# Macroeconomic policy, labour market institutions and inequality
# Notes for session 2

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## Labour market institutions in conventional framework (new classical version)

- Assumption of a fully competitive labour market
- Forward-looking economic agents with well-anchored inflationary expectations
- Leads to vertical Phillips curve in both long run and short
- Full employment or unique natural rate of unemployment (NAIRU)
- Deviations from full employment reflect changes in work-leisure trade-off
- Focus on policy rules, most notably inflation targeting
- Focus on structural reforms to reduce NAIRU

## Labour market institutions in conventional framework (new Keynesian version)

- Assumption of nominal rigidities allows explanation of involuntary unemployment in conventional framework
- Such assumption allows distinction between short run and long run
- In short run, counter-cyclical policies valid
- In long run, structural and labour market reforms are needed to reduce NAIRU by increasing potential GDP
- Part of the agenda of the G20

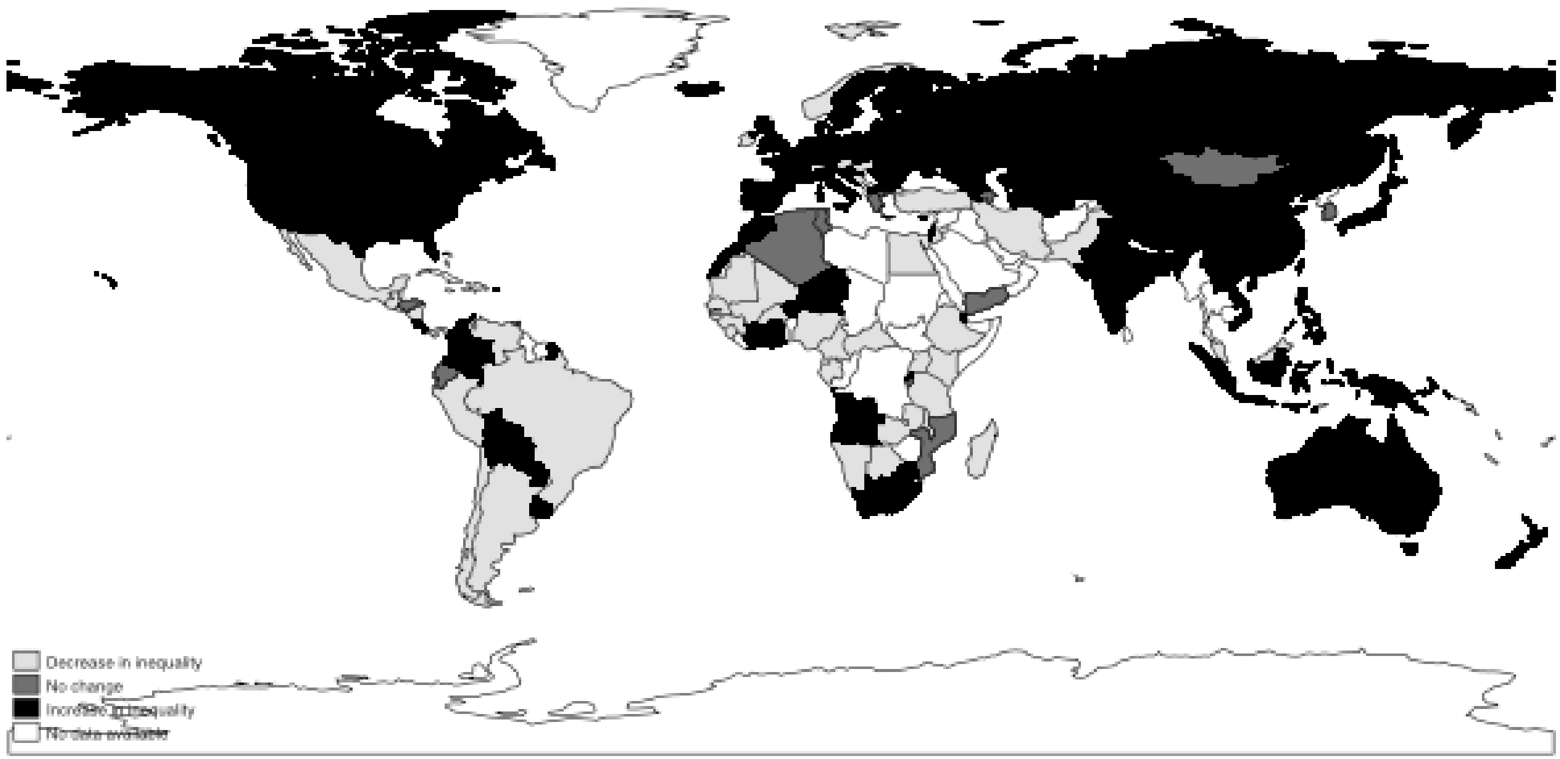
# Labour market institutions in conventional framework : critique

