LABOR AND ECONOMIC REFORMS
IN LATIN AMERICA AND
THE CARIBBEAN
Regional Perspectives on World Development Report 1995

LABOR AND ECONOMIC REFORMS IN LATIN AMERICA AND THE CARIBBEAN

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Contents

Foreword v

1 Policy Background 1
   Reforms in the 1980s 1
   Poverty and income distribution 1

2 Labor Market Conditions 3
   Demographics and labor supply 3
   Employment, unemployment, and real wages 5
   The special case of Caribbean countries 7
   Changing labor market conditions in Latin America, 1960–95 7

3 Policy Reforms and International Integration 10
   Trade reform 11
   The real exchange rate and capital inflows 11
   Broadly based reforms: The key to success 12
   International migration 14

4 Current Labor Market Interventions and the Road to Reform 16
   A role for governments in setting wages? 16
   Dealing with wrongful dismissals 16
   Contributions to social security 18
   Labor-management relations 19

5 The Changing Role of the State 23
   Public sector employment and wages 23
   Setting priorities and choosing better policy instruments 23

6 The Outlook for Workers 25

References 27
This report was prepared in conjunction with World Development Report 1995: Workers in an Integrating World. It was written by Alejandra Cox Edwards under the direction of Michael Walton and in close collaboration with the Latin America and the Caribbean Regional Office. This collaboration was coordinated by Suman Bery. Meta de Coquereauumont and Paul Holtz edited the report. Christian Perez laid out the text.

Ian Bannon, Daniel Cotlear, Sebastian Edwards, Edgardo Favaro, Norman Hicks, Homi Kharas, Danny Leipziger, Luis Londono, Raj Nalari, and Roberto Steiner revised and commented on earlier drafts. Louise Cord, Geoffrey Shepherd, and Mateen Thobani helped draft Box 2. Many other professionals from the Latin America and the Caribbean Region helped with case studies, country reports, and other background materials. Luis Riveros (University of Chile) also commented on an earlier draft.
Over the past decade most countries in the Latin America and Caribbean Region have stabilized their economies and lowered barriers to international trade. These efforts, which have been rewarded by the restoration of positive economic growth, are ultimately driven by the need to advance in the fight against poverty, which is the major economic challenge facing the region. Although the reform process itself may sometimes produce transitory dislocations, deeper engagement with the world economy is the best assurance of rising living standards and reduced inequality for all. For countries in the region, the reform imperative is both strengthened and complicated by certain characteristics: an urbanized population, heavily dependent on informal rather than formal sector activity; high payroll taxes, with their associated disincentive effects; considerable inequality in education levels; and sizable social security financing needs, stemming from the relatively advanced stage of several countries in the demographic transition. These factors, which diminish the impact of reforms already taken to improve the living conditions of the population, need attention if the full benefits of liberalization are to be captured.

The goal of establishing an environment for market-based economic growth grounded in each country's comparative advantage represents a major departure from the past, when direct price interventions were used to address poverty goals and import substitution was used to promote industrialization. Investments undertaken in these distorted economic environments yielded only low rates of total factor productivity growth, diminishing the capacity to increase per capita incomes. Governments attempted to make up for the failure of markets by increasing public sector production, but that ultimately compromised macroeconomic balance and resulted in inflation and recurrent balance of payment crises.

Many of the policies aimed at reducing poverty and tackling inequality in the 1960–80 period—including agrarian reforms, minimum wage legislation, and labor market regulations—were well intentioned, but the region made little or no progress in improving income distribution. Furthermore, such policies discouraged the effective use of the most abundant resources of the region, including labor. Labor policy was seen as a means of directly enhancing workers' well-being through government involvement in wage determination and mandates on fringe benefits and job security. At best, these attempts improved the conditions and security of the minority of formal sector workers, but they added a bias against overall labor demand.

