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Policies to promote adequate employment in Latin America and the Caribbean (LAC)

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Foreword

This paper by T. Mendez and A. Berry of the University of Toronto reviews recent employment developments in Latin America and the likely effects of policy changes. It considers that, in addition to good economic growth, there are three components to a successful employment strategy for the region. These are: a growth pattern in which sectors with the capacity to create substantial amounts of remunerative employment per unit of growth have a large weight in the composition of output growth, i.e. the SME and micro enterprise sectors and within the former the relatively labour-intensive activities; increases in the supply of skills consistent with fast growth of remunerative employment, involving the processes of education, training, etc.; and a labour market which functions as effectively as possible. The authors consider that employment policy will have to improve in Latin America for the outcomes to be satisfactory. Neither the apparent quality of the current policy packages nor a comparison between them and those of countries which have achieved particular success in employment promotion is reassuring.

The authors do not believe that labour market reforms of the type which many Latin American countries are introducing (generally reducing employment protection) will have significant benefits for employment. However, changes in pensions systems could well build up substantial new funds for investment. The authors' main message concerns the needs to raise productivity in the small enterprise sector, partly through entrepreneurial training and partly through the provision of collectively provided services. Better education and training go hand in hand with this and should also contribute to reducing social inequalities. Education and skills need to be increased and the variance in their distribution reduced.

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I. Introduction: Defining the adequacy of employment and the performance of the labour market

Labour market outcomes may be thought of as the result of the structure and pattern of labour demand, the supply of various categories of labour skills, and the way the economic system, including the labour market, fits these two together. Labour demand is important because it must be adequate in quantity and must match the composition of the supply for outcomes to be satisfactory. In situations where the combination of technology and institutions leaves demand too low to imply that full employment can occur together with adequate incomes, this creates a dilemma in which letting the market fully determine wages may imply low incomes for a high share of workers. Some interventions can avoid this outcome, but usually at the risk of harming some other workers who may be even worse off. Such interventions include minimum wage legislation or other steps which push some wages above equilibrium, “make work” policies (e.g. overstaffing of the public sector or of some private firms).

Labour demand tends to reflect a number of aspects of economic structure - firm size, farm size, technologies in use, and a variety of other factors, which can make it higher or lower as well as affecting the slope of the demand curve. The supply of productive skills reflects the level of public and private investment in education and training and the effectiveness with which the relevant institutions (including the labour market) help to match skill-creation with the needs of the economy. Where the initial match is not very good and/or when needs change rapidly (as is widely held to be the case at present), training and retraining of workers with job experience becomes important. The record shows that the best combination of high employment and incomes is likely to come from a relatively equal distribution of capital, showing up in a modest variance of both firm size and types of technologies in use, together with a modest variance in skill/education levels. Much of the extreme difference in the level of inequality between Taiwan, China (quite low) and Brazil (extremely high) is related to these two factors. After its agrarian reform of a half-century ago, Taiwan, China has had a relatively equal distribution of both physical and human capital and a broad base of small and medium enterprise. Brazil has a history of extreme dualism in the agricultural sector, followed by a comparably wide gap between the favoured and the unfavoured in terms of education and human capital as well as other assets.

The objective of labour market policy, as of economic policy more generally, is to contribute to good economic outcomes in the form of low unemployment and underemployment, high labour remuneration, stable jobs, good working conditions, etc. The range and complexity of work situations in developing countries generally means that no single indicator--such as the rate of unemployment, tells a very complete story on how well the labour market is working or how much its performance might be improved. To the extent that there are trade-offs among these desirable outcomes, it requires a social judgement to decide which combinations are the best. In particular the possible trade-off referred to above between the level of employment and the total income of a given category of labour is troublesome. It implies that the "efficient" allocation of labour among alternative uses through equilibrium prices, which under certain conditions maximizes total output or income in the economy, will not generally maximize social welfare. This dilemma is notably present in Latin America at this time, since even where economic growth has been proceeding acceptably, other trends have been worrisome, including rising levels of inequality, high rates of unemployment, high levels of job instability and low rates of formal sector job creation. Under these circumstances it is difficult to evaluate alternative policies for their impacts on social welfare. This complexity has been recently addressed in the context of the Canadian labour market by Osberg et al (1998); such wider-ranging analyses of labour market performance will soon be forthcoming for the United States and other OECD countries. The assessment of labour market policies is also complicated by the fact that in the presence of various unavoidable market imperfections, such as those of the financial system, it is additionally hard to judge what policy shifts will raise social welfare; the world of the "second best" is a complicated one.

Box 1:
When adequate economic growth coexists with such worrisome labour market patterns as high levels of inequality, high rates of unemployment, high levels of job instability and low rates of formal sector job creation, it is important to use multi-faceted measures of economic performance which take more into account than just economic growth.

The policies which affect labour market outcomes (and other outcomes as well, of course) can be somewhat arbitrarily divided into those whose main impact is on the demand for labour, those whose main impact is on the supply of labour skills and those whose main impact is on the effectiveness with which demand and supply come together in the market. It is generally agreed that economic growth usually raises labour demand. There is less agreement as to how much the structure of that demand matters; the currently heavy focus on attainment of economic efficiency, as narrowly defined in the maximization of GDP, and on market mechanisms as the best way to achieve that goal, appears to have relegated other objectives to a secondary role as well as having decreased attention to the possibility that intervention may be necessary to achieve both economic efficiency by that narrow definition and other desired labour market outcomes. It has recently become the conventional wisdom that high levels of investment in human capital are an important input to growth and that the distribution of human capital is key to a good overall distribution of income. The former proposition, while certainly plausible, is not easy to defend empirically (see Pritchett, 1996). The latter is the natural starting point for an important aspect of social policy, but it is not easy to demonstrate exactly what needs to be done to achieve a given improvement in distribution (see below). Currently the more controversial policy issues appear to lie in the area of labour market policy *per se*, where recently introduced or proposed reforms are designed to shift the labour market in the direction of the competitive ideal and thus look unkindly on such interventions as restrictions on the firing of workers, high minimum wages, and other state interventions in the labour market. Before turning to a selective review of some of these policies, we summarize labour market outcomes in Latin America and the Caribbean (LAC) over the last two or three decades and the questions which they appear to raise. They provide one window into, and one set of hypotheses on, labour market functioning.

Given the apparently serious threat that labour market outcomes in the short and medium run in Latin America, say the next 10-15 years, will not be good (see below), it will probably be essential that significant policy improvements be achieved with respect to each of the demand for labour, the supply of skills, and the effectiveness of labour market functioning.

2. Recent Labour market outcomes in Latin America: expectations and interpretations

The recent trends and current status of Latin American labour markets must be seen against the background of the previous several years economic evolution, and in particular the economic downturns precipitated by the debt crisis of the 1980s. The changed conditions of the 1980s required adjustment to deal with a large balance of payments disequilibrium and simultaneously with a frequently large fiscal imbalance, as foreign capital was no longer a resource for governments and revenues fell with the decline in imports and the recessions. The cost of the adjustment undertaken--between 1980 and 1990 the region's trade deficit of 4 per cent of GDP changed to a surplus of comparable size--was high as most countries applied the orthodox medicine of real devaluation and fiscal deficit reduction. All suffered contractionary recessions; trade surpluses were produced via recession. The typical pattern involved export growth and real devaluation but a radical cut in imports. Almost all of the situations of falling per capita income were accompanied by rising inflation, due in part to the devaluations.

By the early 1990s most countries of the region had undertaken (but not necessarily completed) serious reform packages including the dismantling of past restrictions on trade and capital flows, financial sector reform, privatization and attempts to diminish the size and activities of the public sector in other ways, and labour market reforms. Growth averaged 3.5 per cent over 1990-97, still well below that of the decades under the early policy package but better than the 1980s. Growth has however remained fitful, both for the region and for most of its countries, due to a variety of problems including the instability of short-run capital flow into and out of the region.

