9

Labor Markets during the 1990s

JAIME SAAVEDRA

Market-oriented reforms became widespread in Latin America and the Caribbean during the 1990s. The expectations of reformers were that the shift toward a more competitive environment—with a change in the role of the state, so that markets would become the main determinant of relative prices and of resource allocation—would reduce inefficiencies, increase productivity, and spur growth. This would result in an increase in labor demand, which would absorb the increase in the labor force. Higher productivity would eventually lead to higher real wages and better jobs.

In turn, critics of the liberal reforms raised concerns about the possible negative impact that trade liberalization, privatization, and the reduction in the role of the state would have on employment, real wages, and earnings inequality—at least in the short run. To the extent that safety nets in many countries existed (and in many cases still exist) only on paper, some of those concerns were justified.

The lack of full recovery of employment and earnings after the macroeconomic crises of the late 1980s and unmet expectations are probably behind the negative perception regarding the impact of economic growth and structural reforms on the labor market. Employment performance was weak, and many analysts and the popular press voiced a perception

Jaime Saavedra is principal researcher and executive director of Grupo de Análisis para el Desarrollo (GRADE), a think tank based in Lima, Peru. *The author thanks Eduardo Nakasone for his superb research assistance.*

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that even if there was economic growth, it was jobless growth. In addition, during the 1990s, macroeconomic stabilization and a more competitive environment induced by structural reforms, which in some countries included labor market reforms, might have changed the labor market adjustment mechanisms. And even though economic volatility was lower in the 1990s, Latin America is still a highly volatile region—as the developments at the end of the decade confirm—which has had an impact on the labor market.

The evidence shows that during the 1990s employment growth responded to economic growth. Where there was growth, there was employment creation, but the former was insufficient to absorb the increase in the labor force. Conversely, as most Latin American economies went into recession in 1997 or 1998, employment growth stopped. Moreover, lower inflation implied that adjustments through employment were more frequent than adjustments through changes in real wages. But the main problem in Latin America is one of low-quality jobs. The informal sector—understood as employment with no social benefits, unemployment protection, or compliance with occupational safety regulations—accounts for more than half the jobs in urban areas and the vast majority in rural areas, and has shown an upward trend, particularly at the end of the decade.

Labor legislation in the region was drafted with the intention of protecting workers and improving their bargaining position, on the understanding that they are the weak side of the labor relationship. Moreover, it was designed to regulate a relationship that was seen as one of intrinsic and permanent conflict between labor and capital. Labor market regulations in Latin America have a long tradition of reducing flexibility and protecting jobs—even at the cost of reducing the ability of firms to adapt to changes in demand. Firms in tariff-protected sectors, as well as public enterprises and the public administration, enjoyed high rents and were able to bear the risks of the high, quasi-fixed costs generated by regulation. An ever smaller group of workers in the modern urban sector were able to enjoy high-quality jobs, even if their productivity was not enough to cover those costs. With the dismantling of tariffs and the higher exposure to competition and integration, many of these jobs disappeared.

Labor market reforms were implemented in some countries, but legislative changes differed widely in depth and even direction. Despite popular perceptions, labor market reforms have been modest. In several Latin American countries not much happened, and in a few cases, labor market regulations were made even more stringent. Regulations are in most cases designed to provide the average worker with social benefits and job protection that are out of line with the average level of productivity. The high labor costs resulting from regulations are paid by high-productivity workers and those firms that are able and willing to finance these benefits, while others escape the regulations through informality. Since econo-

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mies slowed down at the end of the 1990s, and with increases in nonwage costs in several countries, either unemployment or informal employment has increased.

This chapter reviews the employment performance of the region during the 1990s in the context of the structural reforms that many countries implemented, including in several cases labor market reforms. It is difficult to identify regularities common to all or most of the countries, although there are a few stylized facts that have characterized the evolution of Latin American labor markets during the past decade. Female labor force participation rates have increased steadily, the male-female wage gap has decreased, the share of manufacturing in total employment has fallen, and the informal sector has grown. Other factors seem to be common to many countries, but more empirical work is needed to confirm if these facts are transitory or structural changes. For instance, there is evidence of an increase in labor turnover and of higher returns from education.

As will be discussed in the second section of the chapter, in fact there was employment growth, at least until 1997 or 1998, in the context of a slowdown in the increase in labor force participation. At the end of the decade, there was evidence of increased unemployment in several countries. However, the main problem in Latin America seems to be the quality of the jobs available, including that of new jobs. The section reviews several indicators that serve as proxies for changes in job quality. According to almost all the different criteria that may be invoked to measure job quality, the region seems to be creating more low-quality than high-quality jobs. In most countries, the proportion of workers that do not have health or pension benefits has increased. The proportion of workers in the so-called informal or unregulated sector is increasing, regardless of the definition of informal jobs used. Within the formal sector, turnover—as well as the number of workers on temporary contracts—is increasing. Perhaps high job mobility can in principle be consistent with a highly flexible, dynamic, and healthy labor market. But where mobility is coupled with no social benefits and lower or at best stagnant real wages, a feeling of economic insecurity is inevitable.

As is shown in the third section, many of the changes observed in Latin American labor markets may be related to sectoral reallocations of output and employment induced by structural reforms. Trade reforms and financial reforms generated changes in relative prices, in particular an increase in the relative price of nontradables, that had an effect on the sectoral structure of output, and hence on the structure of employment. There is evidence of a reduction in the share of manufacturing jobs in total urban employment. In a simple theoretical framework, trade should have brought an increase in the output of unskilled labor-intensive goods and consequently an increase in the demand for, and the wages of, unskilled workers. However, liberalization, the increase in foreign direct investment, and

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exchange rate appreciation led to an increase in the incorporation of new technologies, which in turn generated an increase in the demand for skilled workers, in most cases for workers with a tertiary education.

Conversely, there was a clear increase in the share of services—both skill-intensive ones, as in the financial and business services sector, and unskilled-intensive ones, as in retail trade. The other important development in the structure of employment was the reduction in public-sector employment in the majority of Latin American countries, due to public administration downsizing and to privatizations.

We also review briefly who could have been winners and losers from the reform of labor markets. Even if we are still dealing with the short-run effects of reforms that have not always been completed, the lack of social safety nets for those who lost as a result of reform had important political economy implications for the sustainability of the reform process. The evidence shows that the proportion of workers with less secure jobs increased, and much of that change was among workers who used to belong to the middle class (those in the public sector, unions, public utilities, and in large manufacturing firms) and as such had more voice and more mechanisms through which they could manifest their discontent.

The chapter's fourth section reviews changes in labor legislation. Despite the popular perception that labor markets have been deregulated massively in Latin America, a review of the changes in legislation shows that changes have in general been modest. Even in such countries as Peru and Argentina, where there were noticeable changes from the extremely regulated labor markets of the 1970s and 1980s, changes have been erratic and postreform labor legislation cannot be considered flexible by any means. In certain cases, partial changes in regulations made things worse by generating distorted and inefficient outcomes. The increase in the use of temporary employment contracts is a good example.

The fifth section analyzes in detail the informal (or unprotected, or unregulated) sector, which is clearly related to the large prevalence of low-quality jobs in Latin America. A better understanding of its behavior and characteristics is crucial for determining what can be done to increase the number of workers with at least a minimum of social protection.

The sixth section reviews the main features of active labor market policies, which have a long tradition in Latin America. The final section concludes with a brief analysis of the policy changes that need to be implemented to improve the functioning of Latin American labor markets.

Employment and Unemployment during the 1990s

The elimination of distortions caused by import-substitution industrialization strategies was expected to spur sustained economic growth on the

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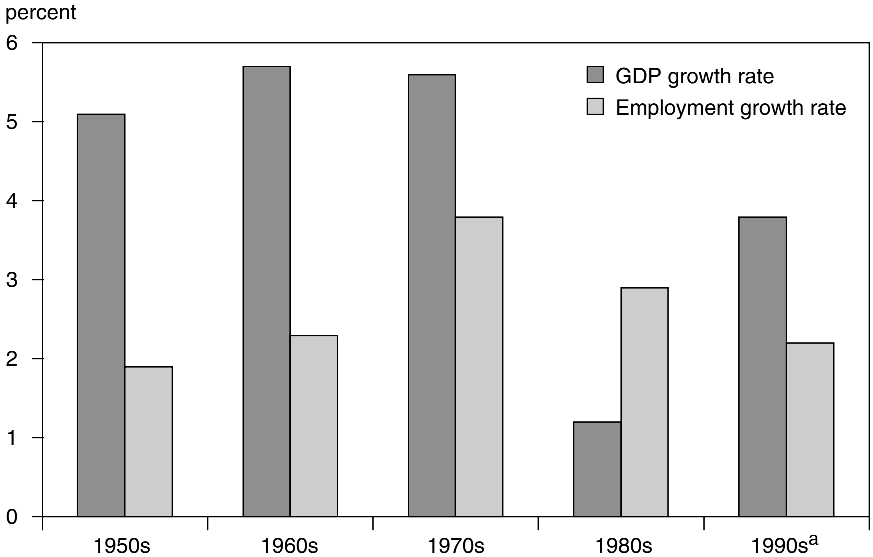
Figure 9.1 Average GDP and employment growth rate of Latin American and Caribbean countries by decade, 1950s-90s (percent)



a. The 1990s include only the 1990-97 period.

Source: Weller (2000).

basis of a more efficient allocation of resources. This growth would generate employment and reductions in poverty rates. Furthermore, simple economic models predicted that trade liberalization would increase the demand for unskilled workers, because the relative abundance of unskilled workers would foster additional growth in sectors intensive in this factor. Therefore, reforms were expected not only to have a positive effect on overall employment, but to have an especially favorable effect on unskilled labor. Moreover, this bias toward unskilled labor was expected to substantially reduce poverty.

However, employment growth in Latin American and Caribbean countries during the 1990s was significantly smaller than in the 1980s. Despite the fact that economic growth was higher during the 1990s than the 1980s (3.9 vs. 1.1 percent), the rate of growth in employment was only 2.1 percent during the latter period, while in the 1980s it reached 2.9 percent (figure 9.1).

The research of Weller (2000) confirms the existence of a positive relationship between economic growth and job creation during the 1990s. Economic growth was not negative for employment; the problem was that job creation was small as a consequence of little growth. Stallings and Peres (2000), on the basis of statistics from Weller, argue that the employment-

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Table 9.1 Female labor force participation rate, selected Latin American countries, 1986-99 (percent)

Country	1986	1992	1995	1999
Argentina	36.7	39.2	40.1	43.9
Bolivia	46.7	46.3	52.8	50.8
Brazil	44.4	50.1	51.3	52.6
Chile	31.6	36.9	39.0	41.4
Colombia	43.7	50.1	49.3	54.6
Costa Rica	39.3	37.3	40.7	44.9
Ecuador	41.3	—	48.2	53.7
Guatemala	—	—	—	54.3
Honduras	45.9	44.2	42.5	53.7
Mexico	29.6	35.6	38.0	42.8
Panama	39.7	43.4	46.9	51.5
Paraguay	52.4	50.7	60.1	—
Peru	—	—	—	62.1
Uruguay	40.3	46.0	47.3	49.6
Venezuela	33.6	39.4	43.3	47.9
Simple average	40.4	43.3	46.1	50.3
Weighted average[a]	39.5	44.6	46.3	50.0

— not available

a. Weighted average using working-age population by country.

Source: UN Economic Commission for Latin America and the Caribbean, *Statistical Yearbook*, 2000.

output elasticity during the 1990s was not significantly different from values found for the 1960s and 1970s. The 1980s were an outlier when, despite the disastrous economic performance, employment grew fast. Employment grew rapidly in the 1980s because the labor force was growing fast, and also because real wages could adjust downward easily in most countries, given the highly inflationary macroeconomic context. This mechanism was no longer available, given the macroeconomic stability achieved during the 1990s. Thus the jobless growth perception so in fashion, at least until 1998, was a consequence of insufficient growth reinforced by lower downward flexibility in real wages.

In part, the lower employment growth during the 1990s was due to demographic factors. As is pointed out by Duryea and Székely (1998), the rate of growth of the working-age population has begun to decline, falling from 3 percent per year in the 1980s to 2.5 percent in the 1990s. The increase in the labor force participation rate during recent decades can mainly be explained by the increase in female participation. During the 1990s, this rate increased sharply in all Latin America countries (table 9.1),[1] although there is evidence of a slowing down in this increase also.

1. The exceptions were Argentina and Uruguay, which witnessed an exogenous baby boom during the late 1960s and early 1970s, as is pointed out by Duryea and Székely (1998) and Kritz (2002).

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The persistent increase in female labor force participation may be signaling structural changes in labor markets. It has increased, on average, by 6 percentage points, with the highest increases in Costa Rica, Colombia, Mexico, and Peru. Duryea, Cox-Edwards, and Ureta (2001) find that increases in female educational attainment explain only a third of the increase in participation. The increase within educational groups may be attributed to the reduction in fertility rates or to a change in females' social status (Berry and Mendez 1999).

Employment evolution is also dependent on the way the labor market adjusts. Despite country differences, lower inflation has meant that almost everywhere wages have stopped being an important adjustment mechanism. Gonzalez (1999) finds some evidence that in countries that carried out price stabilization programs (Argentina, Bolivia, and Chile in an earlier period) the response of employment to output shocks increased during the 1990s, while the wage response fell. The years of recession since 1997 have implied a reduction in employment rates in most countries, while wages have not always fallen at the same time. Instead, unemployment has risen in several countries.

In fact, using information compiled by the International Labor Organization (ILO), based on household surveys, we can see that employment rates (total employment as a percentage of working-age population) moved with the economic cycle (see figure 9.2). Excluding Brazil, employment grew faster than the working-age population, at least until 1997. In Brazil, even if employment growth was positive, it was slower than the growth of the working-age population. In all the other countries, the employment rate grew slightly or remained relatively flat until 1997 or 1998, and since then it has fallen in several countries. The exception was Argentina, where there was a reduction in the employment rate after the Mexican crisis. Thus, employment evolution benefited from the positive economic growth rates achieved following economic stabilization and structural reforms. But in the final years of the decade, employment was curbed by the international financial crises and the resulting lower economic growth rates.

Open urban unemployment has become an increasingly acute problem in Argentina, Colombia, Chile, and Venezuela (table 9.2). Current figures show that on average unemployment rates stand at a high 10 percent, despite the low rate in Mexico and the moderate rate in Brazil. Overall, unemployment rates are in most cases higher than they were during the 1980s. Part of the rise in unemployment seems to be related to the increase in labor force participation rates, but the increase may also be related to the smaller capacity of some economies to adjust to reductions in labor demand through lower real wages.[2]

2. De Ferranti et al. (2002) mention that increases in labor demand in the nontradable and construction sectors observed during the growth period disappeared by the end of the decade.