The recent shift toward market orientation and openness to international trade requires a different approach to labor policy and different instruments for addressing income distribution goals. Labor policy has to be redirected toward enhancing employment opportunities and labor productivity throughout the economy. Market-based growth that makes efficient use of labor increases opportunities for all workers to better themselves. But an unequal distribution of initial endowments (including access to effective education as well as physical assets) tends to perpetuate differences in income distribution across generations. To change these patterns, Latin American countries have to find ways to improve this initial distribution by promoting access to education and targeting the delivery of services to the poor. Deepening reform, including social sector and labor policy reform, holds out the hope of large improvements in the incomes and working conditions of most of the region's workers and a narrowing of differentials between rich and poor.

This report gives special attention to four areas of labor policy. First, direct government intervention in wage determination and strict seniority rules have to give way to a system that rewards effort, high productivity, and good management within a framework that relies on voluntary negotiation of working conditions between workers and firms. Second, job security legislation has to be replaced by a more effective mechanism that protects workers when they change jobs. Third, mandatory contributions to social security and other programs must be designed carefully in order to minimize the distortionary effect of labor taxes. Fourth, government subsidies for training and education must be redirected to the demand side and targeted to those who cannot afford to pay.

Given a deepening both of engagement in the international economy and of internal reform, the countries of Latin America and the Caribbean have the potential for more rapid growth, fuller involvement of labor in the economic mainstream, and substantial poverty reduction in the years ahead.
CHAPTER I

Policy Background

World Development Report 1995 examines the relations between policy, economic performance, and the well-being of workers. It concludes that there is no more powerful mechanism to raise the incomes of workers than market-led development. Integration with the world economy creates tremendous opportunities for countries that manage their domestic economies soundly. A market-based strategy requires public action that enhances the functioning of markets, particularly the labor market—and that has important implications for the selection of instruments of social policy. Transitions to more market-oriented systems inevitably generate winners and losers. Transfer programs, reforms to promote labor mobility, and policies to equip workers for change are all necessary to increase adaptability and spread the benefits of future growth.

These lessons are important for Latin American countries, which pursued industrialization based on import substitution and suffered frequent macroeconomic imbalances from the 1950s through the 1970s. As a consequence they failed to establish an environment conducive to sustained growth in labor productivity. Overvaluation of the real exchange rate hurt labor-intensive exports and agriculture, with detrimental consequences for employment and wages, while inflation hit the poor particularly hard because they have fewer defenses against the direct and indirect consequences of the inflation tax. Analysis of the structural transformation of the region between 1950 and 1980 reveals less reliance on exports than expected, investment at about the expected rate, and more rapid contraction in agricultural employment than expected (Syrquin 1991). At the same time governments tried to improve workers’ welfare through interventions in wage determination and collective bargaining and through legislation on fringe benefits and job security.

Market-oriented reforms have attempted to correct the biases that these policies introduced. In the process the role of the state is slowly being redefined. Some countries substantially reduced effective rates of protection to industrial activities and reestablished incentives for nontraditional export activities. But other areas of policymaking still need attention, including labor policy, public sector employment, property rights, and the provision of public goods and services. Despite considerable variation within the region, there are clear patterns of labor policy that need revision, along with public sector employment and pay policies that influence the functioning of the public sector.

Since the mid-1980s many Latin American countries have improved their macroeconomic stability and begun to restore economic growth. This improvement in aggregate indicators is an important step in reducing poverty and reversing decades of deplorable social conditions. The structural reforms started during the last decade can be sustained only by reducing poverty and increasing the equality of income distribution. Attending to the needs of the poor for education, nutrition, and health will have important direct effects on economic growth; as a larger proportion of the population acquires basic human capital, growth should accelerate.

Reforms in the 1980s

After more than three decades of inward-oriented policies and heavy state intervention, Latin American countries initiated a series of market-oriented reforms in the 1980s to achieve macroeconomic stability and reestablish economic growth. Governments imposed budgetary discipline in the public sector, in some cases by privatizing state enterprises; reduced international trade barriers and realigned exchange rates; and deregulated financial markets (World Bank 1993b). These reforms are changing the role of the state as it pulls back as a producer of goods and services and reduces its intervention in the setting of prices and allocation of investment. Somewhat surprisingly, these reforms have barely affected labor markets in most Latin American countries.