Given the seriousness of the macroeconomic crises suffered during the period since the mid-1970s, it is no surprise that on balance the trends in labour market outcomes have been unfavourable for much of the subsequent period. The challenge in interpreting those outcomes is to sort out the impact of factors other than the crisis itself, and in particular to attempt to identify the effects of policies which have been implemented or have come under discussion. As for the post-crisis 1990s, the labour market outcomes, though certainly better than those of the 1980s, have fallen rather far short of the more optimistic expectations earlier expressed by some of the policy reformers.

The positive expectations of the neo-classical reformers were based on the idea that the pre-existing policy biases had cheapened capital and raised the price of labour, and had suffered from an anti-export bias as well as pro-urban and anti-agriculture biases. Accordingly it was presumed that their removal would raise exports and the rate of growth. More directly relevant to labour market outcomes, agricultural exports (which it was hoped would be especially intensive in low-income labour) would be strongly stimulated, and the removal of the biases in favour of capital intensity would raise the demand for labour at the same time that it increased efficiency, through expanding the more productive modern sector of the economy. Poverty was expected to fall rapidly through the combined positive effects of faster growth and a better distribution of income. The share of GDP falling in the category of tradeables was to rise, necessitating a shift of resources into that sector; in the case of labour this was one reason for such proposed changes to labour codes as the weakening of rules against worker dismissal, cutting of payroll taxes, etc., whose general intent was to increase labour mobility and to diminish the bias against employment in the previous system. Though some of the more general and less cautious statements skipped rather lightly over the possible costs of these policy reforms, more recent assessments from the International Financial Institutions (IFIs) have addressed this aspect and generally accepted that in the short run the labour market effects would tend to be negative, i.e. that the costs would come first and weigh especially heavily on those workers in the market-losing sectors who had little or no mobility to other activities, while the good new jobs would come along later 1; it was thus recognized that the informal sector would have to fill in the employment gap in the interim. 2 The earlier, more optimistic assessments are now untenable in the light of events; the more cautious ones, still based mainly on theory rather than on empirical evidence, are not very different in many of their short-run predictions from those of observers with more negative long-run prognostications.

The structure of production has changed significantly in the post-reform period (for which the 1990s is often taken as a rough proxy), with some activities advancing rapidly and others shrinking. Overall export growth (in quantum terms) was faster than that of GDP over 1990-96 (8.3 per cent per year vs. 3.3 per cent per year) but that of imports was faster still (at 13.3 per cent). This combination gives few hints as to whether production of tradeables sectors has risen faster than GDP or not; the fact that both agriculture and manufacturing grew more slowly than GDP (both at 2.7 per cent) suggests the latter. At a more disaggregated level the wide range of growth outcomes has frequently been described as one of increasing polarization between the more modern, often export-oriented activities and the rest (e.g Weller, 1998). The heterogeneity of technologies in use has increased, leading to the reasonable expectation that the same holds with respect to labour productivities across activities. A major question is how long this trend will persist and whether it will be self-reversing at some future time.

As for the sectoral composition of employment, it is striking that the trends of the 1980s have extended into the 1990s with very little change. Despite falling per capita income, the 1980s saw a continuing sharp decline in the employment share of agriculture; that of industry edged down a bit, with the manufacturing share probably falling faster than that of the other components; services continued to grow very rapidly. In the 1990s, despite the generally more open economies, the goods producing sectors have continued to lose their employment share, especially agriculture and manufacturing (Table 1). Most dramatic is the case of Brazil, where in 1980 16.9 per cent of employment was found in manufacturing but by 1997 this figure had almost halved to just 8.3 per cent. Underlying the combination of changing output and employment shares by sector has been an interesting change in the evolution of labour productivity across these three sectors. Whereas the 1970s saw fairly similar increases in average labour productivity in each of them, the overall decline in labour productivity during the 1980s was mainly the result of

1 This general presumption (voiced, for example, by Cox Edwards and Edwards, 1994) depends on whether the industries which lose protection are still able to cover variable costs and hence survive for a period.

2 International institutions have, with varying degrees of confidence, asserted that the employment benefits will exceed the costs as long as the reforms are duly adopted (World Bank, 1995; UNCTAD, 1995; and ILO, 1995 and 1996 for Latin America). The ILO has emphasized the effects of an increasingly mobile capital on labour standards, which would require an increase in international cooperation to protect those standards. (See also CEPAL, 1996).

a sharp drop in that of the tertiary sector, with only a slight fall in the secondary sector and (as nearly as the data can clarify) a continued rise in that of agriculture. The 1990s have seen the continuation of that last process to the point where by 1997 the primary sector's average labour productivity was almost equal to that of the tertiary sector, which has continued to fall; meanwhile labour productivity in the secondary sector has grown very rapidly, widening the gap between it and the average for the economy and especially the figure for the tertiary sector.

As the earliest and least erratic reformer, the compositional trends in Chile are of particular interest, and present an interesting contrast to the overall regional pattern. Between 1980 and 1997 the employment share of agriculture fell only from 20.9 per cent to 17.5 per cent while that of manufacturing rose from 15.1 per cent to 16.7 per cent (ILO, 1998, 222) even though the output share in manufacturing was falling a little.

Box 2: The sharp decline in the employment shares of agriculture and of manufacturing is a striking feature of the 1990s evolution of the LAC economy. Is it an unhealthy indicator of a lack of employment creating potential in the tradable sectors, a natural transition phase towards higher quality employment in those sectors, or a reflection of their inherently limited capacity to create socially productive employment?

As would be expected, most (perhaps all) of the usual labour market indicators moved negatively during the periods of macroeconomic crises (whose timing varied somewhat from country to country) and positively, or at least less negatively, when the economies were growing. The more important issue is how well they behaved in absolute terms during fairly successful growth periods.

The most useful simple indicator of labour market outcomes, and perhaps also of labour market performance, is the level and distribution of earned income among labour market participants (or aspirants to participation). This outcome reflects and "sums up" the impact all those elements of the economy which affect anyone's labour earnings, including policies the demand side of the market, those on the supply side, and those related to effectiveness of market functioning. It is thus the first piece of evidence to look at. 3 Other indicators also warrant attention, partly since they may have impacts on welfare independent of (i.e. not working through) the level and distribution of income, and partly because they help to understand why the trends in the level and distribution of income come out as they do. In the former category falls any evidence which may reflect the non-monetary benefits and costs of work or of the structure and functioning of the labour market--e.g. working conditions, security of work (actual and perceived), and feelings of injustice or unfairness resulting from how the market works. In the latter category fall most other indicators, including the rate and incidence (among different groups) of open unemployment, the level and incidence of underemployment, the adequacy of access to employment, levels of and trends in wage rates, hours of work, etc. Indirect indicators like the share of the labour force found in the modern sector (correlated with working conditions, job security, and fringe benefits) may also provide useful information.

3 Although the available data include some income from non-labour sources, such (mainly capital) income tends to be severely underreported, so the story the figures tell relates mostly to labour income.

2.1 The income distribution record

It is now generally accepted that Latin America has suffered an increase in inequality without precedent in the period since reasonably adequate data became available in the 1960s; current discussion and analysis focuses mainly on the explanations for that pattern. The timing of that increase has often coincided with the recessions of the period and often with the economic reforms; 4 Morley (1995) concluded that the recessions were substantially to blame, with the implication that with economic recovery the temporarily high inequality would recede. Though this factor may have been significant in a number of countries, it is now clear that an important non-transitory increase in inequality has also taken place. Where reform coincided temporally with recession, recovery typically did not bring inequality back to its pre-recession level, and in a number of cases where the two did not coincide the reforms were accompanied by jumps in inequality (e.g. Colombia, Ecuador). Much attention has been focused on the record in 1990s Chile, partly because of the shift to a civilian government and partly because it was felt that if the increases in inequality were to be transitory, Chile would be the first test case of this proposition since its reforms had been in place the longest. So far there has been no sign of a significant reduction in inequality in that country.