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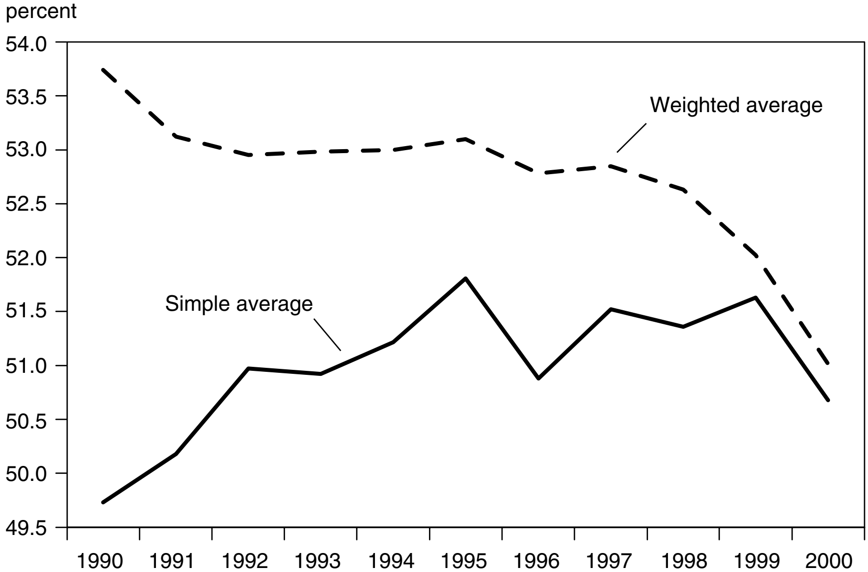
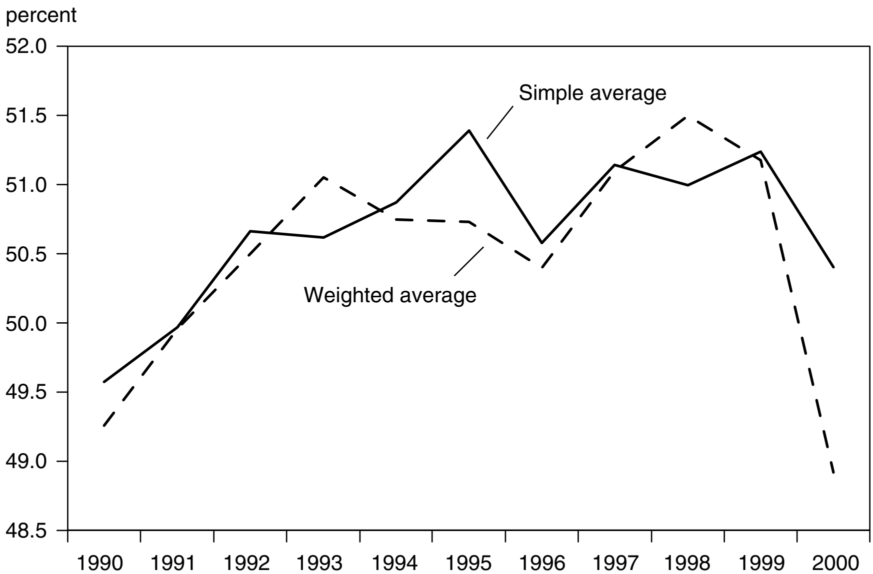
Figure 9.2 Urban employment rates for selected Latin American countries, 1990-2000 (percent)



For all selected countries excluding Brazil



Note: The figure shows simple and weighted averages for Argentina, Bolivia, Brazil, Chile, Costa Rica, Ecuador, El Salvador, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, and Venezuela. The weighted average was calculated using 1995 populations.

Source: ILO (2001).

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Table 9.2 Unemployment rates, selected Latin American countries, 1990-99 (percent)

Country	1990	1993	1994	1995	1996	1997	1998	1999	2000
Argentina	7.4	9.6	11.5	17.5	17.2	14.9	12.9	14.5	15.1
Brazil	4.3	5.4	5.1	4.6	5.4	5.7	7.6	7.6	7.1
Chile	9.2	6.2	8.3	7.4	7.0	7.1	6.9	10.8	10.0
Colombia	10.5	8.6	8.9	8.8	11.2	12.4	15.3	19.4	17.2
Mexico	2.7	3.4	3.7	6.2	5.5	3.7	3.2	2.5	2.2
Peru	8.3	9.9	8.8	8.2	8.0	9.2	8.5	9.1	8.5
Venezuela	10.4	6.6	8.7	10.3	11.8	11.4	11.3	14.9	14.0

Note: Data may vary from country to country because of limitations in the available statistics. For Argentina and Mexico, unemployment rates include only urban areas. For Brazil and Colombia, data are, respectively, from six and seven metropolitan areas. For Peru, data are only for metropolitan Lima. For Chile and Venezuela, data are based on national statistics.

Source: UN Economic Commission for Latin America and the Caribbean, *Statistical Yearbook*, 2000.

In addition, evidence for Colombia suggests that rising unemployment, particularly among the less skilled since 1996, may be related to a sharp rise in nonwage labor costs (Kugler and Kugler 2001). Also, Bergoeing and Morande (2002), in the context of a growth model for Chile, relate the reduction in per capita output in 1999-2001 to a reduction in employment growth, which in turn may be explained by changes in real and perceived increases in hiring costs caused by labor legislation. But in Latin American economies, open unemployment has not always been the best indicator of how quantities are being adjusted and of the labor market situation in general. Given large differences in productivity across sectors, firms, and workers, the largest problem in the labor market is the large segment of the labor force that is in the informal sector or underemployed. The sizable heterogeneity that this implies for the quality of jobs is discussed in the next section.

The Problem of Low-Quality Jobs

Employment growth was biased toward specific groups of workers (as will be discussed in the next section), and there was an increase in the share of jobs that can be considered of low quality. In the early 1990s, the proportion of people who did not have any social benefits was already very high. In most countries, rates of informal employment, as defined by the ILO, were between 40 and 50 percent.[3] By the end of the decade, these

3. In the ILO definition, workers in the informal sector are those who work in small firms, either as wage earners or as microentrepreneurs, nonprofessional self-employed persons, domestic workers, and unpaid family workers.

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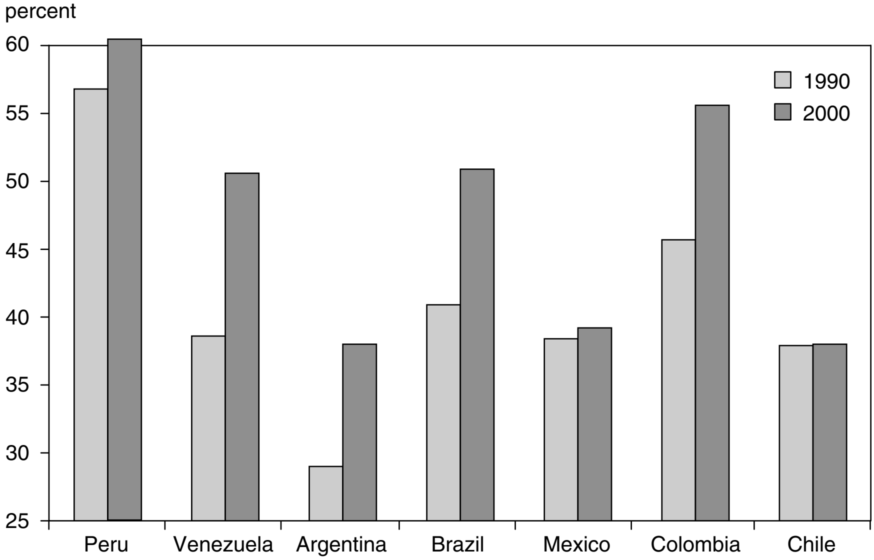
Figure 9.3 Informal-sector employment in Latin America, 1990 and 2000 (percent of nonagricultural employment)



Sources: The data for Chile, Colombia, Venezuela, and Mexico use the International Labor Organization definition (ILO 2001). The data for Peru are from the National Household Survey (MTPS-INEI); for Argentina, from Gasparini, Marchionni, and Sosa-Escudero (2000); and for Brazil, from Ramos (2002). Informal-sector rates for Peru and Argentina are based on compliance with regulations and correspond to metropolitan Lima and greater Buenos Aires, respectively. The evolution in these cases roughly coincides with that calculated using the International Labor Organization definition. In Brazil, the informal sector includes salaried workers (*sem carteira*) and self-employed persons.

rates had increased in most countries, as is shown in figure 9.3. The share of jobs in the informal sector clearly increased in Argentina, Brazil, Mexico, Peru, and Venezuela. Using a different definition based on compliance with tax and labor regulations, or access to social benefits, changes in the rate of informal employment were similar. Only in Chile did the informality rate stay constant.

It should be noted that these estimates of the proportion of unprotected jobs are limited to urban areas. In countries that still have a large rural population, when this population is included, informal employment rates (or the proportion of unprotected jobs) may jump to the 60 to 70 percent range.[4]

4. Also, it should be noted that the definition of "informal" is arbitrary. When a legalistic definition is used, it is clear that there are small firms that operate formally, and there are also large firms that hire workers informally. Moreover, many firms are formal with the tax authorities while informal with the labor authorities.

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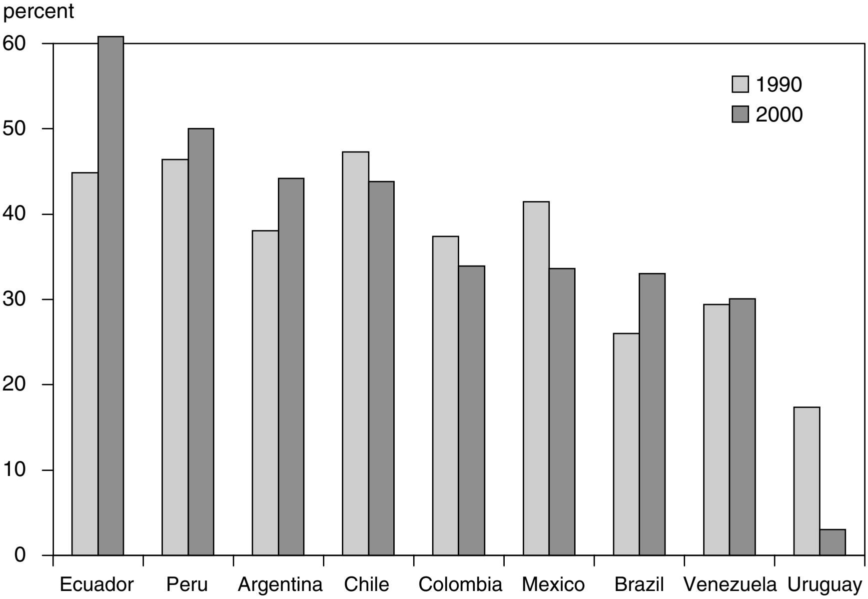
Figure 9.4 Percentage of salaried workers with no access to social security, selected Latin American countries, 1990 and 2000



Sources: ILO (2001). Data for Chile are from Packard (2001) and correspond to the percentage of the economically active population with no contribution to social security. The final period corresponds to 1999.

As is shown in figure 9.4, the percentage of wage earners with no access to social security, either health or pension benefits, increased in most countries, with the exception of Chile, Colombia, Mexico, and Uruguay. In these countries, moreover, salaried employment decreased as a proportion of employment. This is also related to the high figure for self-employment and for the proportion of employment in microenterprises and small firms. Self-employment in countries belonging to the Organization for Economic Cooperation and Development (OECD) ranges between 5 and 15 percent of the labor force, and only Portugal, Spain, and Italy have rates between 15 and 25 percent. In Latin America, self-employment rates are between 25 and 45 percent. A minority of self-employed people own small firms or microenterprises that create salaried jobs, and most of them are self-employed in the nontradable sectors. Even if in some cases they are voluntarily in that type of job, high self-employment rates reflect low average productivity and wages.

There is evidence that job mobility has increased in several Latin American countries. Even for prime-age male workers, turnover increased, at least in Argentina and Peru (figure 9.5). Galiani (2001) shows that turnover

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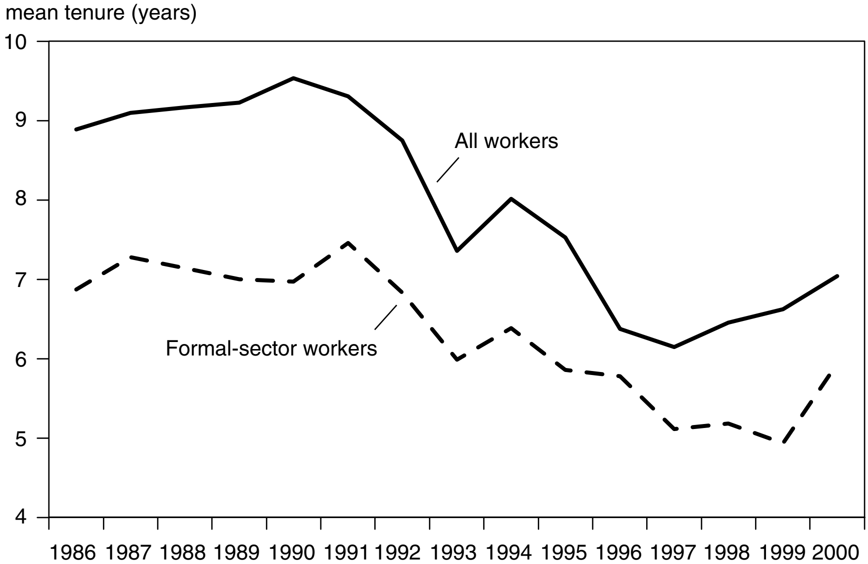
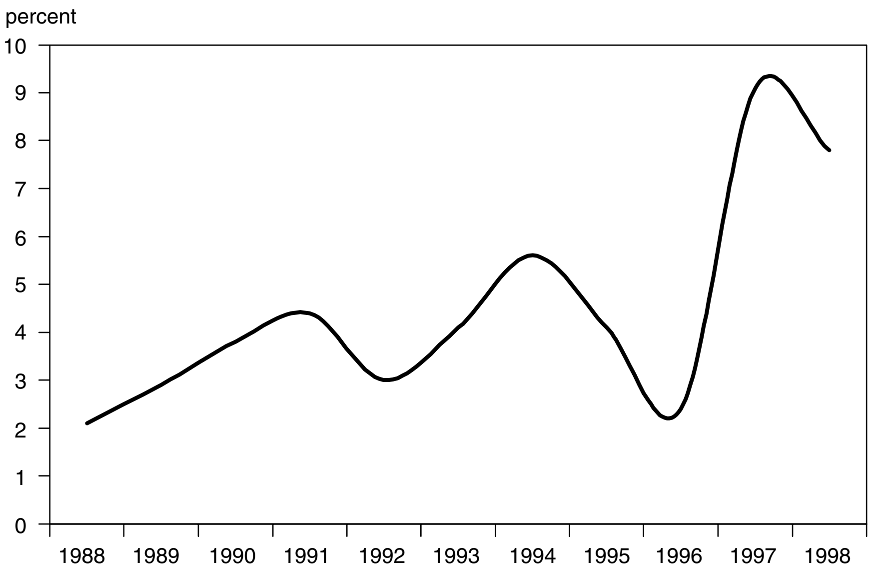
Figure 9.5 Job mobility in Peru and Argentina

Job tenure in Peru, 1986-2000 (years)



Job turnover as a percent of total employment in Argentina, 1988-98



Sources: For Peru, National Household Survey (MTPS-INEI) for 1986, 1988, 1989-95, 1997-2001, metropolitan Lima only. For Argentina, Galiani (2001), calculated using household surveys for all urban agglomerations (25 urban regions surveyed between 1987 and 1998).

