considers in some detail a case study that illustrates the practical issues involved in labor market regulation and subsequent deregulation. The experience of the international dock industry is interesting for several reasons. First, the characteristics of the industry that gave rise to its regulatory structures were very similar across countries. Second, an array of alternative regulatory solutions to the industry's problems have been put in place. Finally, largely led by the United Kingdom's 1989 deregulation of the dock labor market, many governments are currently either fundamentally reforming or completely dismantling their regulatory structures.

4.2 The dock industry has witnessed marked technological changes over the last two decades as a result of the development of lift-on/lift-off containerization and roll-on/roll-off trailers. So rapid was the introduction of the new technology that the labor-intensive processes that had been used for decades were quickly rendered inappropriate. It is no exaggeration to say that the changes in established working practices necessitated by these technological advances were as significant as those required of the manufacturing industry as a whole at the onset of the Industrial Revolution (Turnbull, Woolfson, and Kelly 1992).

Industry Labor Problems

4.3 In the United Kingdom during the early 1990s, port costs were some 60 percent higher than those in continental European ports. In September 1991 a container ship could be unloaded and reloaded in the port of Tilbury (London) at an average rate of 25 TEU (twenty-foot equivalent units) container boxes per gross crane hour. However, the same ship could be handled at the northern European port of Zeebrugge at a rate of 40 TEUs per hour. Significant productivity differentials are also evident at ports in the newly industrialized countries. For instance, whereas productivity rates of 30 TEUs per gross crane hour are currently achieved at U.S. ports, the rates exceed 40 TEUs per hour at Hong Kong and 50 TEUs per hour at Singapore (Turnbull and Sapsford 1993).

4.4 Clearly, these productivity differentials cannot be attributed to technology, because both the vessels and the container boxes are identical. The structure of capital stock in the ports is also not a factor because even 20-year-old cranes are technically capable of high performance
levels. Although a range of factors have been suggested as contributing to such productivity differentials (including the structure of port ownership and administration), the functioning of dock labor markets is now widely recognized as a critical factor.

4.5 The docks have been traditionally characterized by one of the most archaic and inefficient of all occupational or industrial labor markets. Irregular demand for labor and associated casual forms of employment made chronic surplus labor commonplace, which in turn nurtured inefficient working practices and frequent strikes. Excess manning, for example, was a common means of sharing available work. Strikes were typically protests against low average earnings, irregular earnings, unequal job opportunities, or irregular work. Conflict and inefficiency in the international dock industry seemed inseparable from the casual nature of employment. But the problem ran much deeper in the sense that pressures of excess labor supply in the docks can generate a vicious spiral of unemployment, low earnings, conflict and, in many ports, bribery and corruption.

4.6 Faced with industrial conflict and inefficiency (high labor mobility and excessive variability in wage levels), countries began introducing regulatory controls in the dock industry in the late 1940s and early 1950s. In some countries, employers took actions to foster stability (as in the Netherlands). In others, the union took the lead (as in the West Coast U.S. ports). Usually, however, it was government action that established, and subsequently underwrote, a system of joint regulation by employers and unions (as in Australia, Britain, France, and New Zealand).

Regulation and Deregulation on the Waterfront

4.7 The National Dock Labor Scheme was established in 1947 to regulate the dock industry in Britain. Its primary objective was to ensure greater regularity of employment for dock workers and an adequate labor supply for port employers. A national board and 22 local dock labor boards were established to administer the scheme, each with an equal number of employer and worker representatives. Both employers and workers were required to register with the scheme. Registered employers were prohibited from hiring nonregistered dock workers. Registered dock workers who were out of work were placed in a pool of reserve labor and paid "attendance money." If the amount of such money, plus any earnings, fell below a guaranteed wage (agreed to by the National Joint Council for the Port Transport industry), the worker would receive supplementary pay to reach the minimum. In essence, because workers were hired on a shift-by-shift, casual basis, the port operators were merely operational employers, whereas the national board acted as the holding employer.

4.8 The persistence of the casual work relationship between employers and workers and its resulting record of poor industrial relations led an investigating committee to recommend that the casual system of employment be abandoned in favor of a system of tenured permanent employment for registered dock workers (Aldington-Jones 1972). These recommendations were accepted by the government in 1972 in the form of legislation providing a "job for life" for each registered dock worker. Whether this legislation provided a true job for life for dock workers is,
however, questionable because an increase in the rate of job loss in the industry followed its passage.

