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Summary of
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"Macroeconomic Adjustment with Segmented Labor Markets"
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The paper examines the implications of fiscal and labor market policies on output, wages, and unemployment in a small open developing economy with a large informal sector, a heterogeneous work force, and segmented labor markets. The production structure assumes that production in the formal sector consists of traded goods and uses skilled and unskilled labor, and output in the informal sector consists of nontraded goods produced using only unskilled labor. Firms in the formal sector set the wage rate for skilled workers so as to minimize labor costs per efficiency unit in terms of labor. The productivity of skilled workers depends positively on their wage relative to the wage paid in the informal sector. Unskilled workers employed in the formal sector earn a legally-fixed minimum wage, while wages of unskilled workers hired in the informal sector are fully flexible. In equilibrium, a noncompetitive wage differential emerges across skill categories.

With perfect labor mobility across sectors, a permanent reduction in government spending on nontraded goods leads, in the long run, to a depreciation of the real exchange rate, a fall in the market-clearing wage for unskilled labor, an increase in the production of traded goods, and a lower stock of net foreign assets held by the private sector. A permanent reduction in the minimum wage paid to unskilled workers also increases output and the demand for labor in the formal sector. Therefore, a reduction in the minimum wage improves competitiveness and expands the formal sector at the expense of the informal sector.

The basic framework is then extended to introduce direct income taxation and unemployment benefits for skilled workers in the formal sector. When the unemployment benefit scheme consists of paying a constant real wage to the unemployed, the economy may face an "unemployment Laffer curve" relating the wage benefit and the income tax rate. If the economy operates on the efficient portion of the Laffer curve, a reduction in the level of unemployment compensation will raise the level of employment of skilled workers--thus leading to an expansion of the relative size of the formal sector.

Finally, the analysis considers the case where unskilled workers face a decision to migrate from the informal sector to the formal sector. The incentive structure on the basis of which workers form their decision is first derived. It is then shown that in the long run the overall unemployment rate of unskilled workers varies inversely with the market-clearing wage for unskilled labor, but that a change in the minimum wage for unskilled labor in the formal sector has an ambiguous effect. The absence of a stable relation between output and unemployment in the short run, an important prediction of the model, appears to be consistent with the available evidence for developing countries.

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