

What is the impact of labour market regulation on employment in LICs?

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Controversy over the design of labour market policy often centers on achieving the delicate balance between improving workers' conditions by guaranteeing basic rights, and avoiding loss of productivity or employment through excessive regulation. Whereas in developing countries the concern is that labour regulation might reduce total employment, in low-income countries (LICs) there is the additional concern that labour regulation might shift workers from the formal sector to the informal sector.

We systematically reviewed available research on the impact of labour market regulations on employment in LICs. We conducted an extensive search of electronic databases, used "snowballing" techniques, and contacted experts for additional studies that our search might have missed. We found only four studies from LICs that were appropriate for inclusion. Due to the thin evidence base, we included studies in countries considered LICs until recently.

We found four studies from current LICs, 11 studies from recent LICs, and two cross-country studies that met the inclusion criteria; they covered a variety of labour regulations including minimum wages, employment protection, and firing rigidities, among others. All four studies from countries that are currently LICs find that labour regulations are associated with lower employment in the formal sector. One study also considers the impact on employment in the informal sector and finds a positive effect. Seven minimum wage studies from countries that were, until recently, LICs were reviewed, and all of them document that labour regulations have a negative impact on formal employment. Five of them also find that higher minimum wages are associated with higher informal employment. The other four studies from recent LICs examine the impacts of India's labour regulations on employment; three document a negative relationship between the stringency of regulations and formal sector employment. Four studies from recent LICs also consider the effects of a variety of labour regulations on overall employment or unemployment rates, with mixed results.

For minimum-wage regulation, we used the few comparable studies to conduct a meta-regression analysis (MRA) of the effect of minimum wages on formal and informal employment. This analysis lends some quantitative support to these results, though it is limited by the small number of studies with comparable estimates. In the formal sector, we confirm a negative relationship between minimum wages and employment after controlling for potential publication bias, although the statistical significance of the relationship varies across specifications (and the precision might be overestimated due to the small number of studies). When we restrict our analysis to studies that include elasticity estimates, we find an elasticity of about -0.08 in the formal sector, implying that a 10% increase in the minimum wage would reduce formal employment by 0.8%. In the informal sector, our results suggest a positive relationship between minimum wages and the share of informal workers after controlling for publication bias.

Overall, our results suggest that in LICs, labour regulations are associated with a decrease in formal employment, and an increase in informal employment, resulting in an ambiguous effect on total employment.

The working-paper can be accessed at:

http://www.rand.org/content/dam/rand/pubs/working_papers/2012/RAND_WR957.pdf

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