4.9 The most important reason this system of regulation failed to bring employment security, industrial peace, and rising labor productivity was the sheer pace of technological change faced by the industry. The new cargo handling techniques—such as containers, roll-on/roll-off vessels, and bulk carriers—reduced manpower requirements dramatically and at a speed far greater than the rate at which the industry was able to shed labor. Mechanization was a major contributing factor to the marked increase in the industry’s surplus labor rate during the 1970s. Despite an elaborate network of regulation, insecurity of employment remained the hallmark of dock work.

4.10 The regulatory framework that had governed the operation of the dock labor market in the United Kingdom for 40 years was dismantled, almost overnight, in April 1989. Deregulation was largely a reaction to the low labor productivity and poor labor relations record of the U.K. port industry. It also reflected the government’s general view that regulatory and institutional structures impede the free operation of market forces.

4.11 Deregulation of the dock industry produced significant (and most likely sustainable) gains, along with some short-term adjustment costs. Productivity in the U.K. port industry rose sharply in the three years immediately following deregulation. In addition, strike activity dropped significantly. However, strikes are not the only manifestation of industrial conflict, and their reduction is only a partial indicator of improvement (Douglas 1923; Yoder 1940). Absenteeism (and even accidents) at the workplace constitutes an alternative manifestation of industrial conflict (Knowles 1952; Handy 1968). While strike activity was reduced in the dock industry as a consequence of legislative changes there was an increase in absenteeism and accidents (Turnbull and Sapsford 1993; Evans and others 1993).

4.12 The deregulation of the dock industry resembled that of the coal industry in the United Kingdom. Before 1984 the coal industry was also heavily unionized and used old technology, and its workers were paid wages above those that a free market would have enabled them to earn. A nonunionized coal field could have produced nearly one-quarter more output than a unionized one (Pencavel 1977). The deregulation of the coal industry in the early 1980s brought about long-term benefits at the expense of severe industrial conflict in the short run: The miners’ nearly year-long strike was one of the most significant events of that decade.

4.13 This section showed that in the case of a specific industry, the effects of deregulation can be anticipated. Although the evidence suggests that there may be some short-run costs associated with deregulation (such as increases in absenteeism and accidents), there were clear longer-run benefits. However, reforms of interventions that cut across the labor market (such as economywide minimum wages or trade union regulation, discussed in the next chapter) are more difficult to assess and their impact harder to predict.
Empirical Evidence of Economywide Reforms

5.1 In the case of specific industries, results of reforms are predictable within a partial equilibrium framework. The need for trading off short- with long-run effects does not usually arise, because affected workers are typically a small fraction of the labor force. It is, however, particularly difficult to identify and measure economywide effects when systemic policy reforms are undertaken. The path to a "first-best" equilibrium may generate nontrivial unemployment at the macro level, and the eventual pattern of wages is rather unpredictable in the sense that it depends on the slopes and elasticities of products and inputs, as well as product mix and factor intensities (Edwards and Cox-Edwards 1990). Even if employment and wage effects can be estimated, the costs of reforms may be heavily concentrated in the current time period, whereas the benefits may arise in the future. A clear illustration of this "costs now, benefits later" phenomenon is the restructuring now under way in formerly planned economies. Alternatively said, if one accepts that reforms require (unspecified) long and variable lags for full effects, it is nearly impossible to reject the beneficial value of labor deregulation.

5.2 Bearing these difficulties in mind, this chapter first examines the U.K. labor market, which experienced the most radical change in regulation among the OECD economies in recent years. The behavior of the labor market in a wide range of developing countries that underwent adjustment and trade reform is then discussed.

Labor Market Reform in the United Kingdom

5.3 The rigidities in the U.K. labor market have been widely regarded as the cause of the country's poor macroeconomic performance since the 1960s. By the end of the 1970s, the United Kingdom's powerful and inflexible trade unions and high unemployment benefits were two areas of significant concern. Labor deregulation in the 1980s significantly curtailed the role of unions and fundamentally altered industrial relations. Closed shops became practically extinct, management prerogatives were restored, job security regulation was eased, collective agreements became more flexible, unemployment benefits were reduced and eligibility rules became tighter, and trade union membership fell by 3 million during the decade. No aspect of the labor market escaped regulatory reform: Labor demand, labor supply, and the institutional framework were all significantly affected.
5.4 By most measures, however, the United Kingdom's economy does not seem to have benefited from the massive labor reforms of the last 15 years. Although changes in the industrial relations framework and reductions in benefits and the power of unions have altered the distribution of earnings by increasing inequality, they have not led to low inflation with low unemployment (Barrell 1994).