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in Argentina increased dramatically by the end of the decade. In Colombia, there is evidence of an increase in turnover in the formal sector (Kugler and Cardenas 2003), while for Peru, Saavedra and Torero (2003) show that mean job duration among male salaried formal workers 25 to 65 years of age fell from 9.5 years in 1986 to 6.4 in 1997. Maloney (2001) reports that mean tenure—a proxy inversely related to turnover—is much lower in Mexico than in OECD countries.

This increase in job turnover may also be signaling a more intensive use of contractual arrangements that facilitate turnover, with an increase in the amount of risk that firms are able to transfer to workers. Even if this could be read as a positive development and reflect a more efficient reallocation of labor, it might still result in a reduction in welfare for currently working people.

Another summary indicator of the quality of jobs is the real wage. It is very difficult to find regularities regarding wages over the whole region. But except in the case of Chile, the increase in real wages (although positive in most cases in the 1990s) was not enough to recover from the reductions experienced during the 1980s. Another important fact is that, at least partly because of lower inflation, real wages seem to be less volatile than they were in the 1980s. Some of the data available for real wages are shown in figure 9.6. There is some evidence of small increases in real wages in the formal sector of the economy. They rose in Bolivia, Colombia, Ecuador, and Peru, remained relatively constant in Argentina, and fell in Venezuela.

In most countries, therefore, the past decade has brought increases in real earnings in the formal sector. This might be partly related to the increase in productivity observed in the modern sector, in particular in manufacturing. As is shown in figure 9.7, if data are pooled for Brazil, Chile, Colombia, and Peru, there was a clear positive correlation between productivity and real wages in manufacturing during the 1990s.

Nevertheless, no increase in productivity was observed in the informal sector.[5] Figure 9.8 reveals that earnings in the informal sector increased in Bolivia and Argentina, decreased in Colombia, Venezuela, and Ecuador, and remained fairly constant only in Peru. Simple comparisons of the evolution of wages in the formal and informal sector suggest that the benefits of economic recovery have not been spread uniformly. Increases in productivity were observed in certain sectors but not throughout the economy. Figure 9.9 shows that there was a clear increase in productivity in manufacturing in all countries except Venezuela. But in the tertiary sector (table 9.3), where most informal jobs are, and where most of the new jobs

5. Depending on how informality is conceptualized, informal workers and firms are in that sector precisely due to their low and stagnant productivity.

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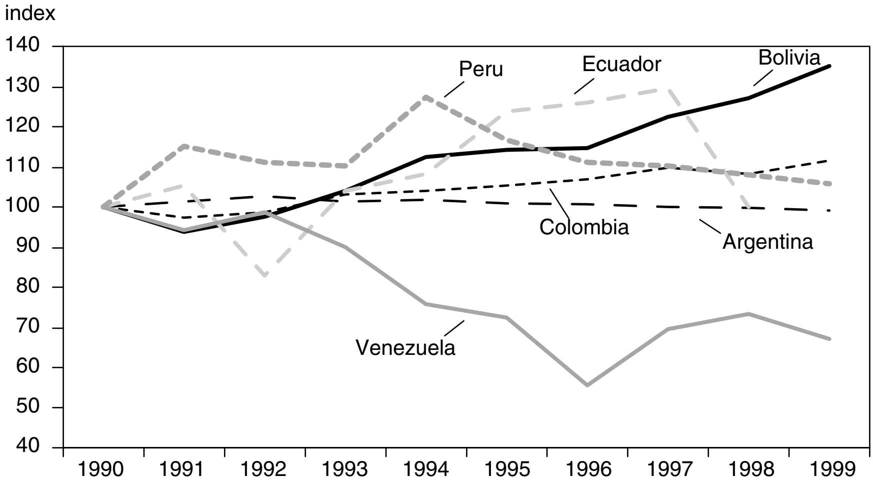
Figure 9.6 Evolution of real wages in the formal sector, selected Latin American countries, 1990-99 (index: 1990 = 100)



Note: Data for Argentina include only wages in manufacturing. Data for Bolivia include the private sector in La Paz. Data for Colombia include only blue-collar workers in manufacturing. Data for Ecuador include nonagricultural firms with more than 10 employees. Data for Peru include blue-collar workers in the private sector (for metropolitan Lima only). Data for Venezuela include blue-collar and white-collar workers in urban areas.

Source: UN Economic Commission for Latin America and the Caribbean, *Statistical Yearbook*, 2000.

were concentrated, labor productivity growth was much lower and was even negative at the end of the 1990s.

Finally, the quality of jobs is also related to economic insecurity. Even though at the macroeconomic level there was less volatility during the 1990s than in the 1980s in GDP growth, in consumption growth, and in labor market aggregates (De Ferranti et al. 2000), there is evidence that insecurity related to the operation of the labor market at the microeconomic level was on the rise. For instance, there is evidence in Argentina and Peru of more economic insecurity among workers in the formal sector. As was shown in figure 9.5, in these two countries turnover increased among formal workers, a phenomenon that is probably related to the increased flexibility needed by firms exposed to a more competitive environment, to the increase in employment in smaller firms, to the reduction in the bargaining power of unions, to the reduction in public-sector employment, and to changes in legislation.

Moreover, in Colombia and Peru more workers now have temporary jobs (figure 9.10)—jobs that in some cases not only explain most of the growth of formal employment but have even replaced permanent jobs. These changes have generated high employment uncertainty for seg-

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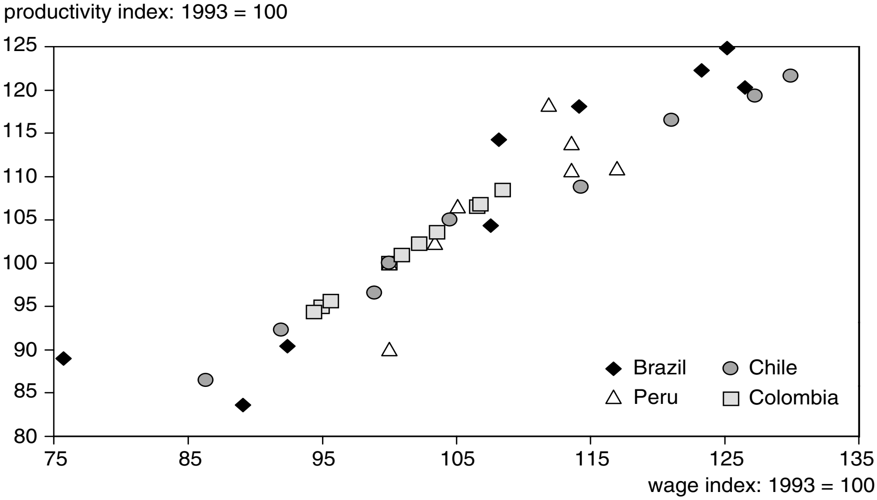
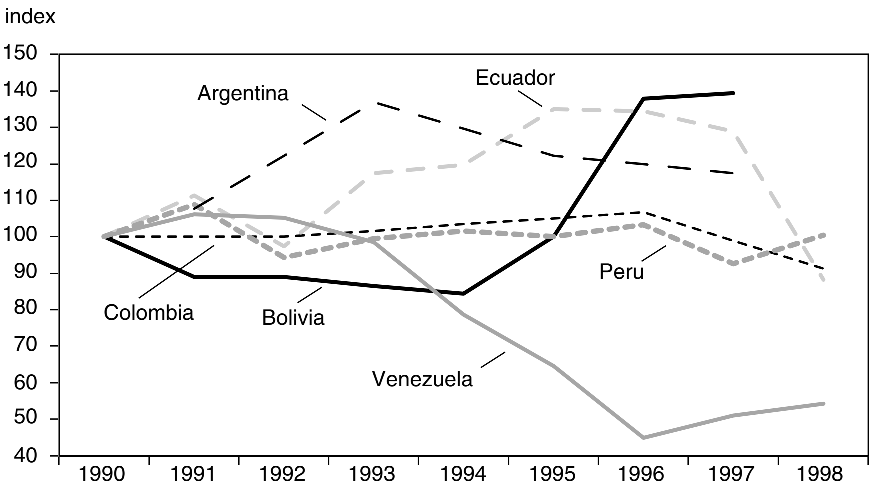
Figure 9.7 Productivity and real wages in manufacturing, selected Latin American countries, 1990-99 (index: 1993 = 100)



Note: Data for Peru include blue-collar workers in the private sector for metropolitan Lima only.

Source: UN Economic Commission for Latin America and the Caribbean, *Statistical Yearbook*, 2000.

Figure 9.8 Evolution of real wages in the informal sector, selected Latin American countries, 1990-98 (index: 1990 = 100)



Sources: Data for Bolivia, Colombia, Ecuador, Peru, and Venezuela are from Egger and García (2001). Data for Argentina are from Arango and Maloney (2000).

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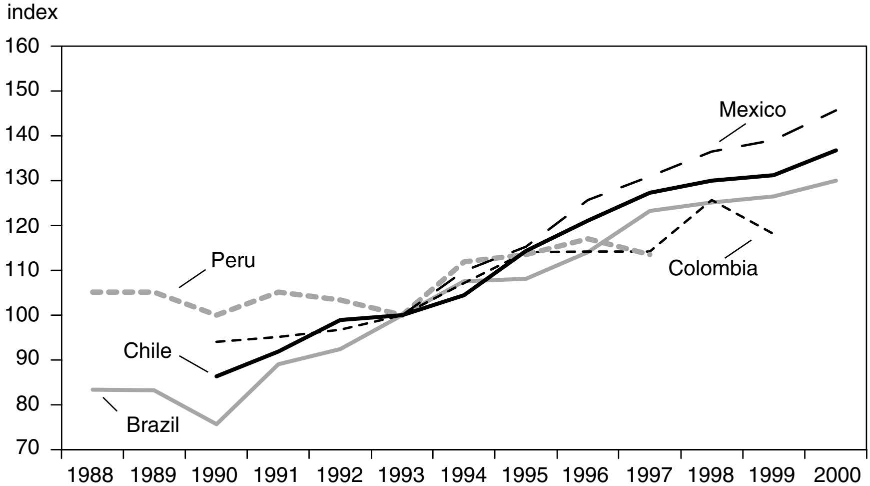
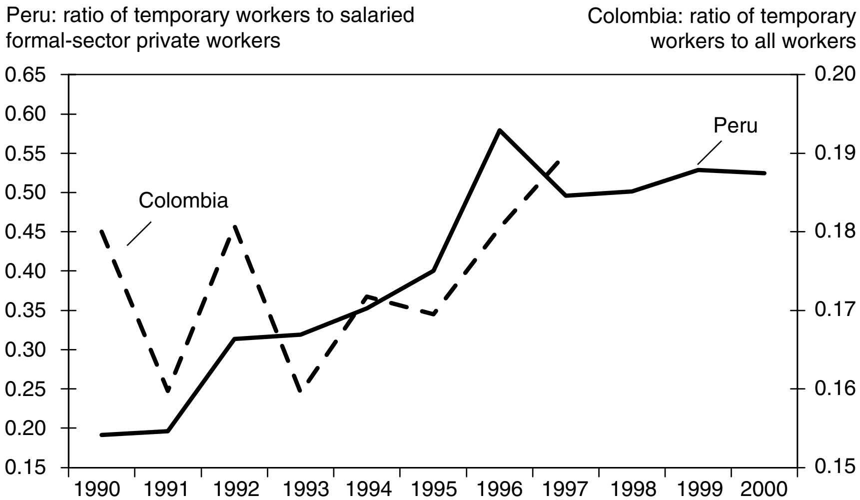
Figure 9.9 Labor productivity in manufacturing, selected Latin American countries, 1988-2000 (index: 1993 = 100)



Sources: Due to the lack of a unique source for calculations of productivity, data are from diverse sources: for Brazil, Instituto de Pesquisa Econômica Aplicada; for Colombia, Reyes (2000); for Peru, National Household Survey, MTPS-INEI; for Chile, Chilean Central Bank; and for Mexico, Instituto Nacional de Estadística Geografía e Informática. For Colombia and Mexico, respectively, the coffee-processing industry and the *maquila* industry are excluded. For Chile, the average product per worker is taken as a proxy.

Figure 9.10 Temporary worker contracts in Peru and Colombia, 1990-2000 (ratios)



Sources: For Colombia, Reyes (2000). For Peru, MTPS-INEI data for metropolitan Lima.

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Table 9.3 Labor productivity in Latin America by economic sector, 1970-97 (annual average percent growth)

Sector	1970-80	1980-90	1990-94	1994-97
Primary	1.8	2.4	3.2	5.6
Secondary	1.1	–0.6	3.6	4.0
Tertiary	1.5	–3.1	0.1	–1.7
Total	2.2	–1.3	2.0	0.8

Source: UN Economic Commission for Latin America and the Caribbean, *Estudio Económico para América Latina y el Caribe*, 1997-98.

ments of the employed population in the formal sector that have traditionally been shielded from fluctuations and that enjoyed job protection stemming from legislation, from working in high-rent sectors, or from working in the public sector.

The Labor Market's Winners and Losers from Structural Reform

The interaction of a set of structural reforms in Latin America had important effects on the operation of the labor market, even if many of the long-run effects are not yet clear. Market-friendly reforms, together with economic integration, influence modes of production, adoption rates of new technologies, human resource policies, and labor demand patterns whose long-term effects are not yet known. Yet even in the short run, trade reform, public-sector downsizing, privatization, and reductions in unionization have had large and profound effects on the labor market opportunities of specific demographic and occupational groups.

Even if the process of job creation and destruction led to a net increase in employment, some jobs were destroyed and some workers lost their jobs, while jobs were created in other sectors and for other workers. Overall, employment opportunities fell for older workers, particularly males. Pages, Duryea, and Jaramillo (2001) report that despite much larger unemployment rates among youth than adults, the gap has fallen in most Latin American countries because unemployment among adults increased more rapidly. Workers who lost their jobs in large manufacturing firms, in unionized firms, in the public administration, or in the public financial system may have dropped out of the labor force after remaining unemployed for a while, unless they found a job in the informal sector. An important regularity that may be crucial for reform's sustainability and political and popular support is that most of the burden of the labor reallocation was on the shoulders of the middle class and in some cases the upper-middle class.

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Trade and Financial Liberalization

Labor markets were affected by trade liberalization, although probably less than many critics expected. One of the arguments of the opponents of an opening of the economy was that the manufacturing sector was going to be adversely affected, because the formerly protected industries would be unable to compete with imports. In fact, in several countries (e.g., Argentina, Brazil, Colombia, and Peru), there was an important transformation within the manufacturing sectors. Several manufacturing subsectors almost disappeared, and several capital goods sectors shrank. Manufacturing imports increased in most countries. Many large firms in such industries as chemicals and plastics turned to importing the same goods that they previously manufactured locally. At the same time, however, several other manufacturing industries that enjoyed some degree of natural protection grew (e.g., beverages, cement, and metallic products), as economies entered a period of fast growth between 1993 and 1998.