Various attempts have been made to explain the increases in inequality in these LAC countries. Because there has been a strong tendency for the main possible contributors to the increased inequality to emerge at about the same time (trade reforms, other market-friendly reforms, bursts of technological change), it has been impossible thus far to sort out the causal process in a convincing way. Nonetheless several lines of analysis are worthy of note and will hopefully produce clearer results as time goes on. 5

The main approach to date has emphasized the widening gap between wages of skilled and less skilled (or educated) workers in Latin America, a pattern which has been very widespread over the last decade or two and which has elicited much analysis and discussion in the United States and other developed countries. The gap between skilled and unskilled workers tends to be larger in developing than in developed countries, and helps to explain the high levels of inequality among earners in many regions, Latin America prominent among them. A general downward trend in this gap had been occurring prior to the late 1980s, with Latin American countries converging fastest toward the developed country pattern of fairly low earnings differentials, according to Lora and Marquez (1998); since then there has been a reversal, again most marked

4

The record of distribution change has been reviewed, *inter alia*, by several authors (Berry, 1997; Altimir, 1994; Morley, 1995).

5

The most ambitious attempt thus far appears to be that of Londoño and Székely (1997). The study attempts to include policy variables related to the economic reforms, together with such other presumed determinants of income distribution as the level and distribution of educational attainment, the rate of inflation, the distribution of land, and others. The authors attribute the changes in distribution to an inadequate accumulation of human capital and to the "extreme" increases in the inequality of access to education, a view which seems implausible and/or partial given that the average level of human capital in the labour force tends to change rather slowly, whereas in many countries the increase in inequality has occurred over a short span of time. Although its data-intensive regression analysis points in the right direction--in the sense that much more work along these lines should be done, the study jumps abruptly to a set of conclusions which, if one judges by the normal evolution in such new areas of research, are unlikely to remain unchanged as the next stages of results come in.

in Latin America (which also has the widest gaps), with the Asian tigers forming an exception as their differentials have continued to fall vis a vis those of the developed countries. Thus, while real wages in Latin America have tended to creep up from their 1991 low, this slow recovery has come with a substantial increase in the gap between white and blue collar workers, most notably in Peru (by more than 30 per cent), Colombia and Mexico. A number of observers (e.g. Lora and Marquez, 1998), explain this large and widening difference as the result of the low level and slow increase in education in Latin America, whose labour force currently has two years less education than the average for its level of development, and four years less than East Asian countries at the same development level. Years of education in the work force have increased at only 0.9 per cent per year vs 1.6 per cent in the 1960s (Duryea and Székely, 1998). The education gap has become particularly conspicuous in the 1990s as a result of the growing demand for skilled labour caused by the upturn in investment. Though they are no doubt at work, it does not appear credible that such gradually acting force could be primarily responsible for the observed distributional shifts, which have tended to be quite abrupt, often occurring in the course of just 2-4 years. In any case, the careful attempts to sort out demand and supply effects (especially Robbins, 1996; Robbins, 1998) have tended to conclude that it is demand shifts that most directly underlie the changing patterns of wages and wage differentials. It remains to be determined what mechanisms explain the changes in the pattern of labour demand, and how they have interacted with shifts on the supply side and with any changes in the way labour markets have been working.

Reforms in the areas of international trade and investment have been consistent elements of the packages instituted in the LAC countries where distribution has worsened significantly, though also present in several cases where it has not (Costa Rica, Peru). Among the alternative theories put forward to explain an observed association between the removal of trade restrictions and increasing inequality, several (eg. Wood, 1994) assume that the labour involved in producing exports is relatively skilled, with the result that intensification of trade widens earnings differentials by level of education. Others involve "skill-enhancing trade" (Robbins, 1995a); ie. the increased capital goods imports associated with trade liberalization can increase the returns to skilled labour, which is complementary to capital goods (Hamermesh, 1993). It has also been widely noted that globalization tends to favour the "large-scale sector" of the economy - large firms, large cities, the more developed regions within the economy, etc. The dominance of large firms in the production of manufactured exports implies less employment creation than would otherwise be expected (Berry, 1992). Since earnings differences associated with firm size (including those across the formal-informal sector divide) and with region are often large, an accentuation of this tendency constitutes a real risk. It has been argued that the opening up of trade should raise the relative incomes of agricultural workers, since the ISI regimes discriminated against the sector and especially against exports from it. The evidence on this point is still very partial (since household surveys often fail to cover rural areas adequately or at all). There are clear examples of recent labour intensive agricultural exports (e.g. Weller, 1997), but there are many other examples in which employment creation is limited by the fact that the activities are organized by large farms or corporations (Carter, et al, 1996). In a number of countries (including Mexico) it appears that a significant part of the agricultural sector cannot compete easily with an onslaught of imports and that its labour resources are not easily mobile to other sectors. The overall story of the impact of the reforms on agriculture and the way this affects labour market outcomes has yet to be told in Latin America. At this point there are few grounds for optimism that the story will be a strongly positive one.

Confusing the analysis of the effects of the reform packages is the frequency with which large capital flows - either inward or outward, have impinged on the tradeables sectors and the economies as a whole. In particular, the demand depressing effects of the import surpluses and appreciated exchange rates accompanying capital inflows may have overwhelmed the potential positive effects of freer trade. Only when this factor is duly taken account of will a fairer assessment of the other elements of the reform package be possible. The one component of that package whose effects are most definitely questionable thus far is the opening up of domestic capital markets. The recent debacle in East Asia only underlines the already obvious problems these flows have caused the countries of Latin America.

Box 3: Most countries of Latin America appear to have undergone significant increases in the inequality of labour incomes (and of all incomes) at some point during the last couple of decades, most often coinciding with the introduction of economic reforms. The causal factors at work are no doubt complicated and have not yet been clarified or much analysed. The pattern suggests a need to scrutinize the elements of the reform to better understand which if any may be contributing to this trend, and increases the urgency to design policies which will have positive distributional effects.

2.2 Trends in labour market structure and outcomes: Participation, unemployment and work stability

Population growth in the LAC region has decelerated decade by decade since the 1950s; by the period 1990-95 it was estimated to be about at 1.8 per cent per year (IDB, 1997, 219). The growth of the labour force (about 2.5 per cent per year over 1990-95) has responded with the usual lag, reflecting the changes in age structure associated with slowing population growth and the ongoing increase in female participation (see below). Provisional estimates suggest that urban population growth slowed to 2.7 per cent per year over 1990-96 while the rural population declined at 0.6 per cent per year (IDB, 1997, 220). Latin America is thus in the midst of an important demographic transition towards the age structure of developed countries and the associated dependency rates; between 1980 and 1995 the share of the population in the age range 15-64 rose from 56 per cent to 61 per cent (World Bank, 1996, 195). The dependency ratio (ratio of old plus young to those of working age) has been falling since about 1970 and will continue to decline until around 2010, after which aged-dependency will be rising enough to increase the overall dependency ratio again. 6 Thus the next decade or a bit more constitutes an interesting transition window, during which the working age population will be high. It will be important that during this period a system be put in place to handle the transfers needed to secure the welfare of the aged in the future; most of Latin America has had pay-as-you-go social security systems, which are dangerous when an aged-dependency crisis looms in the not too distant future.

Increasing participation of women

Female participation rates (PRs) have continued to rise significantly; between 1980 and 1995 the rate (defined as the labour force of all ages divided by the population 15-64) rose from 35 per cent to 44.5 per cent for the LAC region as the share of women in the total labour force

6 In the past the child dependency ratio has been very high; it is now falling fairly quickly. The old-age dependency ratio is rising and will eventually become high (as in developed countries) but is still relatively low. This combination has produced the currently relatively low dependency ratio of the region.

rose from 27 per cent to 33 per cent (World Bank, 1997, 221). The corresponding male rate moved down from 94.4 per cent to 90.1 per cent. The overall rate has continued to edge up--at about 0.2 points per year during the 1990s thus far. Female PRs tend to be positively associated with level of education, with single status (especially if household head), and with small family size for those who are married. Participation has tended to increase over time for women in each family status and educational category. Rates for young, single women have been relatively high for some time. Those for married women appear to have been rising sharply from their low levels of a few decades ago, judging by evidence from Bogota, where this rate jumped from 25 per cent in 1976 to 42 per cent in 1989 (Berry et al, 1994, Table 2.22). The positive overall trend in female participation rates is associated partly with increasing levels of education, partly with the decreasing share of married women who have large families, and partly with the increasing prevalence of female headship. But the intra-category increases appear to be generally reflective of the process of social change and the increasing status and responsibilities of women. Latin society has clearly been evolving towards the pattern of the industrialized countries.