It is now apparent that fiscal discipline, removal of trade barriers, and financial deregulation are not enough to encourage the private sector to invest and create jobs, at least not quickly enough to reduce poverty and build support for market-oriented policies. In addition, governments need to do better in their traditional role of providing public goods (basic infrastructure, police protection). And they need to find new instruments of social policy that do not distort (or that minimize distortions in) the allocation of resources. This requires reforming tax policies, public funding for education, social security systems, subsidized housing, and more. These reforms must reduce the distortions that persist in these economies while preserving social goals—improving the living standards and economic opportunities of the poor.

Poverty and income distribution

Poverty and inequality have long plagued Latin American economies. Between 1950 and the late 1970s the share of income going to the poorest fifth of the population generally declined. Although economic growth between 1960 and 1980 improved living standards—as measured by school enrollments, health conditions, nutrition levels, and other social indicators—by the
Table 1. Population below the poverty line in selected Latin American countries, 1970 and 1981 (percent)

<table>
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</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>8</td>
<td>8</td>
</tr>
<tr>
<td>Brazil</td>
<td>49</td>
<td>43</td>
</tr>
<tr>
<td>Chile</td>
<td>17</td>
<td>16</td>
</tr>
<tr>
<td>Colombia</td>
<td>45</td>
<td>43</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>24</td>
<td>22</td>
</tr>
<tr>
<td>Honduras</td>
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<td>64</td>
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<tr>
<td>Mexico</td>
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<td>29</td>
</tr>
<tr>
<td>Panama</td>
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<td>37</td>
</tr>
<tr>
<td>Peru</td>
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<td>49</td>
</tr>
<tr>
<td>Venezuela</td>
<td>25</td>
<td>24</td>
</tr>
<tr>
<td>Average for ten Latin American countries</td>
<td>39</td>
<td>35</td>
</tr>
</tbody>
</table>


Despite budget cuts, social indicators have continued to improve

Table 2. Social indicators, 1970, 1980, 1990 (weighted averages)

<table>
<thead>
<tr>
<th>Indicator</th>
<th>1970</th>
<th>1980</th>
<th>1990</th>
</tr>
</thead>
<tbody>
<tr>
<td>Illiterate population (percentage of population aged 15 or older)</td>
<td>29.0</td>
<td>23.0</td>
<td>15.3</td>
</tr>
<tr>
<td>Enrollment ratios, ages 6–11</td>
<td>71.0</td>
<td>82.3</td>
<td>87.3</td>
</tr>
<tr>
<td>Gross enrollment ratios, secondary level</td>
<td>31.6</td>
<td>47.4</td>
<td>54.9</td>
</tr>
<tr>
<td>Population per physician</td>
<td>2,053</td>
<td>1,315</td>
<td>1,083</td>
</tr>
<tr>
<td>Percentage of population with access to safe water</td>
<td>53.7</td>
<td>70.1</td>
<td>79.8</td>
</tr>
<tr>
<td>Infant mortality rate (per 1,000 live births)</td>
<td>84.9</td>
<td>63.0</td>
<td>48.2</td>
</tr>
<tr>
<td>Life expectancy at birth (years)</td>
<td>60.1</td>
<td>64.3</td>
<td>67.5</td>
</tr>
</tbody>
</table>

Note: Includes data for countries with populations above 1 million. Source: World Bank 1993b.

early 1980s a large portion of the region's population still lived in poverty (Table 1).

Growth almost always reduces poverty, as demonstrated by Brazil, Colombia, Costa Rica, and Mexico during the 1970s. Morley (1992) calculates that as per capita income grew 41 percent in Costa Rica between 1961 and 1971, poverty was cut in half. Similarly, the region's declining incomes in the 1980s were associated with a rise in the extent and severity of poverty.

Yet many social indicators—infant mortality, school enrollment, life expectancy—have continued to improve despite the rise in poverty (Table 2). Although it is believed that publicly provided services have declined substantially because of the large budget cuts, the overall expenditure probably has not been reduced by much—and may have remained unchanged (Grosh 1992). The lag between budget cuts and measurable change in social indicators may be one reason for the continued improvement in these indicators. Another may be that aggregate trends hide worsening conditions in some parts of society. It is also possible that social spending has become more efficient.