5.5 Why have the U.K. labor reforms had no apparent impact on macroeconomic performance? First, the expected macroeconomic effects may have been neutralized by the move away from employer—union bargaining toward decentralized bargaining, which reduced labor market coordination. However, it is also possible that labor reforms, especially in pay-setting procedures, had weaker effects on economic performance and employment outcomes relative to those of other changes in the economy that emanated from macroeconomic and trade factors (Metcalf 1994).

5.6 Second, although labor reforms may have exerted some independent effect on labor productivity, competitiveness is influenced by a range of factors in addition to productivity in the labor market. Specifically, trends in U.K. competitiveness in world markets during the 1980s were heavily influenced by movements in both relative inflation rates and exchange rates (Brown and Wadhwani 1991). Although micro problems may have been substantially diminished by the supply-side reforms of the 1980s, macro policy was severely constrained by the United Kingdom's participation in the European Union's Exchange Rate Mechanism, which resulted in tight monetary policy (Minford and Riley 1994). In addition, the reduction in worker security, by fostering greater uncertainty for consumers, may have created less stable demand (Anderton and Mayhew 1994).

5.7 Finally, the supply response may have been constrained by the limited skills of British workers and the lack of a responsive training system. This deficiency restricted the adjustment during the rapid change away from manufacturing toward services, and the reduction of employment security did not significantly change worker behavior in the expected direction (Anderton and Mayhew 1994).

5.8 These explanations suggest that labor market rigidities may be less important than those in other (domestic or international) sectors, and that labor regulation or deregulation alone is not sufficient to change the course of the macroeconomy. The "price theorist's ideal changes" that took place in the United Kingdom during the 1980s may have reduced rigidities and union power and increased mobility, incentives, and the responsiveness of wages and employment at the subsector microlevel. But these changes increased wage inequalities without improving at the macro-level either the response of aggregate real wages to unemployment or the transition out of unemployment. These changes do not seem "to reflect the working of an ideal labor market" (Blanchflower and Freeman 1994). The United Kingdom may have ended up with the worse aspects of two possible worlds: the wage inequality of the decentralized U.S. labor market together with the high and lengthy spells of unemployment that are a characteristic of European labor markets.
Labor Regulation, Adjustment, and Trade in Developing Economies

5.9 Labor market regulation in developing countries has been assessed from both micro and macroeconomic perspectives. Reviewing the experience of a sample of 23 developing countries, Fallon and Riveros (1989) concluded that labor regulations such as minimum wages and nonwage costs (including social security, and medical and fringe benefits) appeared to have distortionary effects in the countries and sectors in which they were effectively enforced. They provided evidence that job security regulations can have a negative effect on employment levels at a given level of output but less so on the pace of employment adjustment.

5.10 The Fallon and Riveros study faced the same methodological and empirical issues as those discussed earlier in the case of the United Kingdom. The link between labor regulation and macroeconomic performance is neither linear nor always clear. For example, while it is always tempting to ask whether adjustment could have been faster in the absence of minimum wage legislation, minimum wages may be in general irrelevant for macroeconomic performance or simply ignored de facto. When economic crises occur, either governments tend to let real minimum wages fall or workers simply become willing to accept lower wages when their jobs are at stake. Real minimum wages in Mexico were nearly halved in the 1980s, and 16 percent of male workers and 66 percent of female workers were paid less than the minimum wage by 1988. In Algeria and Jamaica nearly half of the microenterprises did not comply with minimum wage legislation, and evasion in Niger and Swaziland was nearly universal. In Kenya real average wages fell by 23 percent in the first half of the 1980s, but minimum wages had already fallen by 41 percent (World Bank 1995).