- Framework not valid for a developing economy with a large informal sector
- Estimated Phillips curve for South Asia appears to be 'horizontal' (Azad and Das, 2013)
- Inflation mainly from supply-side forces
- Empirical evidence suggests that labour market institutions that seek to protect workers not harmful to employment or growth
- 'New' consensus – too much protection is bad, but so is too little protection

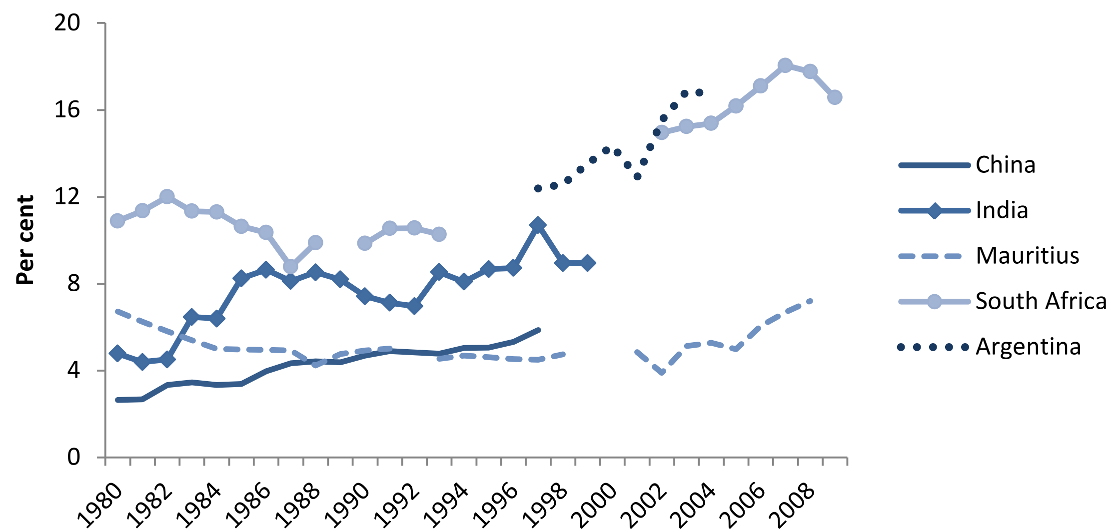
## Inequality, labour market institutions and macro-implications

- Conventional framework ignores inequality and its macro-implications
- Global evidence of rising inequality in many parts of the world
- Declining labour share, increase in share of top 1% and rising wage inequality
- Graphs>>>>

