Law and Employment
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6. Publications of the NBER issued for informational purposes concerning the work of the Bureau, or issued to inform the public of the activities at the Bureau, including but not limited to the NBER Digest and Reporter, shall be consistent with the object stated in paragraph 1. They shall contain a specific disclaimer noting that they have not passed through the review procedures required in this resolution. The Executive Committee of the Board is charged with the review of all such publications from time to time.

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8. Unless otherwise determined by the Board or exempted by the terms of paragraphs 6 and 7, a copy of this resolution shall be printed in each NBER publication as described in paragraph 2 above.
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I.1 Introduction

This book uses microdata from diverse Latin American and Caribbean countries to investigate the impact of regulation on their labor markets. Common methodologies are applied to extract empirical regularities from the region. Latin America and the Caribbean are of interest in their own right. But for several reasons, the lessons learned from studies of these labor markets have much greater generality.

The shifts in the policy regimes experienced in the region are dramatic by the Organization for Economic Cooperation and Development (OECD) standards, and many of these regime shifts are exogenous. This large and exogenous variation provides identifying power not available to analysts studying regulation in Europe and North America. Given the evidence on the comparability of labor demand functions around the world summarized in Hamermesh (1993 and chap. 11 in this volume), lessons about the impact of regulation learned from Latin American labor markets apply more generally.

The studies in this volume are based on microdata. Use of such data avoids reliance on fragile country aggregate statistics that have been the
main source of information used to study European regulation (see, e.g.,
the evidence summarized in Nickell and Layard 1999). Countries have di-
verse economic regions and agents, and aggregation over these regions and
their economic agents masks this diversity. In this chapter, we show the sen-
sitivity of estimates of the impact of regulation obtained from conventional
pooled time series cross sections of countries to alternative choices of
samples and models, although a few important empirical regularities es-
established at the microlevel hold up in macrodata. Our analysis builds the
case for doing disaggregated analyses of the type reported in this book.

The evidence presented here challenges one prevailing view that labor
market regulations affect only the distribution of labor incomes and have
minor effects on efficiency.1 The results presented in this volume suggest
that mandated benefits reduce employment and that job security regula-
tions have a substantial impact on the distribution of employment and on
turnover rates. The most adverse impact of regulation is on youth, mar-
ginal workers, and unskilled workers. Insiders and entrenched workers
gain from regulation, but outsiders suffer. As a consequence, job security
regulations promote inequality among demographic groups. Most of the
individual country studies demonstrate that regulations promoting job se-
curity reduce covered worker exit rates out of employment and out of un-
employment, and on balance reduce employment.

This introductory essay has three main goals: (1) It summarizes the main
lessons to be drawn from the studies assembled here; (2) It places the Latin
American and Caribbean (LAC) regulatory burden in an international
context by comparing the level and changes in LAC labor regulation poli-
cies with those in OECD countries, as well as providing some historical
context about the origins of this regulation; and (3) It updates the work of
Heckman and Pagés (2000) with an expanded sample and better measures
of regulation, providing a cross-country time-series analysis of the impact
of regulation on employment and unemployment. We quantify the cost of
regulation in LAC and OECD regions. The fragility of the macro-based es-
timates documented in our paper suggests one reason why relatively little
is known about the impact of regulations in Europe, despite an abundance
of cross-country time series papers analyzing policies in that region. How-
ever, the macro time series literature does produce some empirical regular-
ities. The methods used to analyze the microevidence presented in this
book should be extended to produce more convincing evidence of the im-
ports of regulations on employment in the OECD region.2

This chapter proceeds in the following way. Section I.2 provides back-
ground on Latin American economic and labor market performance. Sec-

1. Freeman (2000) and Nickell and Layard (1999), among others, adopt this view.
2. See, however, the studies of Abowd et al. (1997), Abowd, Kramarz, and Margolis (1999),
Abowd et al. (2000), Machin and Stewart (1996), Kugler, Jimeno, and Hernanz (2002), and
others, who use microdata to investigate the impact of regulation in Europe.
tion I.3 presents some basic facts about regulation in LAC and compares LAC with OECD countries both in terms of the level and composition of labor cost and in terms of the labor market reforms experienced in the region. Section I.4 summarizes the main lessons from the essays presented in this book. Section I.5 updates Heckman and Pagés (2000) and uses the cost measures derived in section I.3 to examine the impacts of labor regulation on Latin American and OECD employment and unemployment rates. Section I.6 concludes and makes suggestions for future work on regulation in Latin American and OECD labor markets. We first present some background on Latin America and the nature of labor market regulation in the region.

