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Fiscal adjustment and labor market dynamics in an open economy

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Abstract

This paper studies the labor market effects of fiscal adjustment in a two-sector, three-good intertemporal framework. Key features of the model are an informal sector, minimum wages, unionized labor in the formal economy, imperfect labor mobility, and public production of intermediate inputs. "Luxury" and wait unemployment prevail in equilibrium. It is shown that if unions care sufficiently about employment, and if the degree of openness is high, an increase in the price of government services may reduce unemployment in the steady state. A similar result would hold in an efficiency-wage setting if the "disciplinary effect" of unemployment is sufficiently strong.

JEL classification: F41; J31; J64

Keywords: Labor market segmentation; Trade unions; Public sector prices

1. Introduction

Fiscal adjustment typically represents a key component of stabilization programs. A common scenario in middle-income countries is one of excessive budget deficits fueling a rapid expansion in domestic public debt and sharp increases in real interest rates. In turn, high interest rates lead to unsustainable debt dynamics, because the government is unable to

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generate a sufficiently large primary budget surplus. An economic and financial crisis, entailing large social costs in terms of employment and poverty, often ensues, followed by a macroeconomic and structural reform program aimed at increasing the primary surplus and reducing the public debt to manageable proportions. Argentina, Brazil, and Turkey are all recent examples of countries where unsustainable debt dynamics led to crises and subsequent attempts to being fiscal imbalances under control. In Turkey, for instance, the adjustment program introduced in May 2001, shortly after the February currency crisis, called for maintaining a primary surplus on the order of 6.5% of GNP over the medium term, in order to achieve the goal of single digit inflation by 2005 (see Yilmaz and Boratav (2003)).

In practice, budget austerity has taken various forms, including cuts in expenditure on goods and services, increases in direct and indirect taxes, absolute and relative reductions in wage compensation for civil servants, increases in the relative price of public services, changes in the government's wage-setting policies, and the imposition of constraints on the growth in (or reductions in the level of) public sector employment. How the budget deficit is reduced is, of course, just as important as the magnitude of the adjustment. A reduction in the fiscal deficit achieved through cutting investment on productive infrastructure or trimming expenditure on operations and maintenance, for instance, may not be sustainable over time. Moreover, because the public sector is often a major employer in developing countries, fiscal consolidation tends to have significant effects on wages and employment in the private sector. Identifying the channels through which fiscal policies are transmitted to the labor market is thus an essential step in understanding the real effects of adjustment programs in developing countries.[1]

Of particular interest in the present study is the macroeconomic effects associated with attempts to improve the financial situation of public enterprises. These enterprises are, in some countries, major contributors to the budget through direct transfers, in addition to the tax revenue that they provide. In others, however, they represent a drain on public finances because of the large subsidies that they receive. Attempts at improving their financial situation have taken a variety of forms, including measures aimed at increasing efficiency and lowering costs (most notably by reducing "excessive" employment), and market-based pricing policies. In oil-exporting countries, for instance, adjustment has often entailed raising domestic prices of fuel and gasoline—which governments often try to keep at low levels for political reasons—to world market prices. A case in point is Nigeria where, on September 30, 2003, the government lifted its long-standing ceilings on domestic fuel prices, in an attempt to alleviate the adverse effects of subsidies (about US$1 billion a year) on the budget deficit. Because this type of public goods is used as intermediate inputs in the production process in the private sector, opponents often argue that they tend to have contractionary effects on output in both the short and the long run, and to raise unemployment. At the same time, however, advocates of these policies often claim that although there may be short-term costs, the longer-run benefits associated with a reduction in fiscal imbalances (lower interest rates, reduction in inflation expectations, and so on) may be expansionary and may well dominate. For instance, if increases in public sector prices lead to

[1] See Agénor (1996, 2000) and the World Bank (1995) for comprehensive accounts of the literature on the role of the labor market in economic adjustment.