In countries such as Argentina, Brazil, and Peru, the capital inflows generated an increase in the prices of nontradables, which translated into an increase in the demand for labor in that sector, leading to an increase in employment in commerce and in services (Camargo et al. 2000; Pascó-Font and Saavedra 2001). In Colombia, employment in the nontradable sector increased, particularly in commerce, while manufacturing employment fell in absolute terms.

Although in some countries the decline in the level of manufacturing employment was short-lived, in all cases there was a reduction in the share of manufacturing in total employment, as is shown in figure 9.11. In most Latin American countries, services increased their share in total employment, both in such skill-intensive sectors as finance, insurance and banking, and business services, and in such unskilled-intensive sectors as retail and wholesale trade. In some countries, the increase was larger in the case of unskilled-intensive sectors. The reduction in the share of manufacturing is the continuation of a long-run trend, although it seems to have been more pronounced during the 1990s (figure 9.12).[6] The same pattern is observed in OECD countries.

Trade liberalization was also presumed to affect the structure of earnings. Goldberg and Pavcnik (2001) show that in Colombia relative wages fell in industries where tariff reductions were higher. In protected sectors, rents allowed for higher than market-clearing wages, which fell as rents disappeared. Tariffs fell more in sectors intensive in low-skill labor, so less educated workers were hardest hit by the liberalization.

6. Moreover, there is no evidence that trade liberalization has any relationship with unemployment, as shown by Maloney (1999). In cases where unemployment has increased sharply, particularly in Argentina and Colombia at the end of the decade, this occurred years after the onset of liberalization and seems linked mainly to macroeconomic conditions.

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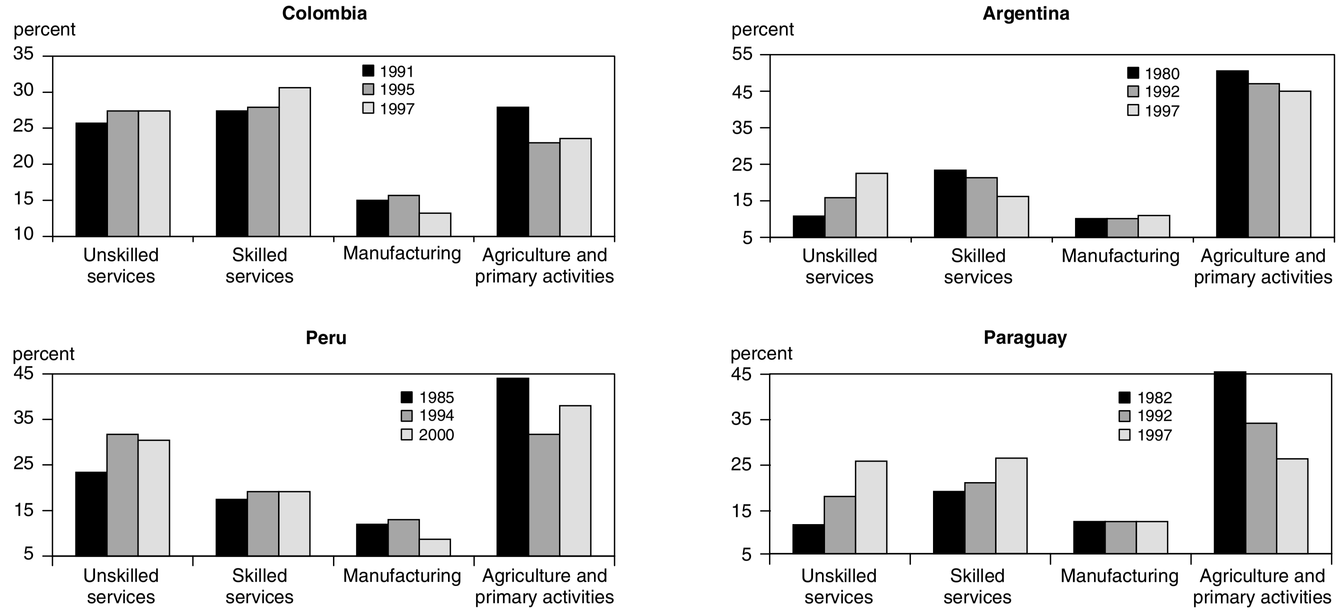
Figure 9.11 Changes in employment composition, selected Latin American countries, various years



Note: For Argentina, unskilled services include trade, employment in restaurants and hotels, and transport and communications; skilled services include utilities, financial services, and other services. For Colombia, unskilled services include trade and communications; skilled services include financial services, utilities, and other services. For Peru, trade, restaurants and hotels, and transport and communications were included in the unskilled services category; financial services, public-sector employment, utilities, and other services were considered as skilled services. For Paraguay, unskilled services include trade and transport; skilled services include utilities, financial services, and other services.

Sources: For Argentina, data are from Frenkel and González Rosada (2001). For Colombia, data are from Ocampo, Sánchez, and Ernesto Tovar (2001). For Peru, employment composition was calculated using data from the World Bank's Living Standards Measurement Study for 1986, 1994, and 2000 (available at www.worldbank.org/lsms/). For Paraguay, data are from Gibson, Molinas, and Moli (2001).

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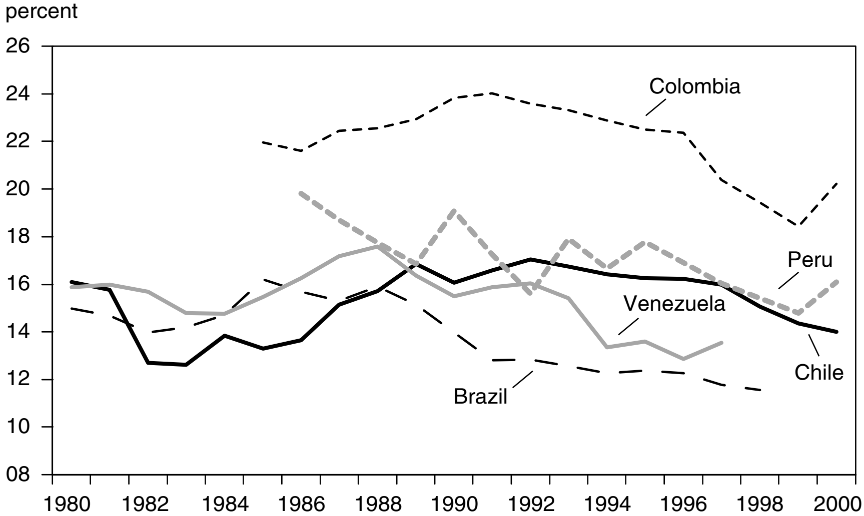
Figure 9.12 Employment share of manufacturing, selected Latin American countries, 1980-2000 (index: 1980 = 100)



Sources: Data are from LABORSTA (http://laborsta.ilo.org) except for Peru, for which data are from the National Household Survey (MTPS-INEI) and include metropolitan Lima only.

In a simple Heckscher-Ohlin framework, trade should have brought an increase in demand for unskilled-labor-intensive goods and consequently an increase in the demand for and wages of unskilled workers. But there is evidence pointing toward the opposite result. Even if in most countries there has been an increase in the supply of skilled workers, there is evidence of an increase in returns to education, particularly tertiary education. Evidence consistent with this trend is presented by Blom, Holm-Nielsen, and Verner (2001) for Brazil; Contreras, Bravo, and Medrano (1999) for Chile; Cárdenas and Bernal (1999) for Colombia; Gindling and Robbins (1999) for Costa Rica; and Saavedra and Maruyama (1999) for Peru. Trade liberalization, together with a more favorable environment for foreign direct investment and exchange rate appreciation, facilitated the absorption of new technologies, which may at least be partially related to an increase in the demand for skilled workers.[7] Consistently, the earnings gap between skilled and unskilled workers increased in several countries, as is reported by Weller (2000) and shown in figure 9.13.

How much of these changes in the returns to education can be linked directly to trade is not clear. As is suggested by Behrman, Birdsall, and Székely (2000a), reform may have reduced the price of capital goods through a decrease in financial costs. Pascó-Font and Saavedra (2001) show that in

7. In most cases, the increase in educational differentials is concentrated on workers with tertiary education.

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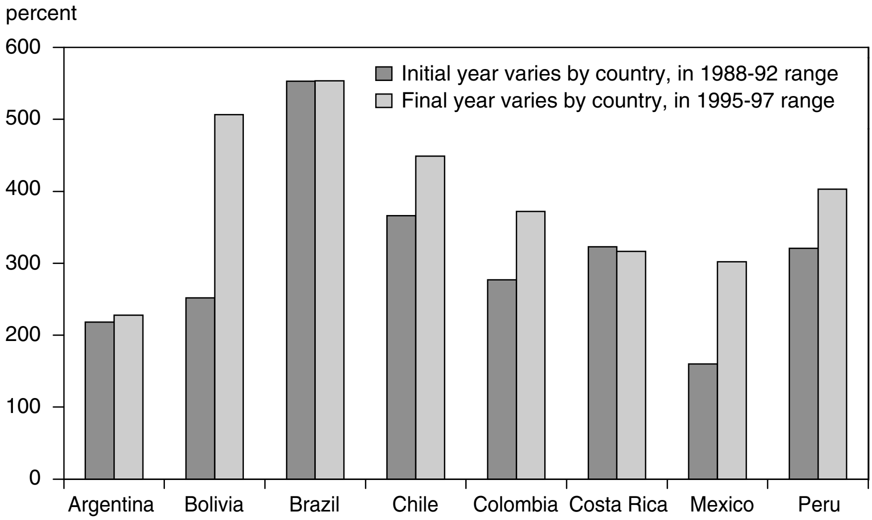
Figure 9.13 Wage of workers with tertiary schooling relative to wage of workers with 7 to 9 years of education, selected Latin American countries



Sources: Weller (2000).

Peru there was a clear reduction in the relative price of imported machinery and an increase in capital goods imports. This may have induced substitution of the complementary factor of capital, skilled labor, against unskilled labor, with potentially negative effects on poverty and inequality. However, recent findings by Morley (2000) show evidence against this effect. Morley examines the evolution of the capital-labor ratio across several Latin American countries and does not find any clear pattern. Moreover, aggregate indices may be hiding within-country changes, and both financial liberalization and the increase in foreign direct investment that accompanied it may have had an effect on particular sectors.

Another, less optimistic interpretation of the increase in returns to education is that many countries in Latin America have experienced a deterioration of the quality of education. In a process that has not yet been well studied, firms may be hiring highly educated persons to perform tasks that in industrial countries are assigned to less educated people. As an example, many Latin American banks hire college graduates as tellers or administrative assistants, tasks that are performed by less educated workers in other countries.[8]

8. In that situation, education may pay from a private point of view, even though socially it just increases the dispersion of earnings around a stagnant mean.

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Also, it should be noted that in most countries the increases in educational earnings differentials were concentrated in tertiary education. Secondary education premia over primary education fell in most cases. Gonzaga, Menezes Filho, and Terra (2002) conclude that in Brazil the reduction in the returns to secondary education may well be explained by the trade-related fall in the relative price of goods whose production is intensive in this type of worker. Overall, evidence points to a worsening in the relative economic position of workers with a secondary education and to an insufficient quantity and quality of more-educated workers.

Downsizing and Privatization

The short-run employment effect of privatization has not yet been well studied. Chong and López-de-Silanes (2003) report that using a large sample of privatized firms in Argentina, Brazil, Colombia, Mexico, and Peru, on average the change in employment in these firms is negative. However, contrary to popular opinion, there is some evidence that privatization had a positive effect on aggregate employment. Chisari, Estache, and Romero (1999), using a computable general equilibrium model, show that the increase in unemployment observed in Argentina in the mid-1990s was mainly related to the tequila effect and not to the privatization of utilities. Pascó-Font and Torero (2001) show that telecommunications privatization in Peru had a negative direct effect on employment but a total positive effect when indirect jobs, mainly through subcontracting, are taken into account.

Employment in the public sector fell in several Latin American countries, both as a consequence of privatization and because of public administration downsizing programs. As is shown in figure 9.14, in Argentina, Colombia, Mexico, Peru, and Venezuela, the share of public-sector employment in total urban employment fell by around a quarter. Only in Brazil and Chile was there an increase in public employment.

However, even if (and in some cases it is a big if) the net change in employment after privatization (or the downsizing of public administration) was positive, the quality of the jobs lost was higher than the quality of new jobs. Unfortunately, many of these high-quality jobs resulted from huge inefficiencies, for many of them were supported by quasi-rents appropriated by public-sector workers who had for a long time been used to higher-than-productivity wages, low effort, weak monitoring, lack of meritocratic promotion mechanisms, and job stability. Because few attempts were made to design appropriate compensation packages, downsizing and privatization implied huge welfare losses for specific demographic groups, whose possibilities of finding another job with similar wages and fringe benefits were very slim.

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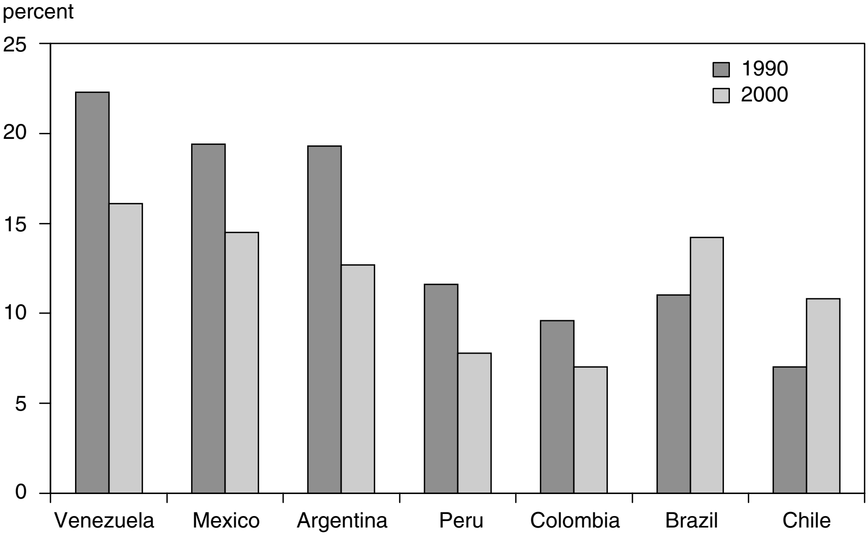
Figure 9.14 Public-sector employment, selected Latin American countries, 1990 and 2000
(percent of nonagricultural employment)



Source: ILO (2001).

Implications for Political Economy

The changes in employment patterns and the employment shocks suffered by specific segments of the population are behind the weak support for reform in Latin American countries. Reductions in public-sector employment meant that fewer of the jobs that have traditionally been shielded from economic fluctuations were protected. And many of those who lost such jobs were not able to find another job with the same level of protection, earnings, and social benefits—or were not able to find a job at all.