I.2 Latin American Economic and Labor Market Performance

Latin American economic performance has been quite disappointing. Since 1970, growth of income per capita has been just over 1 percent per year, higher than in Africa or the Middle East, but much lower than in Asia or in the developed countries (figure 1). Up to the 1980s, trade policies heavily protected Latin American economies from foreign competition. There was a substantial degree of intervention by the state in the economy. The collapse of most economies during that decade due to growing fiscal and monetary imbalances led many countries to implement large structural reforms towards the end of the 1980s and early 1990s. Macroeconomic stabilization policies reduced fiscal deficits and brought inflation under control. Sweeping, fast-paced trade reforms lowered substantial tariff barriers on manufactured goods. Governments undertook fiscal reforms, lifted control over financial markets, and privatized most state-owned firms. Some countries also embarked on labor reforms described in the next section. While growth rates in the 1990s were higher than they were during the 1980s, the rates of growth in this period still fell short of those attained in other parts of the world.

Among the countries covered in this volume (Argentina, Brazil, Chile, Colombia, Peru, Uruguay, Barbados, Jamaica, and Trinidad and Tobago), Chile was the best performer, with an average growth rate of gross domestic product (GDP) of 4.8 during the period 1980–2001 (see table 1). Argentina and Trinidad and Tobago experienced the lowest average growth during the past two decades, despite high average growth rates during the nineties.

In spite of this weak economic performance, GDP per capita (purchasing power parity [PPP] US$ adjusted) levels in Latin American countries are higher than those of other developing regions. According to the World Bank Development Indicators, in 2001 the average GDP per capita in the Latin America and the Caribbean region was $7,050, considerably higher than that of East Asia and the Pacific ($4,233), Central and Eastern Europe ($6,559), South Asia ($2,730), Sub-Saharan Africa ($1,831) or the
Fig. 1  Per capita GDP growth

Source: IADB calculations based on World Development Indicators (World Bank 2001).

Note: Averages are GDP weighted.
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<td>11,320</td>
<td>0.849</td>
<td>1.132</td>
<td>1.16</td>
<td>1.12</td>
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<td>1.28</td>
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<td>1.557</td>
<td>1.60</td>
<td>0.89</td>
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<tr>
<td>Trinidad and Tobago</td>
<td>9,100</td>
<td>0.802</td>
<td>0.108</td>
<td>0.78</td>
<td>1.30</td>
<td>15.85</td>
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<tr>
<td>Average</td>
<td>8,470</td>
<td>0.810</td>
<td>1.970</td>
<td>2.04</td>
<td>1.90</td>
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*Sources:* Columns (1), (3), and (5) World Development Indicators (World Bank 2001); column (2) United Nations (2001); columns (4) and (6) Economic Commission for Latin America and the Caribbean (ECLAC 2001) and International Labour Organization (ILO 2002).

*Notes:* Column (3) is measured in local currency at constant prices; in column (6) the Caribbean rates are not comparable to Latin American rates because they are computed with a different methodology.
Similarly, the regional Human Development Index computed by the United Nations for LAC (0.77) was almost as high as in Central and Eastern Europe (0.78) and higher than in any other region except for the OECD (0.90). Among the countries whose labor markets are analyzed in this volume, Barbados and Argentina exhibited the highest income per capita and human development indexes, while Jamaica and Peru rank the lowest among the countries, both in per capita income and in human development (see table 1).