East Asia's experience demonstrates how sustainable economic growth reduces poverty through many channels, including employment creation and rising real wages. As the region adopted market-oriented policies, labor-intensive activities expanded, and the accumulation of factors that complement labor yielded higher returns. Rural employment increased substantially, lifting rural incomes. Rapidly growing demand for labor in urban markets allowed wages to rise, and the poor shared in rising living standards. Investment in human capital—especially at the preschool and primary levels—helped increase productivity and real wage growth and reduced inequality (World Bank 1995). The higher wages induced further productivity increases throughout the economy and fed back into the growth process.

This report examines key aspects of labor market conditions, on the supply and demand side, as they are affected by the reform process that is integrating Latin American economies with world markets. Four areas are highlighted in which labor policy has made a difference and reforms can benefit growth and improve outcomes for workers. Issues of transition and the challenges facing countries in the region in reforming their social delivery systems are also explored.
During 1965–93 the working-age population grew by about 3 percent a year in all developing regions. This consistent growth stands in sharp contrast to the large differences in GDP and productivity growth across developing regions. Annual GDP growth in East Asia, for example, reached 7.5 percent, in Latin America and the Caribbean it was 4.1 percent, and in Sub-Saharan Africa it was less than 3 percent. The evidence indicates that economic growth is not constrained on the supply side. Sustained growth is possible through the efficient use of natural endowments and the accumulation of complementary resources. The challenge facing Latin America and the Caribbean is to establish an environment that makes efficient use of the region’s resources and expands demand for labor.

There are a number of ways to look at labor market conditions. Workers are concerned with jobs and compensation levels. They make decisions about labor force participation based on labor market conditions and other variables that affect their costs of living. Employers are concerned about worker availability and reliability, as well as labor costs. Their hiring decisions are also influenced by market prices and macroeconomic conditions. For policymakers, rising real wages are often cause for concern, since they may signal a loss in competitiveness; declining real wages are also reason for concern because they represent a worsening situation for workers. To be useful as indicators of performance, labor market indicators must be examined along with other variables. For example, it matters whether changes in real wages are related to labor productivity, affect all workers, or reflect market forces or policy interventions.

Demographics and labor supply
Population growth rates have been falling throughout Latin America, dropping from 2 percent a year in the late 1980s to a projected 1.6 percent for the late 1990s. The region is in a late stage of the demographic transition, when concerns begin to shift from schooling facilities to care of the elderly. Still, there are important variations in patterns of population growth. In some countries, mostly in Central America, populations are still growing rapidly, a result of high fertility. Population growth results from the interaction of behavioral variables (fertility) and demographics (the age distribution of the population). For example, Brazil has a lower fertility rate than Mexico, but because the share of women of reproductive age is larger in Brazil, the population growth rate is higher in Brazil (2.1 percent) than in Mexico (1.9 percent).

Demographic trends affect growth in school-age populations, labor force participation, and old-age dependency (ratio of the elderly to the working-age population). There are close links between population age structure and labor supply, as is illustrated by the cases of Brazil, Guatemala, and Mexico, which have different population age structures (Figure 1).

Except for the young and old age groups, labor force participation rates for men within age groups change little across countries and over time. But for women they increase as fertility falls. A country’s overall rate of participation is the result of interactions between individual behavior (participation) and demographics (age distribution of the population). For example, Brazil, which has a higher life expectancy than its neighbors, tends to support a large share of the elderly out of the labor force.

Working-age population and labor force participation
The working-age population (those between fifteen and sixty-five years old) grew by about 3 percent a year between 1965 and 1993, and is now estimated at about 300 million. The labor force participation rate (those of working age who are working or seeking employment) is estimated to be 56 percent, or nearly 165 million. While the growth rate of the working-age population over the past three decades was comparable to that of other developing regions, the labor force grew faster than in other regions (except for the Middle East and North Africa), fueled mostly by the rising participation of women as fertility rates declined and female schooling levels rose. Like other regions, Latin America saw a decline in participation among the very young—as schooling increased—and the very old (see Figure 1).