Privatizations were not (and should not be) designed to create jobs directly. Privatization is advisable as long as the private sector is better at providing a service than the public sector, provided it is appropriately regulated. Well-implemented privatizations should result in a more efficient provision of services, higher productivity, and eventually more jobs. However, privatization lost appeal due to both (1) a lack of transparency and in some cases blatant corruption, and (2) the direct negative effect on employment in the privatized firms. Even if it is true that many workers who lost their jobs had been extracting rents from the rest of the economy, from a political-economy and a social perspective countries should have offered them appropriate compensation packages.

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These workers were playing by established rules not written by them, and changing the rules of the game for a worker in the middle of her career may lead to serious welfare losses. A large proportion of the workers who lost their jobs used to belong to the middle class, and as such had more voice and more mechanisms through which they could manifest their discontent. This was a radical shift from previous decades, when during macroeconomic downturns the middle class, even if not totally shielded from real wage losses, was at least shielded from losing a job.[9]

There is evidence of strong demand for job stability in Latin America. For instance, in Brazil in 1999 a million people queued for a total of 10,000 stable, formal jobs at the Banco do Brasil (Rodrik 1999). In Peru and Argentina, there is an excess supply of public-sector teachers, even though real salaries have been falling, because these jobs have almost total stability. Workers' willingness to accept lower wages in return for job stability seems to be very high in Latin America.

Changes in Labor Legislation

The United States started regulating its labor market at the federal level during the New Deal, while most European countries had started a few decades earlier (Lindauer 1999). Most Latin American countries started drafting labor legislation in the 1930s, despite their low level of economic development. Labor codes in the region were traditionally designed to protect workers and improve their bargaining position, on the assumption that they were the weak side of the labor contract. Moreover, they were designed to govern a relationship that was assumed, once an urban industrial labor force had emerged, to be one of intrinsic and permanent conflict between labor and capital.[10] In a more neoclassical interpretation, labor regulation was required to counter the existence of asymmetric information and free-riding problems.[11]

The institutions that were created in Latin America were a powerful tool to govern labor relationships in the modern sector of the economy,

9. See Graham and Pettinato (2002) for a discussion on how the reduction of well-being of the middle class may affect the political sustainability of economic reforms.

10. Interestingly, the chapter of the 1931 Chilean Labor Code that pertained to collective bargaining was titled "Collective Conflict" (cited in Edwards and Cox-Edwards 2000).

11. E.g., employers have more information than employees about occupational safety and the economic and financial situation of the firm. Workers may not be willing to save for retirement, assuming that the state or their offspring will support them when they are old. Capital markets are not willing to finance unemployment periods of low-skilled workers so they cannot insure themselves adequately. Finally, minorities and ethnic groups may suffer from labor market discrimination. All these market imperfections justify labor market regulations (Pages and Saavedra 2002).

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but they left huge segments of the labor force totally out of the game. Latin American labor legislation is recognized as among the most restrictive, rigid, and cumbersome in the world, probably only behind that in India and West Africa (Rama 1998). In almost all Latin American countries, labor legislation favors permanent contracts, which limits the use of temporary contracts and other atypical contracts. However, permanent contracts carry high dismissal costs and very high nonwage labor costs, including health and pension contributions, occupational training taxes, payroll taxes, family allowances, vacations, and unemployment subsidies. Moreover, maternity and sick leave, annual bonuses, compulsory profit sharing, and occupational health and safety provisions are heavily regulated. The health and pension systems are plagued by special regimes and exceptions.

Labor market reforms were implemented in several countries, but legislative changes differed widely in depth and even in direction. Despite the popular perception that labor markets have been deregulated massively in Latin America, a review of the evolution of legislation shows that these changes have been diverse and generally modest. In several countries, not much happened, and in a few cases labor market regulations were made even more stringent. In some countries that opened their economies (e.g., Argentina, Colombia, and Peru), there were noticeable changes, particularly in comparison with the extremely regulated labor markets of the 1970s and 1980s.

In these liberalizing countries, job stability rules were made less stringent and firing costs fell. However, in Argentina, Colombia, and Peru, reforms of the pension system, including the use of individual retirement accounts, generated an increase in nonwage labor costs. In other instances where changes have been observed, partial changes in regulations actually made things worse by generating distorted and inefficient outcomes. In Brazil and Chile, labor reforms at the beginning of the 1990s were part of a response to democratization and involved a move in a more protectionist direction (Cook 1998; Amadeo, Gill, and Neri 2000). In Mexico, no major changes occurred, despite much debate. Changes in Bolivia, Paraguay, and Venezuela were small and tended to increase formal workers' rights. The main developments in this area are presented below.

Job Protection and Firing Costs

Most Latin American countries use severance payments as a mechanism to protect workers in the event of unemployment. They are usually calculated as multiples of the monthly salary, and they increase with tenure. These payments are liabilities of the firm that have to be paid if the worker is fired under a circumstance that is not considered a "just cause" by law. On the one hand, these resources allow the worker to smooth income.

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Table 9.4 Changes in the job security index as calculated by Heckman and Pages between 1990 and 1999, selected Latin American countries

Direction of change of index	Country	
Increased	Brazil	
	Chile	
	Dominican Republic	
Remained constant	Argentina	El Salvador
	Bolivia	Mexico
	Costa Rica	Paraguay
	Ecuador	Uruguay
Fell	Colombia	Peru
	Nicaragua	Venezuela
Average for Latin America: 3.1		
Average for OECD: 1.6		
Average for Caribbean: 1.9		

OECD = Organization for Economic Cooperation and Development

Note: The job security index reported in Heckman and Pages (2003) takes into account advance notice, the discounted cost of severance payments adjusted by the probability of dismissal after different time periods and by the probability that economic difficulties of the firm are considered a "just cause," and payments to individual savings accounts. Figures are reported in average monthly wages.

Source: Heckman and Pages (2003).

They also act as a deterrent to firing. On the other hand, as is discussed below, these obligations increase labor costs and reduce the likelihood of hiring. A few countries—Brazil, Colombia, Ecuador, Peru, and Venezuela—in addition to severance payments, use some sort of individual savings accounts, from which funds may be withdrawn by the worker in the event of unemployment.

Heckman and Pages (2003) and Vega (2001) document in detail changes in dismissal costs and other forms of protection against the event of job separation. According to the data they compiled, dismissal costs are much higher in Latin America than in OECD countries, and the reduction during the 1990s was on average small. A summary of their calculations is presented in table 9.4. The small average change, however, hides many different stories. In Brazil, severance payments increased with the 1988 Constitution, and the fine for unjust dismissal was raised from 10 to 40 percent of the worker's FGTS account balance.[12] In Chile, 1990 labor re-

12. The FGTS is the Fundo de Garantia por Tempo de Serviço. It is an individual account held by the worker to which the firm contributes regularly. This fund may be used by workers who quit or are laid off.

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forms increased the ceiling for severance payments from 5 to 11 monthly wages. Severance also included a 20 percent additional charge if no just cause of dismissal could be proved. In Ecuador, the severance payment profile was made steeper, increasing dismissal costs (figure 9.15).

In the other countries where changes were made, dismissal costs were reduced. In Colombia, there was a reduction in dismissal costs, as severance payment rules, tied to the monthly wage at the moment of dismissal, were replaced by individual savings accounts, with monthly payments tied to the current salary. Employers have to make compulsory deposits to their workers' accounts.[13] In Peru, the tenure-related severance payments schedule was made less steep, but the most important change in dismissal costs was the elimination of the obligation to reinstate a worker in his or her job if a labor court determined that the dismissal had no just cause. In Nicaragua and Panama there were also reductions in dismissal cost. Finally, in Venezuela, the requirement of "numerical stability" was eliminated, and in 1997, changes in the rules for the calculation of severance payments implied an effective reduction in dismissal costs. Overall, dismissal costs in Latin America are much higher than in OECD countries, despite lower levels of productivity and income.

The cost of dismissing a worker is also highly influenced by the specific motives that the law in each country accepts as just cause and by the attitudes of labor courts. In Argentina, Chile, Colombia, and Peru, dismissal costs were reduced through an increase in the array of causes that firms could claim for making lower severance payments, mainly the inclusion of economic factors as a just cause for firing. In Mexico, no formal changes to legislation regarding job dismissals have been made, but the attitude of labor courts has changed, leaning less toward preserving the jobs of specific workers (Calderon 2000). Edwards and Cox-Edwards (2000) also mention changing attitudes of labor courts as important sources of effective changes in dismissal costs in Chile, particularly during the 1980s. In Peru, labor courts were also more relaxed in allowing firings under the just-cause clause.

Heckman and Pages (2003) review a large set of studies and conclude that severance payments have an effect on turnover, average employment, and the composition of employment. Specifically, there is evidence for Colombia (Kugler and Cardenas 2003) and Peru (Saavedra and Torero 2003) that the reduction of job security increased turnover, particularly in the formal sector. Conversely, Paes de Barros and Corseuil (2001) find that the increase in job protection in Brazil reduced employment exit rates. In Peru and in Argentina (Mondino and Montoya 2002), there is evidence of a significant negative labor demand impact of dismissal costs in the formal sector. Kugler (2002) shows that the move in Colombia from severance

13. This implied a reduction in the sum that had to be paid by the firm in the event of a dismissal, but a higher nonwage labor cost.

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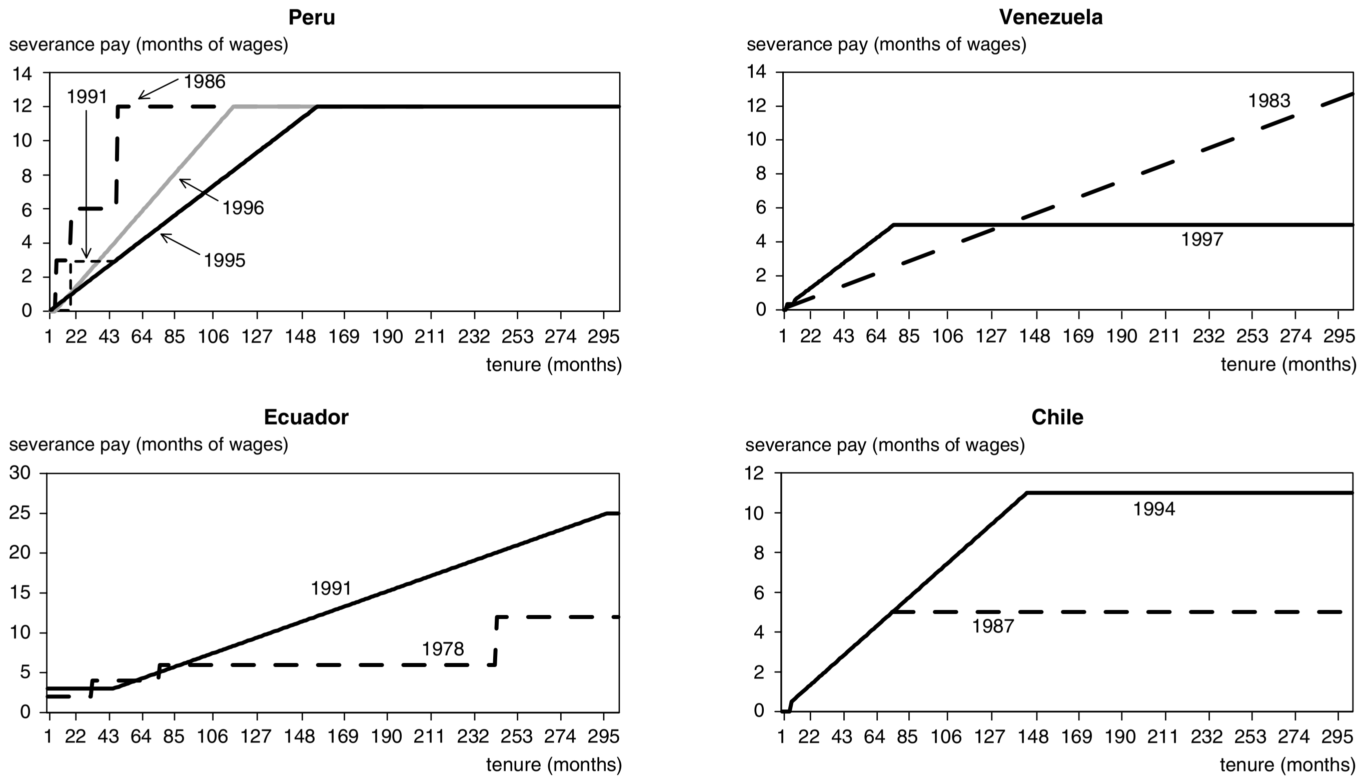
Figure 9.15 Severance payments before and after labor reforms, selected Latin American countries, various years (in terms of months of wages)



Source: Vega (2001).

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payments to a system of individual accounts, whose costs could be partially shifted to workers, led to a reduction of unemployment rates of 1.3 to 1.7 percentage points. Finally, Montenegro and Pages (2002) provide evidence that in Chile job security policies were associated with substantial reductions in the employment-population ratio among young workers and an increase in the same variable among older workers.

Temporary Employment Contracts

As was observed in industrial countries during the 1970s, one way for firms to avoid high dismissal costs—and through which governments give firms an outlet from the high dismissal costs of permanent employment contracts—is to use temporary contracts. Usually, legislation that makes it easier to use temporary contracts encounters less political resistance than changes in severance payments or firing procedures.

In Argentina, after much political struggle, temporary contracts began to be allowed in 1991, but without much success. By 1995, conditions had changed significantly, and their use increased from 6 percent in 1995 to 17 percent in 1997 (Torre and Gerchunoff 1999). Temporary contracts (*modalidades promovidas*) were introduced for specific groups in the labor force, with lower severance payments, depending on the type of contract.[14] In 1998, however, these contracts were again eliminated. In Peru, the red tape required for the use of temporary contracts was greatly diminished, and the role of the administrative authority shifted from approval of these contracts to a mere registry. The main difference between temporary and permanent contracts was that the former carried no right to a severance payment. As is shown in figure 9.5 above, there was a sharp increase in Peru in the share of temporary employment within the formal sector.[15] This was also observed in Colombia. In Brazil, temporary and part-time contracts have been permitted only since 1998.

As is discussed in the last section, the easy way of trying to give firms the necessary additional flexibility in firing through use of temporary contracts is a second-best solution, given the political difficulties governments face in passing legislation that reduces firing costs under permanent contracts. However, this solution may have negative effects on productivity and also in nurturing perceptions of economic insecurity by

14. The *promoción al empleo* contract, for instance, had to be contracted with a registered unemployed person, and allowed a 50 percent reduction in severance payments. Youth contracts were related to training, and exemptions allowed 100 percent on both employers' contributions and severance payments (Pessino 2001).

15. In Peru, temporary contracts increased even after 1998, when absolute formal employment was falling. The implicit replacement of permanent by temporary contracts was in part a response to business expectations of a reversal of labor reforms that might lead to a reintroduction of job stability clauses in permanent contracts.