The increasing participation of women has also raised their share of total income earned in the economies and the share they contribute to total family incomes. The contribution of spouses (who are not heads--almost always the woman) to family income currently ranges from a bit under 25 per cent to about 35 per cent in the Latin cities (ECLAC, 1995, 68). The percent of urban households with both spouses active ranged from under 20 per cent to around 30 per cent in 1980; by 1992 it had jumped to the range 30 per cent to over 40 per cent. For poor households these figures were lower and more varied across the countries; large family size and associated constraints on female participation help keep many families in poverty. The share of urban households headed by females, in the range 17-25 per cent as of 1980, had by 1992 risen by 2-5 percentage points in nearly all LAC countries and is likely to continue to do so through the 1990s and beyond. These patterns are evolving towards those of developed countries.

In spite of their increasing presence in the labour market (and probably in part because of it) "Female heads of households experience higher rates of unemployment, lower numbers of hours worked, lower salaries and greater difficulties in entering the market than do male heads of household." (ECLAC, 1995, 73). In those countries with the highest prevalence of female-headed households the share of indigent households in this category tended to be much greater than the share of all households. Thus in Venezuela, where about 24 per cent of households were female-headed, 46 per cent of indigent households were (ECLAC, 1995, 168). Where the share of female headed households is low, as in Mexico, the share of indigent households which are female-headed is even lower. If these cross-country differences are indicative of likely time trends, it is possible that if female-headedness rises in future the share of poverty found in female headed households will rise more than proportionately. If so, the societies affected will do well to prepare their policy responses in advance.

Box 4: Latin America is in the midst of an important demographic and social transition, with falling birth rates and family size and with increasing female participation rates, economic independence of women, and female headed households. There remains considerable resistance to these trends in some countries, and a need to continuously refine policies to support them.

Unemployment and the permanence/stability of work

There is no evidence of secular trends in open urban unemployment rates in the LAC region, though the level has tended to reflect the economic cycles. The onset of the crisis in 1980-85 saw unemployment rise from 7 to 11 per cent in the region as a whole, and increasingly afflict non-secondary workers (Turnham, 1993, 167). After dropping back in the late 1980s as some macroeconomic recovery occurred, the rate has risen again in the 1990s (from an (unweighted) average of 6.0 per cent in 1990-92 to 7.5 per cent in 1995-97 (ECLAC, 1997, 52.) even though GDP growth has been much better (at an average of 3.5 per cent over 1990-97) than in the 1980s (average 1.0 per cent). At the country by country level, fast growth in the 1990s has tended to lower unemployment and vice versa, with a few exceptions (Table 2). One interpretation (see, e.g. Weller, 1998, 4) is that, though the link between economic growth and the unemployment rate is still present, the trade-off is at a less favourable level than in the 1980s. Another is that, given the typical rate of productivity increase which the region is likely to achieve, growth must reach 5-6 per cent per year for any tightening of the labour market to take place. In contrast to the record on income distribution, there is no general evidence of higher unemployment rates in liberalizing countries. Concerns are warranted in cases like Argentina, whose rate rose sharply from 6.5 per cent in 1991 to 17.5 per cent in the recession year 1995 and still stood at nearly 15 per cent in spite of the high growth in 1997, and in Peru where in spite of the much faster growth of 1995-97 than of 1991-93 the unemployment rate rose. Such contretemps may turn out to be simply bumps along the way, but they may also be a reflection of a delicate employment challenge, as discussed in Section 3 below.

As the Latin American countries move closer in structure to developed countries, the social meaning of unemployment has probably also been moving in that direction, with a smaller component of it appropriately characterized as "luxury good" in character and more of it associated with a low position on the income scale. Its incidence tends to be quite high in the lowest income quintile of urban families; except for Mexico with its very low rates overall, the figure ranges from 17 per cent in Brazil to over 40 per cent in Venezuela, dropping usually to 1-3 per cent in the top quintile (ECLAC, 1995, Table 1-1). Other continuing concerns are youth unemployment and the less educated worker. Older workers are increasingly subject to open unemployment in periods of recession, as in the 1980s; as the labour force ages and the economies shift towards increasingly open trading patterns and the associated need for retraining, the challenge of avoiding unemployment in this category will increase.

Recent opinion surveys in 17 Latin American nations have revealed a high level of concern with future employment possibilities. Even where the rate of open unemployment has been low, such concerns are widely voiced. This fact has both welfare and political implications and will have to be probed in future.

Box 5: Though there has been no secular trend in open urban unemployment rates in the LAC countries, some concern is warranted by the fact that in spite of the modest recovery of the 1990s unemployment has risen somewhat. It remains to be seen whether fast growth or more employment-intensive growth will be the best way to achieve a tightening of the labour market.

Instability of work

A significant expansion of temporary work and part-time work has occurred in many countries, developed and developing, over the last couple of decades. Though the precise magnitude of this trend is not clear for LAC countries, it appears to be important. It is widely believed that the rapid growth of temporary work has been partly in response to rigid job security legislation which makes it hard to dismiss permanent workers, together with market conditions which did not give a high level of confidence that the worker's services would be needed over a long period. Labour legislation applied to permanent rural wage workers has probably been a factor behind the growth of temporary work there (de Janvry; Riveros; Commander). In Colombia, job instability, always high in rural areas, seems to have increased in urban areas since around the end of the 1970s (Lopez Castaño, 1994, 2); temporary jobs constituted about 5-6 per cent of urban employment in 1976-78, had risen to about 13-14 per cent in the late 1980s (Fedesarrollo, 1992, 34) and further to 20 per cent by 1991-92, around which level it has fluctuated during the 1990s (Weller, 1998, Cuadro A.2). Though legislative changes of the early 1990s presumably facilitated some of this increase, much had occurred *de facto* before them.

Several questions remain to be resolved with respect to this trend. First, to what extent does it respond to important and unavoidable market pressures on firms and are these pressures likely to continue for the foreseeable future? Second, how important are the costs it imposes on workers? Does it frequently involve workers who have no strong preference for permanent jobs in any case? Finally, to what extent is this trend likely to worsen family income distribution (if at all)? Are most temporary workers contributing to family income in a secondary role in any case?

> **Box 6**: The apparently sharp rise in temporary work and other forms of job instability must be better understood, both in terms of the extent to which it contributes to business efficiency and the extent to which it is a problem for workers.

2.3 Labour market segmentation: The informal sector

The size of the informal sector is often taken as a measure of the failure of the economy to generate enough reasonably remunerative jobs. It may also be taken as a measure of the inefficiency of the labour market due to its imperfections, some of them policy-induced. To the degree that such segmentation is driven by government or union imposed regulations that push labour costs above market clearing levels leading to inefficiencies in the allocation and use of labour, one of the benefits of flexibilizing reforms could be to reduce it. There are however other possible explanations for the earnings gap between the formal and informal sectors, including the efficiency wage concept. Another view sees at least part of informal activity as the direct or indirect outcome of attempts by large modern enterprises to avoid labour legislation. It has been noted that there is considerable movement in both directions between the formal and informal segments, as usually defined, suggesting that the degree of segmentation between them is sometimes exaggerated.