5.11 Horton, Kanbur, and Mazumdar (1994) examined the interactions between labor markets and adjustment programs in a cross-country context. The countries examined in the study have different (in some cases, widely different) labor market regulatory systems. The study included Argentina, Bolivia, Brazil, Chile, Costa Rica, Côte d'Ivoire, Ghana, Kenya, Malaysia, the Republic of Korea, and Thailand. Still, the authors found that shifts in the intersectoral allocation of labor resources occurred largely in the desired direction—into the tradable goods sector. The role of trade unions in the adjustment emerged as varied and complex (see also Standing 1992). In neither Africa nor Asia did unions constitute a major obstacle to successful adjustment in the aggregate, although the response of unions varied from outright opposition in some cases to active cooperation in others. Unions in Argentina and Brazil attracted some apparent blame for the lack of adjustment, but their presence and activities in Costa Rica did not appear to restrict adjustment in that country. Although much labor market legislation was removed in Bolivia, a significant recovery had yet to emerge when the review was conducted.

5.12 On the face of these results it may be tempting to conclude that the presence of unions does not necessarily lead to adverse macro outcomes. However, another explanation may be that unions in most developing countries are relatively unimportant—that is, they are not a serious obstacle to adjustment simply because they operate on only a small part of the labor market and leave the large informal sector untouched. The conclusion of Horton, Kanbur, and Mazumdar
was that neither aggregate real wage rigidity nor labor market inflexibility appeared to have hindered the process of structural adjustment.

5.13 The evidence on the linkages between labor market characteristics and macroeconomic performance is also mixed in the countries that have a successful economic record (Freeman 1993). The East Asian newly industrialized countries have had remarkably high and consistent growth rates in the last two to three decades. Yet union repression in the Republic of Korea and wage repression in Singapore cannot be considered as significant factors in the growth of their economies as compared to the economies of Taiwan (China) and Hong Kong (World Bank 1993). In addition, these four East Asian economies have performed equally well despite significant differences in the industrial composition of output and employment and considerable transformations of their economies over time (Fields 1994). Thus, neither growth nor adjustment seems to relate singularly to specific labor market characteristics. It seems that in the same way that growth is the driving (positive) force of employment and earnings, macroeconomic imbalances are the driving (negative) force of the economy during adjustment. In fact, the relationship between specific policy variables and economic growth is generally weak with the exception of the investment ratio to GDP (Levine and Renelt 1990). Specifically with respect to labor policies, another study of 31 countries estimated that labor market distortions do not account for more than 10 percent in the variation of economic growth (Agarwala 1983).

5.14 A further source of insight into the process of trade and labor reform is provided by Papageorgiou, Michaely, and Choksi (1991), who evaluated 36 liberalization episodes in 19 countries over the period 1951-82. No strong evidence emerged to suggest that labor market performance, especially as it relates to the structure of regulation, exerted a marked impact on the likelihood of success in liberalization. One possible exception is the case of Spain. The authors argued that the marked rise in aggregate unemployment that accompanied Spain’s liberalization episodes was due to labor market rigidities. Although similar increases in aggregate unemployment accompanied liberalization episodes in Chile, it is interesting to note that the authors attributed the rise in Chile not to labor market rigidities but to problems of exchange rate overshooting. Whether these diagnoses are correct remains an open question: it is by no means an easy task to disentangle the effects of trade liberalization from those of other policy changes (Greenaway 1993).

5.15 What this discussion on the evidence suggests is that isolating specific labor regulatory effects and establishing the causality between the labor market and economic performance are complicated tasks. In some cases diagnoses are easy because regulation has reached overly inefficient or unsustainable levels. For example, employment protection legislation and the resulting severance awards that a worker qualifies for only months after entering into an apparently temporary contract are clearly inefficient and a cost deterrent to employment creation (Cox-Edwards 1993). It is not so much that such provisions defy the arguments for some form of regulation outlined earlier in this paper. Rather, they simply defy common sense.
5.16 Another example of inappropriate regulatory policy is minimum wages that are set below the level of social assistance to which a worker may be entitled. At such a level, it would be as attractive to the worker to remain on benefits as it would be difficult for employers to hire workers. If, by contrast, minimum wages are set much above the competitive wage, they either will be evaded or, when enforced, will be paid to the relatively more skilled workers whose productivity is high enough to justify such costs to their employers. In both of these cases, the objectives of policies, whether social assistance programs or minimum wages, are simply defied by inappropriate policy design and provisions.