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Box 9.1 Summary of payroll tax changes in selected countries

Colombia

Social security reform increased mandatory contributions for pensions and health gradually during the early 1990s. Pension contributions increased from 6.5 to 12.5 percent in 1995 and to 13.5 percent in 1996 for workers earning less than four times the minimum wage and to 14.5 percent for workers earning more than four times the minimum wage. Similarly, health contributions increased gradually, from 7 percent in 1994 to 8 percent in 1995 and to 12 percent in 1996 (Kugler and Cardenas 2002).

Chile

In Chile, payroll tax reform was introduced in the early 1980s. In 1980, a new reform reduced social security contributions from 33 percent on average to 20 percent (10 percent for retirement, 7 percent for health, and 3 percent for disability). Newly hired workers would contribute to the new private pension system, to be managed by private administrators. Old contributors could choose between the new and the old public pay-as-you-go system. In the case of health care, all workers were given the choice to opt out of the public system and to use their 7 percent contribution for a health care insurance provided by a private health insurer. A minimum pension, employment insurance, and family allowances were fully financed by the government (Edwards and Cox-Edwards 2000).

Mexico

Legislation introduced in 1997 reduced mandatory payments for health, disability, and death insurance by about 6 percentage points for the median worker (i.e., from 14.7 to 8.2 percent). The reform replaced a pay-as-you-go system by a retirement plan based on individual retirement accounts. Mandatory contributions for this retirement account increased from 2 to 6.5 percent for the median worker. Overall, total payroll taxes (including some minor payments besides health insur-

workers. For instance, Hopenhayn (2000) shows that the temporary contracts introduced in Argentina generated an increase in hiring, a reduction in long-term employment relationships, and an increase in turnover.

Nonwage Labor Costs

Nonwage labor costs (sometimes called the social wage) in Latin America include health and pension contributions, training contributions, family allowances, annual bonuses, vacations, unemployment subsidies, maternity and sick leave, occupational health and safety provisions, and more. In several countries, there were important increases in nonwage labor costs. In Colombia, mandated contributions increased between 1992 and 1996 by at least 12.5 percentage points, both due to increased health contributions and contributions to the newly created private pension system of individ-

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Box 9.1 *continued*

ance and retirement fund contributions) were only reduced from 21.7 to 19.7 percent (Marrufo 2001).

Argentina

Between 1990 and 1995, payroll taxes represented approximately 60 percent of gross wages (32 percent for social security payments, 14 percent for health insurance, 7.5 percent for family assignments, and 1.5 percent for unemployment insurance plus other contributions). Since then, contributions have fallen. In greater Buenos Aires, total payments have reached 41.8 percent of gross wages. In 1994, the social security system was changed from a state reparto system to a mixed one, whereby workers could choose between remaining in the public system or switching to the private capitalization system. Health insurance, however, is administered by the union representing each firm. Since 1997, workers have been allowed to choose the health insurer of their choice, but within the union system (Pessino 2001).

Peru

Total nonwage costs increased sharply during the early 1990s as a consequence of changes in the calculation of individual retirement accounts (*Compensación por Tempo de Serviço*). In 1992, a parallel private pension fund system, based on individual accounts as an alternative to the state's pay-as-you-go system, was created. When commissions and other fees are included, the contribution was between 11 and 12 percent at the end of the decade. The health contribution was maintained at 9 percent throughout the 1990s but in 1995 the base for calculations was extended to include holiday bonus payments, thus increasing the effective rate. The National Housing Fund contribution, which in practice works as a plain payroll tax, underwent several changes based on fiscal needs and thus fluctuated between 6 and 9 percent. The base for calculation was also increased. (Saavedra and Maruyama 1999).

ual accounts (Kugler and Kugler 2001). In Peru, contributions increased due to increased pension contributions and changes in the established caps and minima (Saavedra and Maruyama 1999). In Brazil in 1988, nonwage costs increased due to the creation of a vacation bonus and increases in childbirth leave (Amadeo, Gill, and Neri 2000).[16] In Mexico, changes in both health and pension contributions compensated each other such that there was a very small reduction in 1997. In contrast, in Argentina contributions fell from the extremely high levels of the early 1990s to a range of 40-45 percent, still one of the highest in Latin America. Changes in nonwage costs in selected countries are summarized in box 9.1.

In Colombia and Peru, in addition to the increase in social security contributions, individual savings accounts that could be used upon dismissal operated as an additional nonwage cost. In Colombia, a severance pay-

16. Brazil also reduced the maximum number of hours per week from 48 to 44.

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ment savings account was established, with amounts that had to be deposited by the employer periodically, a system that replaced the traditional severance payments system. In Peru, these savings accounts already existed (the Compensación por Tempo de Serviço), but in 1991 it was established that these savings had to be deposited in an account in the financial system.[17]

An important institutional change is that in a large group of countries (Argentina, Chile, Colombia, Peru, and later in the 1990s Uruguay, Mexico, Bolivia, and El Salvador), private individual-capitalization-account-based pension systems were introduced, either replacing or alongside old pay-as-you-go systems.[18] Except in Chile, the mandated pension contribution is now higher than it was in the pay-as-you-go system. However, the distortionary effect of this nonwage cost is probably smaller, for benefits are now linked to contributions. In that sense, increases in nonwage costs related to this institutional change might not have a negative effect on employment, at least for certain segments of the population. In the more mature systems, pension savings have increased significantly and constitute an important part of national savings (see chapter 5). However, except in Chile, there has been no significant overall increase in social security coverage, not even where the private system has almost completely displaced the former system.

In the case of health contributions, even where there was no increase in contributions, there is some evidence of a reduction in the quality of services provided, which again suggests that this contribution may be perceived as a tax, in particular by higher-income workers who prefer better-quality health services.

Increases in mandatory payroll contributions and other nonwage costs appear to have negative effects on employment or earnings (or both), according to recent empirical literature.[19] The effect of changes in mandatory contributions depends on the characteristics of labor supply and labor demand and on the specific structure of institutional settings. Edwards and Cox-Edwards (2000) find that in Chile 70 percent of social security contributions are shifted to workers. Marrufo (2001) finds a substantial shift of labor costs to wages in Mexico. Kugler and Kugler (2001) find that in Colombia, of the increase in 10 percentage points in payroll taxes in 1993,

17. Before the reform, the deposit could be kept in the accounting books of the firm. In practice, this meant that these resources were used as working capital by the firms. When firms went bankrupt, workers were not able to collect their funds.

18. In Bolivia, Chile, Mexico, and El Salvador, the public system has been closed.

19. Heckman and Pages (2003) provide a comprehensive compilation of recent empirical work on the effect of labor legislation over the labor market. In his presidential address to the Labor Economics Society, Hamermesh (2002) states that Latin American policy changes should be more exploited by the profession to reach a better understanding of the effect of labor legislation.

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only about a fifth was shifted to workers as lower wages, and consequently there was a negative effect on employment. In their review of the empirical literature on this issue, Heckman and Pages (2003) conclude that a 10 percent increase in nonwage costs in Latin America has a negative impact on the employment rate, but there is a very wide variation in estimates of the quantitative effect, from 0.6 to 4.8 percent. Overall, nonwage costs in Latin American countries are high and in most cases have increased, and empirical evidence in the region points to negative effects of this cost on employment.

Unions and Collective Bargaining

In the highly regulated labor markets of the import-substitution era, unions played the role of protecting their members' jobs and negotiating for higher salaries and fringe benefits and better working conditions. In some countries, unions were part of a corporatist scheme and were heavily regulated by authorities; in others, unions developed more independently and were usually associated with political movements. During this period, high economic rents in modern sectors of the economy were generated by trade protection. Prolabor governments legislated complex labor legislation that provided generous nonwage benefits. The increase in social benefits for unionized workers, together with explicit profit-sharing schemes imposed by labor legislation, forced businesses to share these rents with workers.

Moreover, workers in sectors subject to soft budget constraints—the public administration and state-owned enterprises—and workers in nontradable sectors that also enjoyed economic rents due to oligopolistic structures, such as the banking sector, received salaries and benefits that in most cases went beyond what was justified by their productivity. In the 1990s, these rents fell in the context of the more competitive environment produced by trade liberalization, the elimination of price controls, privatization, and the downsizing of public administration.

Labor legislation regarding collective rights showed important changes during the past decade, although it is difficult to establish a general trend. The region as a whole has many different ways of organizing its labor relations and, despite somewhat similar economic pressures, countries have moved in different and contradictory directions (Cook 1998). Cook argues that countries that were in the process of democratization moved in a more protectionist direction, whereas countries that were implementing economic reforms moved toward "flexibilization." In Argentina, Colombia, and Peru, union density has fallen dramatically as part of a labor flexibilization process in the context of trade liberalization.

In the case of Argentina, however, the union movement maintained its political influence, given the restoration of collective-bargaining rights that

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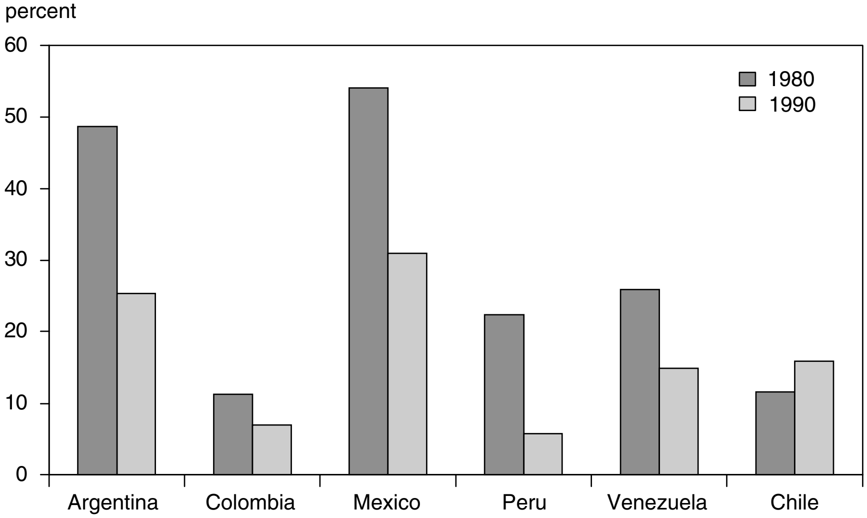
Figure 9.16 Trade union density, 1980 and 1990
(percent of nonagricultural labor force)



Sources: O'Connell (1999), except for Peru, for which data are from the National Household Survey (for metropolitan Lima only) and the unionization rate is calculated as a percentage of salaried workers.

came with the return to democracy in the late 1980s. The latter phenomenon was also observed in Brazil and Uruguay, and these countries tended to move to a more protectionist system. In Uruguay, however, there was a further move toward a less centralized system in 1993, with less intervention of the state and bargaining at the firm level. Chile has also moved toward more protective legislation, under which collective rights are promoted, although it is still more flexible than other Latin American countries.

During the 1990s, Argentina, Brazil, and Mexico maintained highly centralized corporatist systems, with strong state intervention and in most cases with bargaining at the sector level. In other countries, a wave of changes in collective bargaining moved countries toward a more decentralized bargaining model with limited involvement of the authorities.

In several Latin America countries, rates of unionization fell (figure 9.16), continuing a trend that had already started in the 1980s and that is also observed in industrial countries. A large part of the reduction in unionization is explained by the reduction in public-sector employment. However, there has also been a sharp reduction in union affiliation in the private sector.

Labor organizations in Latin America in general were not characterized as high-performance organizations and constantly maintained a belligerent position against firms, following the idea that profits are a pie that

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should be shared between firm owners and workers as part of a political process. Conversely, firm owners failed to develop a less adversarial relationship. In most countries, unions have managed to protect employment and also to obtain higher wages than those of comparable nonunionized workers, but it is not clear that these higher wages reflect higher productivity levels.

In Brazil, Menezes-Filho et al. (2002) have shown that unions have a negative effect on profitability. The relation between union density and productivity, employment, and wages depends on the extent of density. Some unionism has a positive effect on economic performance, but high levels of unionism have negative effects. In Peru, Saavedra and Torero (2002) find a negative impact of unions on profits for all firm sizes and that labor productivity is at best not influenced by unions. There is also evidence for Peru of a positive but diminishing union wage premium. In Uruguay, Cassoni, Allen, and Labadie (2000) find that during the period when bargaining was done at the industry level, unions were able to increase wages; after 1993, the union wage differential vanished in those industries that were exposed to international trade.

Minimum Wages

In some countries, minimum wages are not binding and do not have an important effect on the labor market. However, with the price stability achieved toward the middle of the 1990s, nominal minimum-wage adjustments were not easily eroded by inflation any more, and there was increasing evidence that minimum wages "bite." In Colombia, for instance, Bell (1997) finds negative effects of minimum wages on employment of low-skill and low-wage workers, whereas in Mexico the minimum wage is not binding. Maloney and Nuñez (2001) find that increases in the minimum wage have very significant positive effects on the probability of becoming unemployed, an effect that is stronger for workers with earnings in the neighborhood of the minimum wage. They find that on average a 10 percent increase in the minimum wage reduces employment by 1.5 percent.

Maloney and Nuñez (2001) demonstrate that the economic crisis in Mexico in 1994 required a fall in real wages, which was possible given a nonbinding minimum wage. In Colombia in the late 1990s, in contrast, a reduction in labor demand generated an increase in unemployment, for Colombia maintains a high indexed minimum wage. The informal sector does not easily absorb workers who are not employed in the formal sector, because the minimum wage is also used by the informal sector as a reference. In Brazil, there is evidence that the minimum wage affects not just the formal wage structure but also wage determination in the informal sector (the "lighthouse effect"; Amadeo, Gill, and Neri 2000).

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Regulation and the Informal Sector

For many observers, it is a puzzle as to why employment growth was so sluggish if there was a reduction in labor market rigidities in Latin America during the 1990s. In a few countries, employment adjustments were facilitated by labor market deregulation, mainly through a reduction in firing costs and through the use of temporary employment contracts. However, movement toward a more flexible labor market was clear in only a few countries. Overall, employment grew only as long as there was economic growth, and labor legislation is still a hindrance to an expansion of employment in most countries.

The lack of growth of high-quality jobs—that is, jobs in which productivity is high enough to finance the social benefits mandated by law—is probably the more troublesome phenomenon. As discussed in Saavedra and Chong (1999), entering the informal sector, understood as noncompliance with regulations, is a decision that both firms and employees make on the basis of cost-benefit evaluations that are continuously revised. A firm's degree of compliance with regulations depends on how profitable it is for the firm to do so. That is, there is not a clearly segmented informal sector—in the sense of a formal sector with above-market-clearing wages and workers queuing for a formal job—but a continuum of economic agents repeatedly making decisions about whether and how far to comply with regulations. Moreover, the compliance decision is not a simple dichotomy between formal and informal, because firms may comply with some regulations and not with others. And some workers in a firm may be under formal contracts whereas others are not.