Though the economic crisis of the 1980s in LAC did raise unemployment rates, as noted above, its main labour market impact was to shift workers into the informal sector (Turnham, 1993, 68). A PREALC estimate, which defines the sector narrowly to include just independent workers (except professionals) and domestic servants, is that its share in non-agricultural employment rose from 25.6 per cent to 30.8 per cent in the 1980s 7 (Barrera, 1994, 22), in the process creating nearly half of the new jobs during the decade. Its growth was concentrated in the early 1980s during the heart of the crisis. There is less clarity as to how absolute and relative incomes of the informal sector behaved during the decade of crisis. PREALC (1990) judges that the fall in average earnings over 1980-89 was a great deal sharper in the informal sector (42 per cent) than in the public or small scale (30 per cent) or the medium and large scale (just 7 per cent). These figures may exaggerate the difference in earnings trends, but they are probably accurate in suggesting that the informal sector workers suffered greater losses than those able to retain their formal sector jobs. Data indicate that the former did less well in the early 1980s recessions in Brazil and Chile. For Costa Rica, however, Gindling (1989) reports that the earnings gap between the private-formal sector and the informal one rose or fell over the crisis of 1980-82 (with this movement reversed over the next few years of recovery) according to exactly how the gap was measured, in particular according to whether the comparison was based on the composition of human capital found in the former or the latter sector. This finding suggests caution in the interpretation of results from other countries

More noteworthy than the informal sector's relative expansion in the 1980s is the continuation of this trend in the more favourable growth context of the 1990s. ILO figures, referring to a broader definition of the informal sector than that cited in the above paragraph, show its share rising from 51.6 per cent in 1990 to 57.4 per cent in 1996 (OIT, 1997, 24), implying that it accounted for a large majority of net new jobs. 8 I have not seen data on trends in the relative income of the sector.

What are the implications of a situation in which it appears that the share of total employment in the informal sector may remain very high for some time? An economy which retains a large low-income informal sector even as it grows and per capita average income rises is likely to be suffering an increase in inequality, as so many LAC countries have been. On the other hand, the allocation of much labour to this sector may or may not be inefficient from a static point of view, and if inefficient it may or may not be avoidable through labour market or other policies. Increasingly the evidence seems to suggest that not much efficiency loss results from barriers to movement between the formal and informal sectors. For example, Maloney (1998), on the basis of an insightful analysis of the movement of people between the formal sector and several segments of the informal sector in urban Mexico, concludes that any impediments to movement between the formal and informal sectors do not prevent a considerable flow of economically desirable movement; that neither the earnings differentials of those who move (which go in favour of the informal sector) nor the size of the movements supports the idea of a marked segmentation between these labour market components; that labour force mobility in the formal sector (as measured by the rate of turnover) is not low, as has often been claimed, but

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7 Garcia and Tokman (1985) estimate that from 1950 to 1980 the informal sector's share of non-agricultural labour declined slightly from 30.7 per cent to 28.7 per cent (Tokman, 1990, 99). Use of the normal definition (including paid workers in the small-scale sector also) would put all of these figures higher.

8 In Argentina, Brazil, Costa Rica, Mexico, Peru and Venezuela the majority of new employment came from this sector, while in Chile, Colombia and Panama the formal sector was the main source (OIT, 1997). In almost all countries paid employment grew fastest in the microenterprise sector.

about the same as that of the United States; that there is little evidence of the rigidities that the incentives of the labour code would lead one to expect, and certainly no evidence that people want to stay in the formal sector until they retire--at least two thirds of those entering self-employment from formal salaried employment did so voluntarily, with a desire for greater independence or higher pay cited as the chief motivation; that paid informal sector work (often viewed as the bottom of the informal sector scale) seems to serve as the principal port of entry for the young, poorly educated workers into paid employment, but that their average wait is just two years before moving on, typically to other paid employment. 9 Maloney argues that the very legislation that is thought to induce rigidities into the labour market may in fact stimulate turnover and encourage workers to leave salaried formal sector employment. If the rigidities leave few opportunities for promotion and this is complemented by a general pattern in which blue collar workers hit an advancement ceiling (partly related to features of the culture) this may encourage them to go out on their own. This logic is most compelling where smaller firms can offer comparable remuneration--most likely for low skill workers who could not develop much firm-specific capital in the larger firm.

The policy implications of this unconventional picture of labour market segmentation will depend first on whether it turns out to hold across the region; there is some possibility that Mexico's labour market is atypical. 10 Further, note that the finding of considerable mobility among sectors does not mean that there are not some inefficiency-inducing barriers--it only suggests that these barriers are of much less importance than they have sometimes been held to be. And the finding of relatively easy movement among labour market "segments" does not disprove the contention that the size of the informal sector may be a reflection of unduly low labour absorption in the formal sector due to labour-cost raising interventions. Finally, these recent findings do not detract from the importance of raising overall productivity in the smaller-scale sector. Rather they suggest that this will be the main source of productive employment growth since any shift of labour from the informal sector to more productive jobs in the formal sector which may result from labour market reforms is likely to be modest proportions.

9

This figure is similar to that reported by Sedlacek et al (1995) for Brazil (which has notoriously mobile workers) and to that in the U.S.

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In one of the very few cross-country studies which have tried to use the same definitions and data to evaluate the relative size of the informal sector and the formal-informal income differentials, Marcouiller et al (1997, 378) report no wage differentials which cannot be explained by personal characteristics between formal and informal sectors in Mexico (1990) while that for El Salvador (1990) is relatively large (typically 25-50 per cent depending on how measured) and that for Peru (1985) is also significant for women They note in an earlier version of the paper (Marcouiller et al., 1994, 17) that as recently as 1987 the formal sector workers in Mexico did earn a premium though apparently a smaller one than found in the other two countries. It is possible either that Mexico is somewhat atypical in general or that 1990-91 is an atypical period.

Box 7: The informal sector is a natural part of any developing economy. The evidence from Latin America does not suggest a high level of segmentation between it and the formal sector, nor suggest that existing labour market interventions significantly increase its size. Its growing share of the labour force in the 1990s does, however, point to limited employment creating capacity in the rest of the economy and is for that reason a source of concern.

3. The sectoral character of the employment challenge

Two important sources of employment in the past have become distinctly less so over the last couple of decades in Latin America--the public sector and large private enterprise. Employment growth of the public sector will be severely constrained by the need for fiscal prudence and for a higher level of efficiency than in the past. While the private large enterprise sector will hopefully regain its past employment-creating capacity eventually, this is unlikely in the short run. As of the early 1990s, establishments of, say, 100 workers or more probably accounted for about 15 per cent of all employment. Under the influence of increasingly open economies this sector has seen a good deal of downsizing related to technology upgrading to raise labour productivity and increase competitiveness. During the 1980s there was virtually no net job creation in the large-scale private sector; in the 1990s (through 1996) its contribution appears once again to have been positive but has probably accounted for at most 15 per cent of employment growth. The public sector's contribution has fallen to about zero. Although agriculture continues to provide about 19 per cent of total employment in Latin America, that share has been falling quickly (as expected in any normal course of development) and it appears that the absolute level of employment in agriculture has as well; it would thus be implausible to expect a significant contribution from this sector. 11 The remaining categories are microenterprise (rural and urban) and small and medium enterprise (SMEs). The latter are bigger and achieve higher labour productivity than micro enterprise but less than the large scale sector. In the early 1990s, the great bulk of the new jobs have been generated in the informal sector, but this brings the threat of further polarization of the economy and the society due to a fall in the relative productivity of the sector. Microenterprises can provide a sizeable number of relatively low income jobs and should be encouraged and assisted in doing so, but their potential to create a large number of jobs with really satisfactory income levels is likely to be limited, in spite of the considerable advance which has been made in micro enterprise support systems. The pivotal role of the SME sector in the short and medium run lies in its capacity to create large amounts of remunerative employment (i.e. employment which pays considerably better than the informal sector average) with modest amounts of capital.

11 Major land reforms have the potential to raise the level of productive employment (as evidenced by the earlier experiences of the East Asian countries and others), but it seems unlikely that LAC countries will do enough in this area to generate any significant amount of employment.

Box 8: For the next decade or more the bulk of the employment creation in Latin America will necessarily come from the informal or micro enterprise sector and from the small and medium enterprise sector. Accordingly policy should be directed at fostering higher productivity in micro enterprise and expansion and productivity increases in the SME sector.

4. The broad outlines of a good employment policy

A necessary condition for satisfactory labour market outcomes is a healthy economic growth rate. Once that condition is met, a well designed employment strategy to fit present conditions in LAC has three components: a growth pattern in which those sectors with the capacity to create substantial amounts of remunerative employment per unit of growth have a large weight in the composition of output growth, i.e. the SME and micro enterprise sectors and within the former the relatively labour-intensive activities; increases in the supply of skills consistent with fast growth of remunerative employment, involving the processes of education, training, etc.; and a labour market which functions as effectively as possible. If a high share of new jobs must come from the SME sector and micro enterprise, it is clear that all policy areas, including the more macroeconomic ones must focus on them much more than in the past.