While GDP growth rates were not high, during the period 1980–1999 employment rates grew in the nine countries studied here. The highest growth rates were recorded in Colombia and Peru, countries that also experienced fast growth in female labor force participation. In contrast, average employment growth rates were low in Trinidad and Tobago and in Argentina. According to the International Labor Organization (ILO) and the Economic Commission for Latin America and the Caribbean (ECLAC) data, average urban unemployment rates during the 1980s and 1990s exceeded 8 percent in all countries analyzed in this book except for Brazil. Unemployment comparisons should be treated cautiously because they are not strictly comparable. For instance, in the Caribbean countries the unemployment rates include discouraged workers (those who drop out of the labor force), while such workers are excluded in the Latin American countries, which compute unemployment rates according to more traditional definitions. Many have remarked that the high level of regulation of economic activity in the region accounts for problems in the labor markets in the region, and the essays assembled here shed light on this conjecture.

### I.3 Labor Market Regulations and Institutions in Latin America and the Caribbean

This section sketches the history of labor market regulation in the region and describes and quantifies the regulatory environment in Latin America and the Caribbean. It compares the level of regulation and pace of regulatory reform in LAC countries and OECD countries. When it is credible to do so, we also make an effort to quantify the monetary costs (as a percentage of wages) of full compliance with regulations without discussing whether costs are borne by workers or firms. We discuss this issue more extensively in sections I.4 and I.5.

#### I.3.1 Regulations Governing Individual Contracts

Throughout Latin America, labor codes determine the types of contracts, the lengths of trial periods, and the conditions of part-time work.

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3. That is, they only include persons who are available for work and who are taking specific steps to search for a job.
Regulations favor full-time, indefinite contracts over part-time, fixed-term or temporary contracts. As a form of worker protection, labor codes mandate a minimum advance notice period prior to termination, specify which causes are considered justified causes for dismissal, and establish compensation to be awarded to workers depending on the reason for the termination. In contrast, temporary contracts can be terminated at no cost, provided that the duration of the contract has expired. To prevent firms from exclusively hiring workers under temporary contracts, in most countries the use of such arrangements is severely restricted. Labor codes also limit trial periods—that is, the period of time during which a firm can test and dismiss a worker at no cost if his or her performance is considered unsatisfactory.

Although most OECD countries began regulating their labor markets when they had attained relatively high income per capita, Latin America and other developing countries started regulating their markets much earlier in the development process (Lindauer 1999). The first regulations date from the beginning of the twentieth century. The motivation for these regulations was the perceived need to protect the welfare of workers against the excessive power of employers, and to insure workers against the risk of job loss and income insecurity (Lindauer 1999). The Mexican Constitution of 1917 articulated the principle that protecting workers was one of the duties of the state. By the 1930s and 1940s, most countries had a labor code. The belief that each new reform should only strengthen the set of warranties and benefits awarded from previous laws became widespread. For many years, successive reforms expanded the protection that the law afforded to workers. There was little examination of the question of whether such regulations would affect economic performance. However, until the 1980s most countries in the LAC region were isolated and their industries heavily protected. Labor regulations were one way of distributing the rents from protection among covered workers and employers. Regulations are a low-cost way (from the point of government fiscal authorities) of providing social insurance to protect workers. The weak fiscal systems in place in the region together with the low level of income, and a tradition of tax evasion, corruption, and noncompliance made the social insurance schemes used in more developed countries prohibitively costly.

Military rule often led to deregulation of labor markets. Unions were frequent targets, as much for political as for economic reasons. The political and economic environment in LAC changed substantially in the 1980s and 1990s. Most countries restored democracy after long periods of military rule. These political changes bred some labor reforms—first, to restore union activity, which had been made illegal in many military regimes and, second, to reach a new social pact. In Chile, Brazil, and the Dominican Republic, at the beginning of the 1990s and later in Nicaragua in 1996, these reforms produced more protective labor regulations.
A new constitution was enacted in 1988 in Brazil as part of the process of redemocratization during the second half of the 1980s (see Barros and Corseuil, chap. 5 in this volume). This new constitution revised labor regulations that had been in place since the 1940s. The new constitution reduced the maximum working hours per week from forty-eight to forty-four hours; reduced the maximum number of hours for a continuous work shift from eight to six hours; increased the minimum overtime premium from 20 percent to 50 percent; increased maternity leave from three to four months; and increased the value of paid vacations from 1/3 to at least 4/3 of the normal monthly wage. The new constitution also modified the mandatory individual saving accounts system created in 1966. Prior to the reforms, the law required employers to deposit 8 percent of employees’ wages into a worker-owned account. In case of a firm-initiated separation, workers could withdraw the accumulated funds (plus the interest rate). In addition, if a firm initiated a separation, it had to pay a penalty equivalent to 10 percent of the amount accumulated in the account. As part of the 1988 reform, this penalty was increased to 40 percent, considerably increasing the cost of dismissing a worker.

