Capital market integration and optimal employment protection policies

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Abstract

This study analyses the effect of capital liberalization on employment protection policies. I assume two sector model, flexible capital market and rigid labor market. There are two types household, workers and capitalists, and they are risk-averse. While workers have no capital, capitalists have capital. When capital markets is integrated, capitalists can invest their capital to capital markets in foreign countries. Government can set following policies, unemployment insurance, firing taxes, payroll taxes, and capital taxes. Integration of capital markets leads inefficient policies under which the productivity is higher than that in non-integrated capital markets, but there is inequality and high frequency of job destruction.