A firm faces monetary and nonmonetary costs of entering the formal sector: fees, licenses, taxes, payment of social benefits, compliance with health and safety regulations, and so on. And there is a cost of staying informal, given by the fines that the firm may have to pay if detected by authorities. Among microentrepreneurs, other key costs of becoming or staying informal are related to the restrictions on establishing commercial relationships with formally registered firms, the difficulty of exercising property rights, and the pecuniary costs of being caught not complying with regulations. This has to be balanced against the benefits of formality, in particular, the possibility of broadening the scale of production, establishing commercial relationships with bigger firms, and accessing credit in the financial markets. Benefits have to be higher than costs for informal-sector entrepreneurs to be willing to change their legal status. When benefits do not exist or are not valued, or when enforcement is weak, many individuals and firms will find it convenient to stay in or switch to the informal sector.

For wage earners, the choice between being formal or informal hinges on the choice of working in occupations with different characteristics. It is

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the firm offering the job that decides if it is expedient to comply with existing rules and regulations. Creating a formal job implies the inclusion of specific labor costs for the firm: taxes, nonwage costs, and administrative procedures. The firm will be willing to incur these costs if it is able to transfer at least part of them to workers in the form of lower salaries, or if it perceives that providing the benefits they finance will increase productivity. A firm might not be able to pass these costs on to workers if the labor market is tight, if there is a minimum wage, or if workers do not value the resulting benefits.

It is not strange that a majority of small firms choose to have informal employment relationships, both because their productivity is too low to be able to finance social benefits and because workers in the relevant market are not willing to receive lower salaries to cover these costs. Some workers also will choose informal jobs if they are not willing to pay for social benefits.

Maloney (1999) advances arguments on the same line. He claims that workers might prefer informal employment because of certain desirable characteristics, like the flexibility and independence of being self-employed, or the possibility of evading paying for certain nonwage labor costs that are not highly valued by low-productivity wage earners. This will be particularly likely where labor codes are inefficient and productivity differentials between the formal and informal sector are small. He argues that this is an alternative to the dualistic view of a segmented labor market in which workers queue for formal-sector jobs.[20]

In this framework, rises in productivity and reductions in labor taxes (either plain payroll taxes or legal benefits that are perceived as taxes) increase demand for formal salaried employment and reduce the profitability of operating as an informal self-employed person or microentrepreneur. The higher are taxes, the higher is the likelihood of it being profitable to run—or work in—an informal enterprise.

The central question is whether poorly designed institutions hamper the generation of higher-quality jobs, that is, jobs in which workers have at least a minimum of social benefits. In Latin America, the costs of formality are still too high compared with the perceived value of benefits, given productivity. If a formal job comes with a package of benefits that includes certain services that workers do not value, or that the firm's productivity is not high enough to pay for, then formal jobs will not be created. If the package of such benefits as vacations and dismissal costs is too

20. In fact, Cunningham and Maloney (1999) find that in Mexico, during a period of economic growth, 70 percent of those entering the informal sector did so to increase earnings or because they were lured by the higher flexibility. Robles et al. (2001) report that in Peru microentrepreneurs in textiles and metal mechanics who started their firms because they wanted independence would move to a permanent formal job if they were paid significantly more than what they received as entrepreneurs.

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generous, given productivity levels, only a small number of workers will end up enjoying them. As long as workers are not willing to accept lower wages to pay for fringe benefits, or firms are not willing and able to finance them, they will find ways to avoid paying such benefits.

In many cases, workers are not willing to pay for these benefits because, at low levels of income, discount rates are too high and they value current consumption much more. Therefore, willingness to save for an old-age pension, for instance, is low, because they will perceive all or part of these payments as taxes. Something similar applies to health benefits, where they prefer to run the risk of not receiving proper medical care rather than paying premiums.[21] By the same token, firms may not want or are unable to invest in adequate occupational safety regulations. Moreover, long vacations, as are mandated by law in Brazil and Peru, are not observed by informal firms, and they act as a plain additional tax in larger firms, reducing labor demand. In many cases, workers in large and medium-sized firms, which force them to take vacations under the risk of being fined by the authorities, spend those days working in another job.

An interesting example of the way rigidities imposed by legislation have negative effects on welfare and productivity comes from the regulation of the number of hours worked. Many countries restrict the number of hours that can be worked, even paying overtime, or reduce firms' possibilities of changing schedules. Some multinational firms require Latin American subcontractors to limit the number of hours to just 8. However, given the market level of the hourly wage, workers would prefer working 10 or 12 hours. If the firm limits the number of hours to 8, they will work another shift in another firm, incurring unnecessary transaction costs. In such cases, the 8-hour limit does not benefit the worker but only reduces the firm's productivity and the worker's welfare.

Given this framework, why did informal employment increase during the 1990s? Or, why did the proportion of workers with access to social benefits decrease during the 1990s? The answer lies in a comparison between productivity and rents versus the benefits of being formal. When economies were closed, there were rents in oligopolistic sectors and in the public sector. As economies liberalized trade and deregulated goods markets, profits fell in many oligopolistic sectors, and soft-budget-constrained public enterprises and institutions disappeared or were downsized. Consequently, sectors that were inefficient but that maintained high-quality jobs financed by those rents shrank or disappeared.

In many cases, there is evidence of high productivity growth, but concentrated in certain manufacturing subsectors, public utilities (usually privatized), and business services, and employment creation in these sec-

21. In this case, for high-wage workers, health insurance might be perceived as a tax if the type of service they receive is of low quality and they prefer to contract additional health insurance from other—usually private—providers.

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tors was meager. The number of jobs created in those high-productivity sectors was not enough to replace the jobs lost in low-productivity but formerly high-rent sectors. In the rest of the economy, there was employment creation, but in low-productivity jobs. In addition, within the informal sector, market niches that had been competitive with protection—for instance, informal manufacturing—were driven out of the market by cheaper imports.

During the 1990s, trade liberalization and greater exposure to competition in general forced firms to reduce costs. Yet nonwage labor costs were maintained at very high levels, or even increased in several countries. Conversely, job protection mechanisms were reduced in only a few countries. Because the evolution of productivity and the need to reduce costs was not compatible with the evolution of costs mandated by law, informal contractual regulations were a more frequent outcome. Despite heavy regulation, the labor market in most Latin American countries has undergone a de facto flexibilization process as some firms and employees have moved underground. In large parts of the region's labor markets, there is total flexibility, and wages, working conditions, and contracts are freely determined.

Finally, even though the labor code lays down how flexible or rigid the labor market is supposed to be, the extent to which these regulations affect the operation of the labor market depends heavily on the capability and willingness of the authorities to enforce regulations. The effect also often depends on unwritten rules that dictate the typical behavior of labor courts, in some cases with a prolabor bias and in other cases probusiness, usually depending on the political orientation of the government.

Active Labor Market Policies

Active labor market policies in Latin America have a long tradition in the areas of intermediation services and occupational training. In the 1990s, social investment funds and training programs directed to specific groups were added to the policy menu.

Labor intermediation services are intended to improve the quality and speed of the match between firms and workers looking for a job. They are slowly evolving from the monopolistic public employment services of the 1960s and 1970s into more modern and technologically savvy institutions that try to provide a more comprehensive array of employment services. This process of modernization has made progress in different countries at different speeds, but there have already been many interesting experiences throughout the region. Currently, labor intermediation services and job exchanges using computer-based systems are in place in Brazil, Chile, Mexico, and several Central American countries. In addition, countries are experimenting with different types of public–private alliances as a

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cost-effective way of increasing service coverage. Interesting but still limited experiences are found in Argentina, Guatemala, and Peru.[22]

Similarly, there is a long tradition of occupational and vocational training systems in Latin America. In most countries, large public training services, financed by payroll contributions, dominate the market. These institutions provide training services to youth as an alternative to higher education, and also to adults already in the labor force. Postsecondary training institutions expanded their coverage during the 1990s, but in many cases this happened at the expense of quality. However, the ability of this system to adapt to current requirements, together with its overall efficiency, has been questioned (Márquez 2002).

During the 1990s, training programs oriented toward increasing productivity and providing a labor market experience to specific groups—in many cases as a part of countries' poverty alleviation strategies—were developed. Projects targeted to unemployed youth, such as Chile Joven (started in 1992), Proyecto Joven in Argentina (1994), Opción Joven in Uruguay (1995), and Projoven in Peru (1996), were implemented with different degrees of success and on different scales.

These youth programs have several elements that should be part of a public strategy for occupational training. Training is financed by the government but is provided by public and private training institutions, which compete on a price and quality basis to provide the service. Institutions may only submit a tender if they can fulfill minimum quality standards established by the programs. Training courses have to be complemented by an internship arranged by the training institution. The structure of incentive implicit in these type of programs has led to an increase in quality standards and better coordination between firms and training institutions.

A few countries have implemented or continued programs aimed at reducing welfare losses due to economic shocks to provide market skills to displaced workers. Workfare programs—such as the Trabajar program in Argentina and the A Trabajar program in Peru—have been implemented. Also, social investment funds, which were heavily supported by multilateral development banks, have provided job opportunities in rural and urban marginal communities as part of the implementation of small-scale infrastructure projects. Programs oriented toward providing training and other support to adults displaced from shrinking economic sectors are scarce and generally have not been effective.

The Policy Agenda

The highly skewed income distributions in Latin America are related to an extremely unequal set of opportunities that workers face in finding

22. A review of current trends in Latin America regarding labor intermediation services and policy recommendations in this area may be found in Mazza (2001).

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a high-quality job, given varying abilities and preferences. Inequality of opportunity in the labor market is related to several types of inequality of opportunity—opportunities to access high-quality education and health services, to get high-quality training, to find jobs that can provide basic benefits, and to use income-smoothing mechanisms. Some of these are prelabor market problems, but others may be subject to influence by labor legislation or active labor market policies

Education and Occupational Training

Education is probably the single most important factor that will determine productivity growth and the generation of higher-quality jobs. As is discussed in chapter 8, education faces formidable challenges in the region. Several policies aimed at promoting human capital investment also are part of the labor policy agenda, such as the provision of high-quality occupational training (both as a postsecondary alternative and for workers already in the labor force) and incentives for on-the-job training. Governments should try to shift their role from the direct provision of general training services to that of regulation and certification, with the objective of ensuring that all training institutions comply with minimum quality standards. The underlying objective should be to ensure that all potential trainees have the opportunity to access adequate training.

Training is in fact a very profitable investment, particularly among disadvantaged youth. The models of youth-training programs in which the government finances the training while providers are selected on a competitive basis should be expanded. Several public programs in the region are wisely combining direct training subsidies with monitoring and quality supervision of training institutions. The raising of quality standards for training has positive effects for program participants as well as for the occupational training market as a whole. Provided these courses are tied to a practical training period in a firm, they give trainees an opportunity to have a first exposure to formal salaried employment, increasing the probability of securing a better job match in the future.

Demand-side subsidies for training need to be accompanied by a more intensive use of mechanisms to monitor and certify the quality of the occupational training service, for the main problem in the market for occupational training in Latin America is not insufficient supply but an extremely heterogeneous supply and very scarce information for potential trainees about the quality of the service they are receiving. Helping parents and youth to distinguish between high- and low-quality training institutions will enable families to make better educational investments (which are huge, even among the poor), which will also foster more investment.

Increasing the quality of occupational training is crucial for two other reasons. First, a large majority of the Latin American labor force has al-

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ready completed its cycle of basic education, and in many cases the quality of that education was very poor. Most of these workers will not go into tertiary education but will spend several decades in the labor market. For these workers, the only chance of strengthening their skills and increasing the possibility of securing a better job is occupational training. Second, rapid technological change and economic integration will require constant retraining of the labor force, independent of the amount of formal education already attained.

As well as subsidizing training in specialized institutions, governments should promote investment in training in the workplace, through direct subsidies that complement private contributions. Also, training programs for personnel of small and medium-sized firms and for workers displaced from shrinking sectors should be part of a public-private strategy for human capital investment. In the latter case, programs and subsidies directed to these displaced workers should be part of a social safety net oriented toward supporting workers hurt by unexpected shocks.[23]

Finally, countries should move toward schemes of public subsidies for training provided by private institutions. In general, private institutions have the potential to give higher-quality training, in particular if it is linked to the needs of private firms.

Information, Certification, and Intermediation Services

Governments should promote the provision of an array of information services regarding jobs, labor market conditions, skill requirements, and training opportunities, so as to improve the match between supply and demand for labor at all skill levels. Given the necessity of expanding the availability of these services, countries should try to use all the available resources in both the public and private sectors.

These services should also include the provision of information on the skill requirements for jobs, and on the availability of training opportunities to acquire the specific skills required by employers. Also, much progress is required in monitoring the labor market to provide information on current and future trends regarding occupations, skill requirements, training needs, wages, and labor demand. Such information, if properly disseminated, could help job seekers, training seekers, workers, employers, and training institutions. In addition, job placement and job search assistance and counseling services should be expanded.

A crucial institutional constraint is the lack of credibility and the poor reputation of public agencies among firms (Mazza 2001). For this reason,

23. It is not yet clear whether the highest social return is obtained from programs that attempt to retrain workers, from plain subsidies, or from subsidies directed to promote training of currently working older workers.

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a complete restructuring of the institutional setting is required in many countries. Also, intermediation services usually cater only to firms in the formal sector; given that the majority of Latin American economies have an informal sector that surpasses 50 percent of the labor force, these services should also try to cover the firms in this sector.

A more efficient flow of information also is required on the skills and abilities of workers. Much learning and many skills are acquired through on-the-job training, experience, and other informal mechanisms. Programs aiming to provide certification of skills acquired outside formal training institutions are already in place in some countries, such as Chile and Mexico, but are incipient in most others. These programs require establishing institutional mechanisms to define competency norms, which should ideally be set jointly by firms, workers, and the responsible authority (usually a dependency of the ministry of labor). Once these norms are established, a body with a good reputation needs to certify that a worker is competent in a specific skill.

In the same way that firms should have at their disposal mechanisms that can allow them to know the specific abilities and competencies of workers, workers should have access to information regarding what they need to learn and where they can learn it. In most Latin American countries, information regarding the quality of training institutions is nonexistent, so much progress is needed in monitoring and supervising the performance of institutions and in providing this information to the public.

Labor Market Legislation

The reform of labor laws faces formidable challenges. More than ever, these laws must allow for the efficient operation of the labor market and at the same time create the right incentives for employers and employees to create job relationships that can ensure that workers feel secure and enjoy access to social benefits. Labor legislation thus should not be thought of primarily as either more rigid or more flexible; countries should aim for better regulation.

Most of the Latin American labor codes were written according to a legal doctrine that is based on the so-called fundamental rights of workers. However, these labor codes generally protect only those who already have a formal job and actually reduce the possibility of more workers being able to access a formal job. An important objective of labor legislation should be to create conditions in which most workers can have jobs with access to basic social benefits: health insurance, old-age protection, and income-smoothing mechanisms to cover episodes of unemployment. Legislation should not try to artificially protect workers by giving them rights that cannot be sustained by productivity. No matter how thoroughly the authorities enforce the legislation and unions monitor that the

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rights granted by legislation to their members are fulfilled, these rights will only apply to the most productive firms and will be purely mythical for a large part of the population.