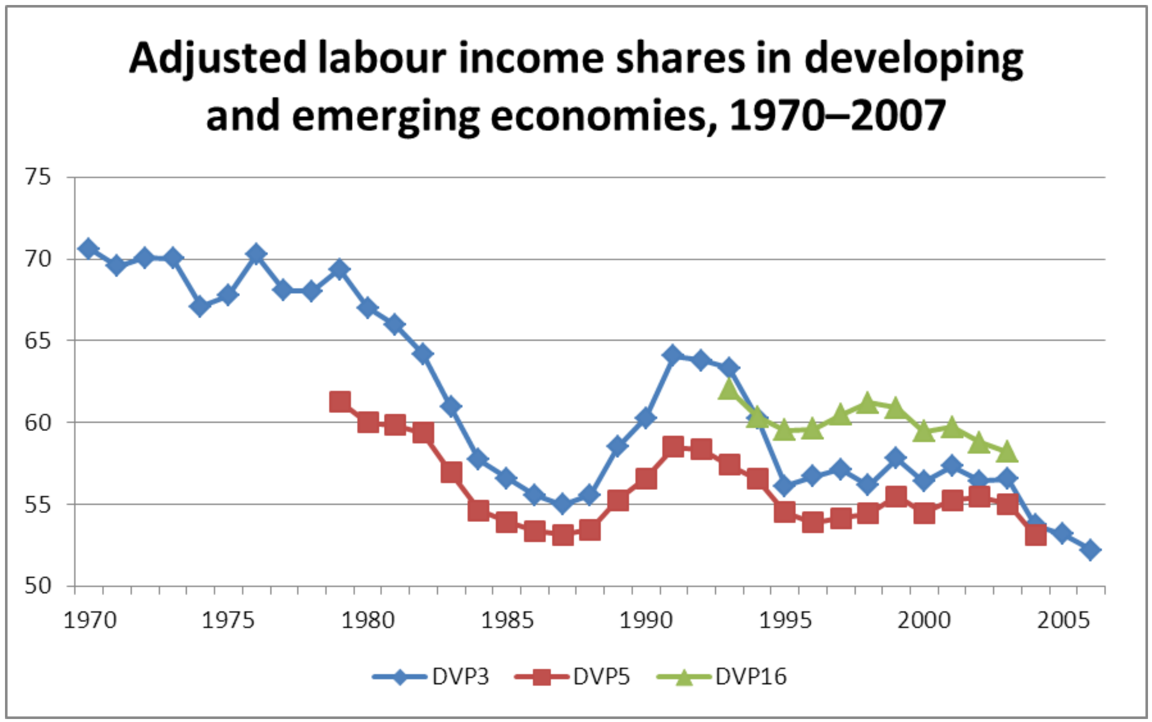
# Map of global inequality



# Increase in income share of top 1%



# Declining labour share



## Wage inequality and low pay

- The distance between the top 10 per cent and the bottom 10% of wage earners has increased in 23 out of 31 countries
- The proportion of those with low pay (defined as less than two-thirds of the median wage) has also increased in 25 out of 37 countries.

## Inequality, labour market institutions and macro-implications

- Does the rise in inequality matter from a macro-perspective?
- Yes…
- Ability for growth to reduce poverty impaired
- Growth itself might be adversely affected
- Gini ratio of 0.4 and above associated with higher probability of lower growth (Berg and Ostry, 2011)

## Inequality, labour market institutions and macro-implications

- Should we target the labour income share as a macroeconomic policy goal?
- Answer not clear-cut, especially from a developing country perspective
- Declining labour income share compatible with sharp decline in working poverty (e.g. China)
- Impact of decline in labour income share on *level* of aggregate demand ambiguous

# Inequality, labour market institutions and macro-implications

- 'Simulation' results based on 15 countries (includes India) of a 1% increase in labour income share suggest (ILO Global Wage Report 2012/13):
- Decline in private consumption in all cases
- Private investment rises in 10 cases
- Net exports rise in all cases
- So…cannot uambiguously conclude that seeking to increase labour income share will boost aggregate demand and thus output and employment

## Inequality, labour market institutions and macro-implications

- Which way now?
- Need to understand sources of declining labour income share:
- (1) skill-biased technical change
- (2) globalization
- (3) erosion of bargaining power of workers in advanced countries, inadequate existence in developing countries

## Inequality, labour market institutions and macro-implications

- Focus on (3)
- Build up bargaining power of workers by developing labour market institutions
- But…takes time
- Another possibility is global coordination of wage policy to avoid 'race to the bottom'
- But…no example of such coordination, unlike exchange rate coordination

## Inequality, labour market institutions and macro-implications

- Hence, rely more on country-specific approaches, most notably minimum wages
- If well designed and with good compliance, can act as a bulwark against low pay and sustain private consumption
- Meta-analysis reveals that such benefits *not* offset by loss of aggregate employment (Nataraj et al 2012)

## Inequality, labour market institutions and macro-implications

- Wage policy needs to be combined with other policy instruments to combat inequality
- Fiscal policy instruments best way to deal with inequality in both developed and developing countries (Bastagli et al 2012)
- Covers groups in labour market and those outside
- Examples…conditional cash transfers, progressive tax system, public expenditure on education, health, infrastructure

- Asia Pacific lags behind other regions,most notably Latin America, in tax-GDP ratio
- This is around 15% in Asia Pacific and the almost at par with Sub Saharan Africa
- Comparative figure is 20% of GDP in Latin America
- Social spending as % of GDP in Asia-Pacific also among the lowest in the world
- Hence, challenge of adequate resource mobilization, more social spending in Asia Pacific to combat inequality

# Final slide, session 2

- Thank you!

- For more details on these presentations, please contact islami@ilo.org