EC330-3-SP – Lecture 13

The Labour Market and the Informal Economy

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Plan of talk

- **Introduction**

1. Models of sectoral reallocation during transition
2. Labour markets and unemployment during transition
3. The informal economy during transition

- **Wrap-up**

Aim and learning outcomes

- **aim**: discuss the objectives and, mostly, the outcomes of post-socialist reforms in terms of sectoral reallocation
- **learning outcomes**
  - understand why sectoral reallocation matters for transition
  - summarise the relevant theoretical models
  - compare transition experience with labour markets and unemployment
  - discuss the evolution and the determinants of the post-socialist unofficial economy

Reforms => reallocation => efficiency

- post-socialist **reforms**
  - liberalisation of prices and trade and formal introduction of markets
  - subsequent large-scale privatisation and restructuring process
- aimed at a major improvement in economic **efficiency**
  - efficiency gains were expected to naturally occur, from
    - closure of SOEs
    - emergence of privatised firms
  - at a *macro* level, the *micro* phenomena of changing ownership and incentives were expected to result in
    - sharply declining state sector
    - rapidly expanding private sector, the backbone of a prosperous society
- increased efficiency of the economy
  - was thus associated with a **huge sectoral reallocation** of resources
  - the **trade-off** involved how fast to close down money-losing SOEs

Aghion and Blanchard (1994): model

- **static model** that looks at sectoral reallocation of *labour*
  - there is some *optimal rate of unemployment*
  - defining a *corresponding optimal speed of sectoral reallocation*
- **unemployment** is rationalised by the presence of frictions in the labour market which affect the wage level
  - unemployment is needed to exert *downward pressure on wages*
  - but *if excessive*, the *fiscal burden in terms of unemployment benefits* financed through taxation (on labour in the private sector) too high
- any **excess unemployment** above the optimal level
  - reduces wages
  - *but* also increases the total wage costs borne by private-sector firms
- **key lesson**
  - *too fast* close-down of enterprises
  - can generate *low* demand for labour

Aghion and Blanchard (1994): relevance?

transition in **East Germany**

- *plunge in employment* of nearly 50% in just more than a year
  - pre-unification level: 9.7 million
  - by end-1991: 5 million
- these data confirm that
  - *job destruction* was *rapid* and *deep*
  - whereas *job creation* was *slow* and of a much *weaker* scope
- *but* it is not evident that the main reason for poor job creation has been low labour demand, in particular due to a tax on labour

no such *excess* rates of closure of SOEs in the **other post-socialist economies**

Castanheira and Roland (2000)

- **another model** of sectoral reallocation during transition
  - highlighting *capital* accumulation and *dynamics* in general equilibrium
  - *focus* justified stating that much of the capital accumulated during socialism had to be scrapped and replaced by new capital
  - kept as *similar* as possible to the standard Ramsey model
- **key assumptions**
  - *no* installation costs, time-to-build considerations or other *frictions*
  - analysis thus concentrates on the *consumption-saving decision* alone
- **key conclusions**
  - *similarly* to Aghion and Blanchard (1994), closing SOEs *too fast* may be counterproductive, and thus slow down sectoral reallocation
  - *but* the channel through which the effect of the excessive speed of closure works is the *depression of output and savings* generated endogenously
  - *moreover*, to obtain a negative effect of an *overly slow* speed of closure as well, an additional assumption needed: soft budget constraint of SOEs

Unemployment during transition

- under **socialism**
  - open unemployment rates were practically zero
  - participation rate of women in the labour force was high
  - labour mobility was low
    - administrative arrangements tied most workers to their current job indirectly
      - through fixed lifetime residence in a town
      - or through housing sold or let at a subsidised price
    - nevertheless, changing jobs did occur, although within a narrow region
- once **market** prices and forces were allowed
  - many products and technologies became obsolete => loss-making SOEs
    - world relative price structure
    - foreign and domestic competition
    - shifts in consumer demand
  - *job destruction* and *job creation* had since then determined the emergence and dynamics of high **unemployment** in transition economies: Table 13.1