Firing Costs

Many countries resort to the use of temporary employment contracts as a way to relax the rigidity imposed by dismissal costs. In European countries and in several Latin American countries, restrictions on the use of this type of contract have been reduced, by increasing the proportion of the payroll that can be hired under temporary contracts, the number of years for which they can be renewed, or the reasons for which their use is permitted. The reliance on temporary contracts is a second-best policy response to the political resistance to reducing firing costs in regular contracts.

These contracts probably leave workers and firms worse off, however, because their temporary nature may reduce productivity and salaries while increasing workers' perception of job insecurity. This is a case in which partial reform may be more harmful than no reform. Argentina, Colombia, and Peru allowed for increased use of these contracts during the 1990s, and in all cases labor turnover increased. When turnover increases due to technological, demographic, or organizational practices, countries should allow for smooth job-to-job transitions with the lowest possible short-term reduction in consumption for workers. Yet it does not make sense to induce higher turnover through legislation.

In 1998, Argentina moved toward prohibiting temporary contracts, but unfortunately without flexibilizing the use of permanent contracts. Temporary contracts helped increase employment in Argentina. Making it more difficult to use them would have been the right policy, if accompanied by a reduction in the cost of permanent contracts.

Countries should encourage firms to make permanent contracts, rather than trying to artificially enforce their use. For firms' use of these contracts to increase, they need to provide the flexibility required by the marketplace. If they are not flexible, they will only be used by a small group of firms; the rest will rely on temporary contracts, if available, or on part-time contracts or plain informal labor relationships.[24]

Firing costs should be designed as part of the income-smoothing mechanisms. In general, despite the reductions observed in some countries, firing costs are still very high and did not decrease substantially during the 1990s. Even if there are ways for firms to adjust to rigid regulation and incorporate more flexibility into their use of labor, it would be more efficient for all parties to have low firing costs. Both workers and firms would then know that their contractual arrangement has no definite termination date but will continue as long as is profitable for both parties.

24. With a reasonable cost structure for permanent contracts, temporary contracts should only be used when the labor requirement is for a specific time period.

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Given the imperfection of capital markets, it is necessary to have mechanisms to smooth consumption and protect workers and their families during periods of unemployment. But that objective has to be attained without hampering the economy's ability to create jobs. Most current job protection mechanisms leave part of the labor force without the possibility of securing a job that carries social benefits in the formal sector, hamper efficient job mobility within the formal sector, and constitute an additional force that increases inequality.

Job Protection and Income Smoothing

Severance payments, individual savings accounts, and unemployment insurance have been the main mechanisms used by Latin American countries to reduce job turnover and give workers a way to finance periods of unemployment. As was discussed above, these mechanisms can have unfortunate effects on the operation of the labor market. Countries should choose institutions that provide effective protection without hampering job creation.

The application of unemployment insurance systems in Latin America is at best complicated, and they are not that common in the region. Where they exist at all, these programs are usually small and cover only a fraction of the formal sector. Given the huge informal sector in almost all Latin American economies, unemployment insurance systems can be too costly to be operated successfully, because keeping track of employment histories and job-search efforts is excessively complicated.

Severance payments are still popular in the region and are a simple way to provide workers with a way of financing unemployment periods. However, in most cases, they are still too high, and because they are tied to the most recent salary level they constitute a large contingent claim on the firm in bad times. Individual accounts, as in the Colombian scheme, allow for spreading out that cost in time, eliminate uncertainty, and make it possible to share part of the cost with workers, who will also internalize the cost of the insurance, thereby reducing disincentive effects.

Yet unlike unemployment insurance systems, individual accounts do not allow for risk pooling across workers. Countries with such schemes, such as Brazil and Peru, may improve them by restricting the size of the fund to that consistent with the median length of unemployment, avoiding an excessively large accumulation. This would also reduce the bias that such legislation generates against older workers, who were particularly affected during the 1990s.[25] Chile has recently adopted a mechanism that combines an insurance component with the accumulation of an individual fund and a severance payment by the employer. It is not clear yet whether this design is appropriate for the Chilean labor market, and even

25. Another possibility is to allow the use of part of these savings as collateral for mortgages or other exceptional uses.

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less clear whether it would work in other Latin American economies with much larger informal sectors. However, it does aim to protect income and reduce welfare fluctuations, while simultaneously minimizing the employment-reducing effect of the typical job protection scheme and avoiding hampering the job mobility needed to maintain competitiveness in increasingly integrated markets.

Social Security Contributions

Nonwage labor costs are relatively high in most countries of the region, given productivity levels. Tax rates are in most cases relatively in line with international standards, although those rates may be too high to allow for an efficient operation of the labor market. Willingness to pay these contributions will increase with productivity, assuming that workers with higher earnings have lower discount rates and will thus give more value to future income (notably by valuing savings for an old-age pension more highly). By the same token, they will attach more value to health insurance.

Countries should continue moving toward tying contributions to benefits, as has already happened with pension contributions in Argentina, Chile, Colombia, Mexico, and Peru, all of which have introduced private pension systems. This reduces the potential negative employment effects of pay-as-you-go systems. However, the new system of individual capitalization accounts does not provide risk pooling across individuals, so extreme care has to be taken to regulate them properly so as to reduce risks with workers' savings.

In addition, minimum pensions should be established, in particular covering the transition period, for workers who were not confronted with the right savings incentives during a large part of their working lives. Another problem that many Latin American countries confront is that health and pension systems are plagued by special regimes, which generate small lobby groups with very high stakes in preventing required reforms.

Job quality is related to job security, earnings, and occupational safety. But in most of the region's countries, it is also linked to quality of life. If one loses a formal job, he or she loses health coverage and in most cases the possibility of access to a pension. We need to learn more about the possibility of de-linking these social benefits from labor status. At present, all good things come together: job protection, health services, savings for retirement. All are linked to labor status, so either one has the productivity required to pay for everything or one does not have anything.

Collective Bargaining and Industrial Relations

Better labor market outcomes can prevail if both firms and organized labor make the effort to create an incentive structure in which there is a balance between competitiveness and workers' rights. Agreements reached by firms' organizations and unions should take care not to end up excluding the

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large majority of the labor force from being part of a modern labor relationship. Countries need to design a model of labor relations in which unions work more in partnership with firms and do not adopt an exclusively confrontational relationship. Unions should establish programs and policies aimed at increasing productivity (training, work councils, and the like), transforming themselves into high-performance organizations that protect and promote their members' interests while simultaneously improving productivity. Although adversarial relations are inevitable at times and can be functional, they can become perverse if they lead unions and firms to ignore their common interests. High-performance unions will give great weight to cooperation and flexibility so as to raise productivity, not merely to pursue contracts, rules, and regulations (Saavedra and Torero 2002).

Governments should foster the adoption of modern human resource practices, the use of firm-based training programs, and voluntary worker participation in decision making and profits, all with the objective of increasing productivity. Labor laws should regulate both unions and business councils to ensure, particularly in the former, democratic decision-making processes, and at the same time avoid government intervention in their functioning. It seems inevitable that corporatist models—in which the state intervenes in management-union relations, in union registration, and in internal union affairs—end up being highly politicized. The state should remain the guarantor of the existence of appropriate bargaining mechanisms, but it should only intervene when called upon.

There are signs that the process of backward movement of unions has stopped. In Brazil, Chile, Mexico, and Peru, unions are taking a more important role in determining legislative changes. However, it is not clear how collective bargaining and industrial relations will evolve in each country. The challenge is to secure representation in the context of very large informal sectors.

Enforcement

Workers' rights granted by legislation are enforced in different degrees by labor authorities. In many countries, a lack of enforcement leads to noncompliance. In some cases, noncompliance can be corrected with a proper combination of low-cost enforcement, fines, and dissemination campaigns on the advantages of complying with rules on productivity and workers' welfare. However, none of these measures will ensure compliance if productivity is so low that firms cannot afford to pay the costs of complying with existing regulations. The latter situation is common in Latin America and is consistent with the existence of huge informal sectors where workers lack any protection.

In some countries, changes in the impact of legislation on the operation of the labor market have been related to changes in the ability and will-

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ingness of the authorities to enforce the law. This may be a consequence of shifts in the ideological orientation of the government. In other cases, the willingness to enforce is reduced when the economy goes into a recession. In Latin America, these de facto flexibilizations are not uncommon, particularly when small firms and microenterprises account for a large share of employment and their ability to comply with regulations is low and volatile.

These adjustment mechanisms, however, are inefficient both from economic and social points of view. Changes in enforcement standards introduce uncertainty and unpredictability that reduce profitability and investment. And a flexibilization of the labor market that stems just from weak enforcement may be perceived as an unfair attitude of the authorities, which are prepared to side with businesses regardless of what is legally established.[26] This type of flexibilization is politically unsustainable in the long run, so if firms make decisions based also on expected changes in legislation, it may not have the desired positive impact of a legal flexibilization.

Considerations for Implementing Reforms

The debate about labor legislation concerns who bears risks. Protective legislation has typically established that firms should bear the risks of economic fluctuations. Given economic shocks that may affect employment and salaries, legislation gave workers protection that had to be financed by firms; it obliged them to maintain salaries, using downward wage inflexibility clauses, and to maintain employment through steep severance payment rules.[27]

These practices were possible in Latin America in large firms that traditionally enjoyed tariff protection, were able to extract subsidies from corrupt or inept government officials, or were financed by a soft public budget constraint. Such rents have disappeared in most cases, so only large and highly productive firms can maintain this type of benefit. Consequently, firms are seeking ways to shift a larger part of the burden to workers. In some countries, this has been facilitated by changes in labor legislation; but as discussed above, changes in labor laws have not been that important. In most cases, this increase in flexibility has been met through the use of atypical contractual relationships, outsourcing, subcontracting, and, in the extreme, informal labor relationships.

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26. Cook (1998) argues that protective legislation met little resistance from employers in El Salvador, Guatemala, and Paraguay because of de facto flexibilization.

27. Extreme examples were the *estabilidad numérica* in Venezuela, where firms could dismiss workers but had to maintain the same number of employees. Even worse was the Peruvian *estabilidad laboral absoluta*, whereby workers were practically owners of their posts.

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Legislation needs to define the fair share of risk that workers and firms should bear to maximize society's overall welfare. Legislation may mandate that all the risk has to be borne by firms, but if that proves to be unsustainable, then compliance will only be partial. The challenge faced by labor legislation is therefore immense. It is senseless to continue making marginal changes in current laws as if more than half of the urban labor force—the informal sector—and most of the rural labor force in most countries did not exist. Countries must find ways to extend basic social benefits to a large part of the population.

But reform will always have winners and losers. During the transition toward a more market-oriented economy, for instance, safety nets that should have given specific groups of the population relief were precarious. Most governments, multilateral development banks, and international cooperative institutions were concerned to provide assistance to poor and extremely poor people, in a valid effort to target scarce resources toward the population with the lowest welfare levels. Much less importance, however, was given to specific groups that suffered large welfare reductions. Labor reform may harm a small group, even though it may be beneficial for the rest of the population. These negative effects on the welfare of specific groups that lose as a result of reform should not be neglected, and adequate and fair compensation needs to be treated as part of the cost of reform. Failure to do so may undermine the sustainability of reform.

Finally, the reform of labor legislation will have an important effect on the labor market only if it is perceived by economic agents as permanent. Moreover, the stability of rules is valuable in itself. Rules are more likely to be permanent if they are defined as part of a discussion and consultation process in which all relevant actors are involved.

Gender and Ethnic Discrimination

In most countries, the male-female wage gap has fallen dramatically, at least partly due to a reduction in the educational gap between males and females. In addition, female employment opportunities have increased significantly, and their employment rates have grown much more quickly than those of males. Despite these developments, Latin America still has one of the highest occupational segregation rates of any region of the world (meaning that the dissimilarity between male and female occupational structures is among the highest). Even if progress has been observed, active labor market policies should be oriented toward both eliminating the identification of specific careers with males or females and ending unjustified earnings differentials.

In the case of ethnic and racial discrimination, there is scattered evidence for such countries as Brazil, Guatemala, and Peru that there are unexplained earnings differentials even in urban settings among workers

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who are similar except for differences in ethnic or social background. In many Latin American countries, occupational segregation related to race and ethnicity is not a thing of the past. In many cases, it reflects prelabor market inequality of opportunities in education, health care, and access to social services; in other cases, it reflects plain consumer or employer discrimination. At least with regard to the labor market, the authorities should actively promote the eradication of discriminatory practices and should disseminate knowledge of the economic and social costs of discrimination to consumers and employers. They should certainly enforce the antidiscrimination laws that many countries have already enacted.

Concluding Comments

After the initial wave of market-oriented reforms and macroeconomic stabilization, most countries started a process of employment expansion that lasted until 1997 or 1998, when it was halted by economic crisis. But the increase in employment was not in general accompanied by an increase in productivity, so real wage growth was not significant and informality increased. Employment creation was much faster in low-productivity sectors. In addition, labor market-related economic insecurity was on the rise as turnover increased, and temporary contractual arrangements were more common. So the main problem in Latin America is of low-quality jobs.

Reforms had as a consequence the loss of jobs in the public sector, in state-owned enterprises, and in protected manufacturing industries. All these jobs commanded high wages and social benefits supported by the quasi rents that the previous protectionist and interventionist economic models generated. Reforms also produced an increase in productivity in some sectors, but it was not large, or general, or sustained. And employment creation in those sectors was meager.

An important proportion of workers who lost their jobs and were not able to find another salaried formal position used to belong to the middle class and as such had more voice and more mechanisms through which to manifest their discontent. If these workers, particularly older workers, were the losers during this period, women and youth, conversely, enjoyed greater employment opportunities. Also, relative wages of more educated workers showed a clear increase.

Reforms aimed at making the labor market more flexible were implemented in several countries, but overall, labor legislation has not changed dramatically, and it still hampers formal job creation. This, together with the increase in nonwage costs observed in many countries and the sluggish productivity growth, is behind the growth of informality. In most countries, the percentage of workers without social benefits has increased; and typically, still half the urban employed labor force works informally, as well as most of the rural labor force.

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The challenges Latin American faces to increase productivity and generate better jobs are formidable. It needs to improve dramatically its educational and occupational training systems, promoting equality of opportunities in these markets. It should stimulate the development of efficient information systems regarding jobs, skill requirements, quality of training and educational institutions, labor market conditions, and the like to allow for better decisions of families, workers, and firms in the educational and labor markets.

Labor market reform is required to ensure the efficient operation of the labor market and at the same time create the right incentives for employers and employees to create job relationships that can facilitate workers' security and access to social benefits. Labor legislation needs to define the fair share of risk that workers and firms should bear to maximize society's overall welfare. It may mandate that all the risk has to be borne by firms, but if that is not economically sustainable, compliance will only be partial. Reforms in labor regulation thus should not be thought of primarily as either more rigid or more flexible; countries should aim for better regulation. And any labor reform that is part of a process involving all actors will more likely be seen as permanent, and consequently more likely to improve the functioning of the labor market and workers' welfare.

Finally, it is essential that a model of modern labor relations in which unions work more in partnership with firms—with the aim of increasing productivity rather than facing an exclusively confrontational relationship—becomes widespread.

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