Labor force participation rates for women have increased from an average of 28 percent in the 1970s to 38 percent in the early 1990s. There are large variations across countries, with the rate ranging from a low of 24 percent in Bolivia (1989) to a high of 51 percent in El Salvador (1990). No direct link exists between economic development and women’s labor force participation. Still, rapid development is often accompanied by higher female participation, higher levels of schooling for girls, and lower fertility rates. Labor market conditions matter too. In El Salvador, for example, military conflict and migration reduced the domestic supply of male labor, inducing the entry of women into the labor force. The regional economic downturn of the 1980s also had an impact on women’s participation, which tends to rise with recessions in low-income countries.
Demographic changes influence labor force participation

Figure 1. Population and labor force by age and gender in Brazil, Guatemala, and Mexico, 1965 and 1995 (millions)

Brazil 1965

Brazil 1995

Guatemala 1965

Guatemala 1995

Mexico 1965

Mexico 1995

Source: ILO estimates and projections.

Rising levels of schooling
Primary schooling reached 100 percent coverage in most Latin American and Caribbean countries in the 1970s, although secondary-level coverage continued to show large disparities across countries, ranging from 8 percent in Guatemala and Haiti to 70 percent in Barbados. Secondary schooling has since expanded rapidly, and by 1990 coverage rates had doubled in most countries. Exceptions include El Salvador—where secondary coverage remains under 30 percent—and Brazil—where it reached only 40 percent, a low rate for a country at its income level (Figure 2). In contrast with other regions, gender differences in secondary schooling were already negligible in the 1970s.

While Latin American and Caribbean countries have made considerable progress in providing education, other regions have done as well or better. In 1985 countries in Latin America and the Caribbean and those in East Asia had about the same share of population with some schooling (Figure 3). East Asia had a larger proportion of population with secondary schooling or more, while Latin America and the Caribbean had a higher proportion with higher education. Since then East Asia has increased both overall enrollments and the share of students with secondary or more
schooling faster than Latin America and the Caribbean, though it still trails in higher education coverage. Note that overall education levels change slowly, despite significant advances in coverage. That is because investment is concentrated among the young, while the distribution takes into account the entire population. The relative performance of schooling investment in Latin America and the Caribbean is heavily influenced by Brazil, which represents a third of the region's population.

**Employment, unemployment, and real wages**

Formal employment is an important fraction of the labor force. The Economic Commission for Latin America and the Caribbean estimates that in 1990 employers, employees in firms with more than five employees, professionals, and the public sector accounted for 43 percent of the urban labor force in Bolivia, 54 percent in Brazil, 60 percent in Chile and Panama, and nearly 70 percent in Costa Rica and Venezuela. Public sector employees make up a large share of formal employees: 37 percent in Venezuela, 42 percent in Costa Rica, and 50 percent in Panama. Regionwide, 52 percent of employment is generated in the services sector, 26 percent in industry, and 22 percent in agriculture. Central American countries are less urbanized (about 40 percent) and more agrarian than South American countries, where close to 80 percent of the population lives in urban areas (Table 3).

The rural economy is receiving considerable attention in Latin American countries, after years of neglect. Recent reforms have given a boost to agriculture, which had been burdened by years of macroeconomic instability, real exchange rate overvaluation, and import substitution to promote industrialization. (East Asia's more balanced policy toward agriculture, by contrast,
Table 3. Urban and rural employment in selected countries, 1990 (percent)