Table 13.1: data on unemployment rates

Transition Economies: Unemployment Rate (% p.a.)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Armenia	-	-	-	-	-	-	-	10.8	9.3	...	...	...	...
Azerbaijan	-	-	-	0.5	0.7	0.8	0.9	1.0	1.1	1.2	1.2	...	...
Belarus	-	-	0.5	1.4	2.1	2.7	3.9	2.8	2.3	2.1	2.1	...	...
Bulgaria	1.7	11.1	15.3	16.4	12.4	11.1	12.5	13.7	12.2	16.0	17.9	...	-
China	2.5	2.3	2.3	2.6	2.8	2.9	3.0	3.0	3.1	3.1	3.1	...	...
Czech Republic	-	-	-	3.8	3.9	3.5	4.0	4.8	6.5	8.7	8.8	8.1	7.3
Estonia	-	-	3.7	6.5	7.6	9.7	10.0	9.7	9.9	12.3	13.7	12.6	...
Georgia	-	-	-	-	-	-	-	-	14.5	13.8	10.8	11.0	...
Hungary	-	-	9.8	11.9	10.7	10.2	9.9	8.7	7.8	7.0	6.4	5.7	5.8
Kazakhstan	-	-	0.4	0.6	1.1	2.1	4.2	3.8	3.7	3.9	3.7	2.9	...
Kyrgyz Republic	-	-	-	0.2	0.8	3.0	4.5	3.1	3.2	3.0	3.1	3.2	...
Latvia	-	-	2.3	5.8	6.5	6.6	7.2	7.0	9.2	9.1	7.8	7.7	...
Lithuania	-	0.3	3.5	3.5	4.5	7.3	6.2	6.7	6.5	10.0	12.6	12.9	...
Moldova	-	-	0.7	0.7	1.1	1.0	1.5	1.5	1.9	11.2	8.5	7.3	6.8
Poland	6.3	11.8	13.6	16.4	16.0	15.2	13.2	10.5	10.4	13.0	13.9	16.2	17.8
Romania	-	3.0	8.2	10.4	11.0	10.0	7.8	7.5	9.3	11.3	11.2	9.0	10.0
Russia	-	0.1	0.8	5.7	7.5	8.9	9.9	11.3	13.3	12.7	10.6	9.0	...
Slovakia	-	-	-	-	13.7	13.1	11.3	11.8	12.5	16.2	18.6	19.2	18.5
Slovenia	-	-	11.5	14.6	14.5	14.0	13.9	14.4	14.5	13.6	12.2	11.6	11.6
Ukraine	-	-	-	-	-	5.6	7.6	8.9	11.3	11.9	11.7	11.1	10.2

Source: ESDS/IMF: International Financial Statistics (online), annual series.

Stylised facts on transition labour markets

- **Haltiwagner, Lehmann and Terrell (2003)**
  - patterns of job destruction and job creation have varied
    - *early* in the reforms, job destruction clearly dominated job creation
    - at *later* stages:
      - job creation roughly equal to job destruction in most of *Eastern Europe*
      - but not in Russia and some other *former USSR* economies
  - new and small firms contributed *disproportionately* to job creation
  - mostly job reallocation *within*, not *across*, sectors
- **Roland (2000)**
  - a major *wave of layoffs* following the output fall by more than one year
  - job *leavers*, not job *losers*, i.e. *voluntary* quits have predominated
  - *job-to-job* flows rather important relative to flows *into unemployment*
  - *low* worker mobility because of in-kind payments and social benefits
- **Boeri (2000):** *failing job creation responsible* for persisting unemployment
  - job *destruction*: on average, monthly inflow rates of
    - 0.5% in transition economies
    - 1% in Europe and 2-3% in North America
  - job *creation*: at most 5% of job seekers able to find new work in 1 month

Informal (unofficial) economy

- **activities**
  - which are not officially measured because they are not reported
  - may be illegal
  - or legal but inappropriately accounted for, e.g. to avoid taxation
- **not special to transition**, but small(er) in market economies
- an idea about the **size** of the underground economy is *useful*
  - tax collection
  - formulating policy
  - household income
- **measurement** is *imprecise* and sensitive to methodology
  - *direct* estimates of *income* or *expenditure* by the survey method are not reliable (since people tend to conceal their revenues)
  - hence, *indirect* methods
    - the *demand for* ***cash*** relative to broader monetary aggregates
    - the high correlation between ***electricity*** *consumption* and GDP

The informal economy: size and determinants during transition

- Kaufmann and Kaliberda (1996): **1994** estimates
- Johnson, Kaufmann and Shleifer (1997): **1995** update
- Alexeev and Pyle (2003): more precision, *eliminating* 12% initial (for 1989) estimate **uniform** across USSR
  - Table 2, p. 158
  - Table 6, p. 165
- Johnson, Kaufmann, McMillan and Woodruff (1999)
  - Roland (2000), Table 8.2, p. 186 reproduces their results
  - Eastern Europe vs Russia, Ukraine and former Soviet Union

Concluding wrap-up

- **What have we learnt?**
  - why *sectoral reallocation* matters for transition
  - which the main *models* proposed to explain it are
  - how *labour markets and unemployment* evolved during transition
  - why the *post-socialist informal sector* emerged and how its size differs across major groups of countries
- **Where we go next**: to the effects of reforms on *poverty and welfare* during transition