Employment policy (broadly defined to include support for the sectors which will generate most of the new jobs) will probably have to improve in Latin America for the outcomes to be satisfactory over the next decade or so. If the needed advances in the micro enterprise and SME sectors could be confidently expected on the basis of policies currently in place, there would be no major challenge. But neither the apparent quality of the current policy packages nor a comparison between them and those of countries which have achieved particular success (especially on the SME front--see Berry, 1998) is reassuring. Rather, it appears than substantial policy improvements will be called for. One challenge involves the increasingly open character of the economies. For export activities to be labour intensive and to have a significantly positive effect on labour markets it is typically necessary that they involve SME in the secondary and tertiary sectors and small farms in agriculture. The great "growth with equity" experiences of the East Asian countries which pursued pro-export policies all involved, sooner or later, a strong involvement of SMEs, usually as subcontractors to larger exporters, but at least in the case of Taiwan (China) also as direct exporters. Taiwan (China) is the prototype in which the SME sector plays a pivotal role by itself; it is widely believed that its outstanding success in achieving both dramatically fast growth and perhaps the lowest level of inequality of any developing market economy are substantially attributable to this dominant SME role (Fei, Ranis and Kwo, 1979). The record in the Republic of Korea is probably more interesting, since its experience over the past two decades demonstrates just how fast the SME sector can grow in a country with considerable structural similarities to many Latin nations, based on a combination of favourable context and strong public policy support. 12 The experiences of these three countries and of others in the region (especially Hong Kong) make it clear that there is no inconsistency between

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In the early 1970s the Republic of Korea's industrial structure was more similar to that of Latin countries like Brazil and Mexico than to that of Taiwan, China in the sense of its being dominated by large, vertically integrated firms which did relatively little subcontracting. Since that time however, SME output and employment growth have been very fast indeed (Cho, 1995) and the level of income inequality in the country has diminished.

great success in world markets and a booming SME sector, rather the contrary appears to be the case. At the same time there is no doubt that a more open economy creates new dangers to the health of this sector, so that in the absence of well thought out policy its performance may fall far short of potential. The increasing prevalence of flexible specialization has persuaded many analysts that smaller firms will play an increasing role in the industrial structures of the future, both in developed countries and developing ones. Although the Latin American policy record with SMEs is not impressive, the considerable educational advance in Latin America over recent decades, together with its now substantial industrial history, suggest that the supply of entrepreneurial talent for SMEs is satisfactory or better than before in a number of countries. If properly complemented by collectively provided services these advantages provide a promising setting for an SME boom.

The contribution of microenterprises is different from that of the SME sector. The latter generally provides satisfactorily remunerative employment; the challenge for SMEs is to increase the total employment base, an expansion that can be thought of as taking up some of the slack from the shrinking sectors (the public sector and agriculture in many countries) as well as providing a better option to some of the workers currently engaged in the micro enterprise sector. The challenge to microenterprises is not to increase their relative or absolute employment but rather to raise the productivity of workers in the sector, both for the direct benefits of giving them higher incomes and because, to the extent that earnings options in this sector define the reservation price of many other workers and hence their supply price to other sectors, the earnings levels in micro enterprise can control earnings elsewhere as well.

Two distinct, but sometimes converging lines of action are needed on the skills supply side. First, it will be necessary that the educational and training policies duly reflect where the net employment will come from - the SME and microenterprise sectors. One concrete implication is the need for a wide base of entrepreneurial skills and the educational and training activities needed to meet this goal. Second, the general nature of the challenge in the area of human capital has been widely recognized as one of raising the average level and decreasing the variance of skills and of providing those skills which are in demand. Some of the implications of this broad goal are clear: more training in the area of computers and information technology, better quality of schooling at most levels, special attempts to raise the human capital of those at the bottom of the socio-economic pyramid, etc. Beyond such generalizations lies the task of working out the details corresponding to individual country situations. Achieving the desired goals will require carefully crafted policy in the light of the current fiscal stringencies, the fact that such accumulation by the children of poor families requires a substantial subsidy, and the fact that increased education of the poor may trigger a reaction by better off families in order to maintain the existing educational and hence earnings gap, creating a dilemma for public policy. Since institutional change in this area takes time, it is inevitable that the presence of a large group of workers with low human capital will remain a problem for some time in most LAC countries. Accordingly it is important that the demand for such labour remains as strong as possible until the supply eventually dries up; this demand-side aspect of the solution will depend mainly on the agricultural, microenterprise and SME sectors and their continued ability to make use of such workers. For some of the experienced workers in this category, it will be important that retraining be available, especially where such workers do not have younger family members who are well trained and can hold up family income. In general rapid advances from cohort to cohort in human capital formation are likely to bring dislocation and increased inequality, especially where the extended family is in the process of being weakened. Steps will be needed to guard against that outcome.

Training programmes for currently employed workers fall into a different category. While they help workers they also directly help employers. In addition, they interact with unemployment insurance systems; a good retraining programme should be perceived as alleviating the problem of unemployment, from both the workers' and society's point of view (the latter represented in part by the fiscal costs). Such programmes are especially relevant in periods of fast technological change like the present and particularly where many SMEs are confronting and must achieve rapid technological change. Large firms, especially in industrial countries, do a great deal of in-house training and other firms do a fair amount of it too. Most LAC countries have lagged seriously in this regard. A high level of direct firm involvement in the provision and/or purchase of the training would be desirable in many SME activities but cannot realistically be expected to occur on its own at anything near the appropriate level; even less would this be the case in microenterprise. Training for these sectors must be seen largely as a public good and substantially funded by (though not necessarily provided by) the state. Where associations of firms operate effectively they can play a role in planning for and provision of such services.

Finally, employment policy must address the question of whether the institutions (legislation, practices, etc.) which affect labour market functioning are appropriate to current circumstances. This issue is considered below. Although few firm conclusions can be drawn, it seems likely that this policy area will be the least important of the three dealt with here.

Box 9: Latin American countries will need to substantially strengthen their employment policies to provide a reasonable chance of satisfactory outcomes over the next decade or so. Important components of those polices should raise the demand for labour, especially that in the lower skill categories, and improve the supply of relevant skills, especially from groups who currently have few marketable ones. Much of the policy to raise the demand for labour will have to focus on smaller farms, microenterprise and SMEs.

5. Major issues of labour market reform

Some have argued that a set of well-chosen labour market reforms in LAC could provide significant gains in efficiency and in employment. In reviewing some of the elements proposed it is important to note the interface between labour policy and social policy more generally. Perhaps the most complicating aspect of labour market policy is that it is inevitably part of the broader battery of social policies. One objective is to make the labour market work better, improving the efficiency of labour allocation among firms, etc. consistent with the long-run welfare of the workers; the other is to play a special sort of income maintenance role--holding up the incomes of low wage workers (minimum wage), holding up the incomes of those prone to unemployment (unemployment insurance), raising the productivity of those whose skills are becoming obsolete (retraining) and so on. The challenge, with respect to most of the important components of labour policy is to achieve a specific goal (eg. protection against the uncertainties associated with unemployment) while meshing smoothly with other elements of the income maintenance system (the social safety net) and not inducing an excessive degree of negative side-effects. What really matters is how well the whole system of social institutions, including those associated with the labour market, performs, thus no single component can be judged definitively without reference to the total system.

There are valid suspicions that elements of the traditional labour codes in many Latin countries have contributed to economic inefficiency. The most general criticism is that the existing rules of the game make the labour market too rigid, thereby:

(ii) preventing an efficient shifting of human resources among industries when necessary (through dismissal rules); this concern is a general one but has been especially emphasized in the context of more open economies needing to compete internationally;

(ii) keeping the cost of labour too high in general (through high payroll taxes and to some extent minimum wages) thereby discouraging use of labour in favour of capital, sometimes discouraging investment and growth, and weakening international competitiveness;

(iii) through the unpredictability of either unions or state intervention (whichever is relevant), thus creating too much uncertainty for investors or potential employers and thus discouraging either investment or job creation.