In the case of Chile, the 1990 reform introduced with the return to democracy reestablished some of the protection to workers that had been eliminated during the military regime. Under the dictatorship, union activity had been severely restricted and some benefits, such as indemnities for dismissal, had been substantially reduced. In 1990, the new law increased maximum indemnities from five to eleven months of pay. It also reintroduced the need for firms to prove just cause for dismissal, although unlike the case in other countries, the new law considered the economic needs of the firm a just cause.

While in some countries lawmakers were busy increasing legal protection for workers, the economic environment was changing substantially. The deep economic crisis that ensued with the debt crisis of the early 1980s called into question the protectionist model. The relatively good performance of the Chilean economy, which in the mid-1970s opened to trade and introduced many promarket reforms, spawned imitators all across Latin America. By the second half of the 1980s and the early 1990s, most countries had drastically reduced tariffs on imports. The new openness to international trade increased the demand for labor market flexibility. It was argued that without sweeping labor market reforms, Latin American economies would not be able to compete internationally. This was the main motivation behind the reforms that introduced temporary contracts in Argentina, Colombia, Ecuador, Nicaragua, and Peru and that reduced the cost of dismissing workers with indefinite contracts in Colombia (1990).
Temporary and fixed-term contracts were introduced in Argentina in 1991, and their role was expanded in 1995 (see Hopenhayn, chap. 9 in this volume). These changes were influenced by similar reforms in Spain during the 1980s. Special fixed-term duration employment promotion contracts could be awarded to unemployed workers and to workers younger than twenty-five and older than forty years old. For some types of contracts, severance pay was reduced by 100 percent. However, these contracts were eliminated in 1998, when the share of persons working under these arrangements had increased substantially. Ecuador, Peru, and Colombia also lifted restrictions on the use of these types of programs in the early 1990s. In Peru, the number of workers hired under these contracts increased enormously. In Brazil, the use of such contracts has been liberalized since 1998.

The 1991 reforms in Peru reduced the cost of dismissing workers hired under indefinite contracts. During 1971–1991, workers who had completed trial periods were granted permanent job security. If a firm dismissed a worker and could not prove just cause in labor courts, the worker could choose between being reinstated in his or her job or receiving a severance payment of three months’ wages per year of work (with a maximum of twelve months pay). In practice, because workers could always ask to be reinstated and then settle for a higher severance pay, the mandatory amount was a lower bound of the firing cost. See Saavedra and Torero (chap. 2 in this volume).

Beginning in 1991, workers hired after that year could be dismissed at will upon payment of a severance benefit. In addition, just cause clauses were extended to allow the dismissal of workers who did not perform up to expectations. The severance pay schedule was reduced from three months’ wages to one month’s wage for every year of tenure for workers with more than one year in the firm, with a minimum of three months’ wages and a maximum of twelve. The 1993 constitution replaced the right of workers to a permanent job with the right of firms to dismiss workers. In July 1995, a second wave of labor reforms simplified the severance payment to one month per year of work, up to a maximum of twelve months, and the two-tier severance system was eliminated. These modifications substantially reduced the cost of dismissing workers. However, in November 1996 the severance payments rule was increased again to one and one-half months’ wages per year of work, with an unaltered maximum cap of twelve wages.

In Colombia, the 1990 labor reforms liberalized many aspects of labor regulation. Besides regulations introducing the use of temporary contracts, the most important changes were those in the Cesantias, or severance pay that firms owed to workers at the end of the work relationship, regardless of the cause or the party that initiated separation. Prior to the reforms, employers were mandated to pay severance of one month per year at the time of the separation based on the salary at the separation. Work-