5.17 Employment and pay practices in the government sector are themselves a source of labor market distortions in many countries. For example, mandatory hiring of university graduates into the civil service is widely practiced in developing countries such as Egypt, Guinea, Mali, Senegal, Sudan, and Togo (Squire and Suthiwart-Narueput 1994). Such practices cannot be justified on either efficiency or equity grounds, and are usually adopted because of problems outside the labor market (such as the overt public subsidization of higher education) or political economy considerations. They also can hinder attempts to provide a viable and efficient civil service. Overstaffing in the Egyptian government sector had already reached 40 percent by the mid-1970s (Gelb, Knight, and Sabot 1991). In other countries the net change in government employment during adjustment has been unclear because the downsizing of the civil service in some areas was offset by the automatic rehiring of graduates of training colleges in sectors exempted from retrenchment (such as security or education workers).

5.18 Finally, the deficit-financed growth of the public sector as an employer of last resort is another case in which the arguments made in this paper do not apply. For example, the civil service in Tanzania has grown 4.5 percent a year over the last 30 years, while average pay has fallen in real terms by 75 percent since 1972 and the debt situation has deteriorated. Similar changes have been observed in the public sector in other countries (Lindauer, Meesook, and Suebsaeng 1988). The magnitude of these figures suggests that such policies go far beyond what even the most comprehensive demand management recipe would ever prescribe. In such cases the issue is not whether deregulation would be beneficial. The answer is clearly affirmative. Rather, the crucial question is how civil society can align the (apparently) political considerations that created such regulations with the economic reality and concern for the general welfare of the population.
Summary

6.1 The Marshallian laws and peculiarities of labor provide sufficient ground for countries to regulate various aspects of the labor market. Labor market regulation also can be used to address adverse effects caused by imperfections in other markets. However, there are no theoretical reasons to suggest that labor policies can be introduced uncritically. What is appropriate in some circumstances may not necessarily be right in others.

6.2 Decisions regarding what to regulate, when to regulate, and by how much to regulate will vary in each particular situation. Where excessive or inappropriate regulation is easily identified, the case for deregulation is clear cut, as the discussion of the British dock industry and of high minimum wages and employment in the government sector illustrated. This does not, however, prove the case for complete deregulation of the labor market, as the discussion on the redefinition of the regulatory framework in the United Kingdom and on developing countries' experience with adjustment revealed.

6.3 Labor policies should not be adopted simply because of an abstract belief that markets work better in the absence of regulation. Rather, such policies should be based on a critical evaluation of the evidence and an assessment of the likely effects of deregulation against the intended objectives, whether economic or noneconomic. Indeed, decisions about whether to regulate, deregulate, or let the labor market be guided by its own invisible hand involve economic as well as political judgments. Often policymakers regard it in their personal interest to consider views of interest groups. It is both unrealistic and somewhat naive to expect policymakers to introduce policies today solely because of the benefits they promise for some time in the long run. And even if policies would create gains in the short run, the compensation principle of welfare economics (which holds that the winners can compensate the losers) may not be relevant if the benefits are dispersed, and the potential losers can forestall reform and preserve their status by bribing the potential winners. When political considerations become relevant, the issue is not simply more or less regulation but also better or worse governments. In practice, countries have achieved notable and sustained economic growth and social development with regulated labor markets. However, increasing international competition and the globalization of production call for a redefinition of the regulatory framework to enable labor market adjustment and increase labor market flexibility as defined in this paper.
6.4 To improve the understanding of how labor markets and regulation work, future research should integrate the study of various aspects of labor flexibility and institutional aspects in which labor is exchanged within the context of the macro and international economy. Such analysis should take into account labor heterogeneity and norms and resulting social institutions in order to better assess the differential impact of trade and technology on product and labor demand. From this knowledge will come an understanding of the demand for different skills and workers' earnings, the response of the education and training system to changes in the demand for labor and workers' earnings, and the effects of constraints faced by the suppliers of labor with respect to housing and geographical mobility.

6.5 The key to the success of future research may be not so much what will be studied but how. This can be highlighted with the quotation of the researcher (Rees 1993) who introduced the subject of labor economics in its modern form to the profession:

the neoclassical theory of wage determination, which I taught for 30 years and have tried to explain in my textbook, has nothing to say about wage fairness. The factors involved in setting wages and salaries in the real world seem to be very different than those specified in the neoclassical theory. . . . [Fairness is] a powerful force in determining wage structure, but does not exclude the ultimate effect of neoclassical wage determinants (p. 243).

6.6 Research must move away from the notion that an explicit microfoundation is required for every behavioral assumption. The analytical niceties do not always provide a reliable basis for prediction in complex, continuously evolving economic systems.
References