Many reform packages include the idea of shifting some or all of the responsibility for protecting the worker against unemployment (dismissal rules, including costly severance packages) and against such other contingencies as health problems or low income on retirement (social security financed by payroll taxes and employer contributions) away from the employer and towards the worker and/or the state. Thus unemployment insurance systems have been started in several countries, partly in the hope that they will provide the protection against loss of job which the strong rules against dismissal have previously been designed to give. Reforms of the social security/pension systems have also been undertaken in a number of countries with various objectives in mind, including a lowering of labour cost to the employer.

Most components of the typical reform package do have considerable economic logic and deserve policy consideration. In general, however, there is at this time little empirical evidence on the magnitude and sometimes even the direction of their likely effects, suggesting that their implementation might make more sense when the evidence is clearer and that a serious research effort should be mounted quickly. More directly relevant to the present discussion, there is no reason at this time to expect that the reforms would improve labour market functioning significantly (e.g. to the point of being a key element in a strong set of policies to promote employment and efficiency). It is possible, however, that the effective mobilization of an investable fund through better management of pension systems might, as in Chile, have an important effect on total investment and hence on growth and employment creation. In this case the effect is not through a more efficient labour market but through the aggregate supply of savings for investment purposes.

5.1 Where not to look for major benefits from labour reforms

Before turning to the more serious arguments in favour of certain of the proposed reforms, it is appropriate to note several specific arguments which have little if any merit.

The pseudo-myth of high labour costs damaging international competitiveness. A currently common view is that their increasing integration into international markets will often imply a need for lower labour costs if the Latin American countries are to be internationally competitive. It is accepted by all that labour policy affects firm competitiveness; often SME are recognized to be in a particularly delicate situation in this regard. Both many supporters of an outward-orientation and many critics of it tend to accept the view that high labour costs damage a country's competitive performance.

The emphasis on labour costs in this discussion reflects a failure to take due account either of the basic principle of international trade theory, ie. comparative advantage, or of the (related) dominant role of the exchange rate in determining the international competitiveness of a country's industries. The error is to confuse what helps the competitiveness of a firm (any way to keep costs down, including low labour costs) with what mainly determines the competitiveness of a country (the exchange rate). The theory of comparative advantage implies that a country's capacity to trade and to gain from that trade does not depend on its technological level or the costs of any specific factor of production.

In the shorter run during which the underlying forces and mechanisms of an economy have not had time to work themselves out, the level of any given cost or the technology in use can and often does affect a country's success in international trade. Where management of the exchange rate has more than one objective, its capacity to maintain the balance of payments in equilibrium may be prejudiced. In many Latin American countries, for example, the exchange rate has been saddled both with the latter function and that of controlling inflation through a stable price of imports, which requires a stable exchange rate. Under such circumstances, labour costs can influence competitiveness. Tokman and Martinez (1997) estimate the relative impact of labour costs (taxes included) vis a vis other determinants of competitiveness of manufactured goods from five Latin American countries over the first quinquennium of the 1990s, finding that in general the more important short run determinants of competitiveness were macroeconomic variables, in particular the exchange rate. Thus, at least during this period, the theoretical expectation that the exchange rate would be the main factor at work is borne out.

Box 10: Except in the short run and under certain circumstances (when exchange rate management has other objectives than equilibrium in the international accounts), labour costs are unrelated to an economy's international competitiveness.

The need for labour mobility in order to shift human resources from the non-tradeables sector to the tradeables sector

One of the main arguments in favour of diminishing the constraints on the firing of labour and more generally on labour shifting among activities has been the need to shift many resources towards the tradable goods sector. To the extent that the primary and secondary sectors are associated with tradables, there is, however, no evidence of such a general shift taking place thus far in Latin America (though employment associated with the production of certain exportables has risen sharply); instead these sectors have been rapidly raising their labour productivity, and the expectation that tradables sectors in general will undergo a period of rising productivity is now widespread. Thus this particular argument for labour mobility does not appear to hold much validity, unless it is claimed that existing rigidities have contributed importantly to the lack of employment creation in the tradeables activities.

The need to weaken the segmentation between and informal labour markets

This commonly stated goal of labour policy reforms is unlikely to yield much fruit in the form of more or better employment, since there is thus far little evidence that segmentation does much to worsen labour allocation (see the discussion of Section 2.3 above).

These caveats notwithstanding, the alleged weaknesses of labour market functioning in Latin America do deserve serious attention. Their reconsideration must weigh carefully the benefits to all parties most directly affected (the workers and the employers) but also society at large through indirect effects (eg. on investible funds and on overall growth).

5.2 The "rules of dismissal" question

Regardless of whether the costs of rigid dismissal rules are high or not, it seems appropriate that as they approach industrial country status the Latin American nations should shift from their present focus on this tool of worker protection to a broader-based unemployment insurance system. The existing system of worker protection through dismissal rules protects only a minority of the labour force, and in a way which undoubtedly does lower efficiency in some cases. The dilemma at this time is that it remains to be seen when and under what conditions these countries will be able to adopt unemployment insurance systems which do provide a satisfactory coverage. One suggestion along these lines, which would broaden the base of coverage and at the same time have a built-in defence against abuse of the system (a serious problem in countries with at best modest administrative capacities at this time) is that of Cortazar (1995).

Modifications to the existing rules on protection against dismissal and the design of new systems to insure against the costs of unemployment should take into account the following factors or considerations:

(i) that empirical research isolating the effects of these rules in the Latin American context is in its infancy and accordingly unlikely to produce firm results for some time. 13

(ii) the increased role of tradeables and the associated need for flexibility suggests that, even if there is little evidence that dismissal rules have been important in determining overall labour market outcomes in the past, they still might be in the future.

(iii) at the same time that flexibility may be increasingly important in the more open economy, raising skill levels will also become more necessary due to changing technologies and other factors. This highlights the importance of a country's achieving effective contributions to skilling from all possible sources--the formal educational system, vocational training, and in-house and on-the-job training. This latter type of training, although reasonably widespread in some countries of Latin America, is much less prevalent than in most developed countries. High labour turnover will tend to discourage it.

(iv) it is probable that the category of firms most needing flexibility in the management of their labour forces (and thus most likely to be harmed by excessively rigid dismissal rules) are the SMEs. At present we have too little understanding as to how heavily the work dismissal rules weigh on various segments of this category to know whether their impact is important or not. Somewhere between what is usually called small (say 5-25 or so workers) and the upper end of the medium sized category (say 100 workers) usually

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13 Although Marquez and Pages (1998, 1) refer to "robust evidence that the protection of employment stability is associated with a higher incidence of self-employment, and somewhat weaker evidence that it is associated with lower employment rates" this is putting the case too strongly. Their cross-country regressions create some presumption in favour of such effects, but remain open to many possible mis-specifications, including the fact that the variables describing the dismissal systems of various countries are the official ones; in a region famous for the incomplete implementation of its legislation, this is a serious methodological problem.

constitutes the threshold between non-application and serious application of the various elements of labour legislation.

Box 11: Though the empirical evidence on the negative efficiency impacts of dismissal rules is not persuasive at this time, their gradual replacement in many LAC countries is desirable on other grounds in any case.

5.3 The excessive payroll taxes question

Payroll taxes have tended to be very high in most Latin American countries relative both to developed countries and to other LDCs (Riveros, 1996; Guasch, 1998). The context is different from that of developed countries since coverage is partial (microenterprise and smaller firms up to a size which varies from country to country are not covered) and partial coverage can have the effect of creating or widening a labour cost gap between the larger and the smaller-scale sectors. The main aspects of this policy issue are:

(i) how large a labour cost gap vis à vis the smaller-scale sector do payroll taxes create and how damaging is that gap? Although studies like Maloney's (1998) suggest at most a modest gap, most others report something more substantial (say over 25 per cent even allowing for some of the incidence of the tax falling on the worker). The resulting efficiency loss and the lost employment in the larger scale sector are harder to judge; the usually lower capital costs of larger firms act as a partial (or complete?) offset to the higher cost of labour, leaving it unclear theoretically whether there would be a significant efficiency loss from the resulting labour market imperfection or not. Solid empirical studies are lacking.

(ii) regardless of how much of the tax falls on the worker, one of the issues is how effectively the proceeds of it are used. Considerable criticism has been aimed at the efficiency of the pension and health services provided by these social security taxes in Latin America. Many workers clearly do not view the value of these as commensurate peso for peso with wage income, in which case the argument in favour of maintaining them unreformed is greatly weakened. A number of countries are offering the worker options in the management of pension funds built up through payroll taxes. Switching from pay-as-you-go funding of pensions to the fully funded system should raise national savings, a major boon from the Chilean system, for example.

(iii) where the management of payroll taxes is efficiently handled, they may be the least cost way of financing socially desirable benefits. Such taxes are simple and easy to operate and are a relatively efficient form of taxation, at least compared to taxes on income or capital. The combination of their distortionary effects plus the direct costs of collection may thus be less than for the alternatives, especially when they are effectively tied to benefits. It may be, as argued by Kesselman (1997) in the context of Canada, that the energy spent in reforming social security might best be directed at improving benefit-tax linkages, rather than focussing on the need to get these taxes to low levels.

(iv) as noted above, high labour costs, to which high payroll taxes contribute, are unlikely to have any significant effect on international competitiveness, which is based on comparative advantage, not absolute levels of either productivity or factor costs. Their distortionary effects on deciding which industries are able to achieve such competitiveness will be lessened to the extent that there is substantial shifting of the incidence to the worker (a common finding in studies from developed countries, though relatively untested in Latin American countries) and that the payroll tax is not too unevenly applied across the tradeables activities, something which does vary considerably by country.

Box 12: Whether payroll taxes should be relatively high is at least as much an issue of public fiance (how best to fund and to administer a general service with minimum efficiency losses) as one of simply assessing the absolute level of the efficiency losses associated with that possible instrument.

5.4 The Minium Wage (MW) question

The two main issues around minimum wages in Latin America are the extent to which they provide protection to the poor (the original intent in most cases) and whether they have the effect of pushing some wages above their equilibrium levels and hence constraining the demand for labour. In many countries the basic minimum has been set quite low vis a vis the formal sector wage structure, but in some there are numerous minima, making it hard to test for their possible effects. The minimum wage setting machinery varies widely across countries, and in some cases has become very complex, with participation by labour and management as well as the central decision-making authorities.

It is credible, as argued by Lopez and Riveros (1989), that the MW neither pushes up a significant number of wages nor has much direct capacity to protect the poor, given the context of labour market segmentation and the resulting modest level of coverage of the instrument. 14 This is less obvious for the more industrialized countries of the region like Argentina, however, and will hopefully become less the case with time as labour market segmentation decreases and potential coverage of the MW rises. And there could be indirect effects on the poor if, although their earnings are not directly held up by the legislated minimum wage, the structure of earnings in the informal sector is somewhat tied to that minimum or to formal sector wages themselves affected by it.

Several authors have suggested that MWs help to cushion real wage declines and to alleviate poverty during economic crises. Morley (1995) observed that during the 1980s in Latin America, movements of the real minimum wage were correlated negatively to movements in

14
Marquez and Pages (1998) analyse household survey data on wage structure in a number of LAC countries. Based on whether there are "spikes" (relatively large numbers of workers earning near the minimum wage level, they conclude that in Argentina, Bolivia, Chile and Peru (1996) there is no evidence that the MW affects the wage distribution in such a way as might imply higher unemployment, since the share of workers near the MW is low (around 10 per cent) and there is no evidence of a spike, either in the total wage distribution or when it is disaggregated by sex, rural-urban residence, or age. For another group (Brazil, Colombia, Costa Rica and Venezuela) they reach the opposite conclusion (p. 33), since 15-25 per cent of workers fall in the bracket between 0.9 and 1.2 times the MW and appear as a big “spike”. This sort of study will have to be pushed farther to ascertain the meaning of the not inconsiderable shares of workers with wages below this band--around 12 per cent in Brazil, 15 per cent in Colombia, and 20 per cent in Costa Rica and Venezuela. These may be informal sector workers whom one would not expect to be covered, or they may be workers whose presence suggests that the MW does not bind even in the fairly formal sector.

poverty, after allowing for the growth of per capita income 15 and concluded that this effect is related to the fact that the usual trade-off between the wage and the number of jobs in the formal sector is weakened when job opportunities in the formal sector are declining in any case.

Box 13: The impact of minimum wages, either on poverty alleviation or on economic efficiency in LAC are probably too little understood to suggest that significant changes be made.

6. Summary perspective

During the 1990s the LAC economy has recovered some of the dynamism it displayed before the economic crisis of the 1980s. Several indicators of labour market outcomes remain distinctly worrisome, however - most notably the sharp increases in labour (and overall income) inequality suffered by most countries. Other concerns are the high levels of unemployment in some countries, with a slight upward trend for the regional average; the rapid increase in the prevalence of unstable employment, in the absence of any unemployment insurance schemes with broad coverage; and the continuing difficulties faced by certain groups of female participants in the labour market.

Given the limited or even negative employment creating potential of the agricultural, public and large private enterprise sectors over the next decade or so, it is clear that the great bulk of new jobs will come from the microenterprise sector and the SME sector. Accordingly, it is crucial that the SME sector expands and that productivity in the micro enterprise sector be raised. The former objective will be especially crucial to overall success, and will require significant policy improvements. On the labour supply side, it is important that education and skills be increased, that the variance in the distribution of those skills be reduced, and that the content of education and training be matched more accurately with the needs of the economy. Several reforms of labour legislation and practices may contribute to improved outcomes, but this is at present unclear and only limited hopes should be placed on the impact of most of the labour reform programmes currently being implemented.

15 A similar result is reported by Lustig and McLeod (1996).

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Table 1. Sectoral Composition of Employment and Output in Latin America and the Caribbean: 1980, 1990 and 1997

Sector	1980	1990	1997
Employment			
Agriculture[a]	34	25	19
Industry	25	24	23
(Manufacturing	16.7	15 (?)	12.8)
Services	41	51	58
Total	100	100	100
Output[c]			
Agriculture[a]	10	10	10
Industry [b]	40	36	33
(Manufacturing	27	25	21)
Services	50	54	57
	100	100	100
Total			

[a] Includes fishing, hunting and forestry.
[b] Includes mining, manufacturing, construction and public utilities.
[c] Final column data are for 1995.
Sources: Employment figures for 1980 and 1990 are from World Bank, 1997, p. 221. Those from 1997 are from ILO 1998, p. 218 and p. 222 and refer only to the ten countries with the largest labour forces (those with over four million people in 1997). The figures for manufacturing in 1980 are from the latter source. The 1990 figure is an estimate based on a variety of sources. The output figures come from The World Bank, 1997, p. 213 for 1980 and 1997 and from The World Bank 1992, p. 233 for 1990. As a result the figures may not be quite comparable.

Table 2. Growth and the rate of open urban unemployment, selected countries, 1991-3 and 1995-7 (per cent)

Country	GDP Growth, 1991-93	GDP Growth, 1995-97	Unemployment rate, 1991-93	Unemployment rate, 1995-97
Argentina	8.4	2.0	7.7	16.5
Brazil	1.2	3.5	5.3	5.3
Chile	7.8	7.3	7.5	7.3
Colombia	3.8	3.7	9.7	10.9
Costa Rica	5.1	1.4	4.8	6.1
Ecuador	3.9	2.7	8.7	8.8
Mexico	3.3	1.7	3.0	5.2
Peru	2.6	5.6	8.4	9.1
Dominican Republic	3.2	6.4	19.9	16.1
Uruguay	4.7	2.9	8.7	11.4
Venezuela	5.4	2.6	8.3	12.0
Latin America[a]	3.5	3.0	6.0	7.5

(a) Excludes countries of the Caribbean. It is not clear whether the figures for Latin America as a whole are weighted or not. See my own calculations.

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