<table>
<thead>
<tr>
<th>Country</th>
<th>Urban population (share)</th>
<th>Private sector employers, professionals, and firms with more than five employees</th>
<th>Public sector</th>
<th>Self-employed, small firms, and domestics</th>
<th>Employers</th>
<th>Wage employees</th>
<th>Self-employed farm</th>
<th>Self-employed nonfarm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Venezuela</td>
<td>84</td>
<td>45.6</td>
<td>22.5</td>
<td>31.9</td>
<td>6.9</td>
<td>46.2</td>
<td>33.1</td>
<td>13.2</td>
</tr>
<tr>
<td>Chile</td>
<td>91</td>
<td>69.4</td>
<td>29.3</td>
<td>38.1</td>
<td>2.9</td>
<td>64.7</td>
<td>25.1</td>
<td>7.2</td>
</tr>
<tr>
<td>Brazil</td>
<td>76</td>
<td>54.0</td>
<td>25.0</td>
<td>32.5</td>
<td>3.1</td>
<td>42.5</td>
<td>45.6</td>
<td>8.8</td>
</tr>
<tr>
<td>Panama</td>
<td>70</td>
<td>32.6</td>
<td>25.0</td>
<td>34.1</td>
<td>2.0</td>
<td>38.9</td>
<td>47.3</td>
<td>11.8</td>
</tr>
<tr>
<td>Costa Rica</td>
<td>46</td>
<td>42.5</td>
<td>25.0</td>
<td>34.1</td>
<td>2.0</td>
<td>68.3</td>
<td>18.6</td>
<td>11.8</td>
</tr>
<tr>
<td>Guatemala</td>
<td>38</td>
<td>31.3</td>
<td>14.8</td>
<td>34.1</td>
<td>0.5</td>
<td>38.3</td>
<td>47.9</td>
<td>13.2</td>
</tr>
<tr>
<td>Honduras</td>
<td>35</td>
<td>30.1</td>
<td>14.8</td>
<td>34.1</td>
<td>0.5</td>
<td>33.9</td>
<td>48.7</td>
<td>17.2</td>
</tr>
</tbody>
</table>

* a. Included under private sector.

Encouraged the development of productive rural nonfarm activities. A recent World Bank study found that the likelihood of rural poverty in Ecuador falls significantly with increases in per capita landholdings, years of schooling, and the proportion of household members with a regular off-farm job.

In some countries nonfarm rural labor demand has arisen in response to seasonal patterns, while in others it has been associated with booms in the processing of local raw materials. In many countries workers move back and forth between rural and urban areas, working in rural areas in peak seasons and as urban street vendors in the slack season. As a result, a large degree of seasonality in the production of coffee or sugar can be accommodated by worker movements. Recognizing the importance of this mobility in the design of labor legislation can be an important step toward increasing overall efficiency, improving labor productivity, and generating better opportunities. In a number of countries labor legislation works against this pattern of rural-urban movement rather than supporting it. Temporary formal contracts are restricted in duration and renewability, hourly contracts are often restricted, and benefits required by law assume the existence of a long-term contract.

In all economies there is a continuum of employment opportunities, from self-employment within the household to formal employment in registered enterprises. Informal activities are chosen as a way of avoiding taxation. The urban labor force working in the informal sector is as high as 75 percent in some developing countries (Burkina Faso, Sierra Leone). Informality and labor productivity are negatively related. Holding GDP per worker constant, the incidence of informality is highest in Latin America and the Caribbean (Figure 4). Two policy-related factors help to explain the incidence of urban informality: a pro-industry, anti-agriculture bias, which encouraged faster rural-urban migration than in other regions, and labor policies that overlooked the role of wages and working conditions as incentives and market signals, reducing the number of formal jobs and encouraging the development of the informal sector.

Informal sector activity is high in Latin America

Figure 4. Regional patterns of urban informality (percent)

Social security systems with weak links between benefits and mandated contributions encourage workers to avoid the payroll tax by working in the unregulated informal sector. A study of the Brazilian social security system found that workers stay in the informal sector as long as possible, switching to formal employment only to meet the vesting requirements of the pension system. During the late 1980s private sector workers in Peru began to abandon wage employment contracts to become short-term independent contractors, which allowed them to use the equivalent of the mandatory 9 percent payroll contribution for public health insurance to buy private health insurance.

Another reason that workers may stay in the informal sector is that, where promotions are based on seniority, formal employment may not reward entrepreneurship, initiative, or individual effort. A study comparing the informal sectors in El Salvador, Mexico, and Peru found that wages were higher in the informal sector than in the formal sector in Mexico, suggesting that Mexican workers may be paying for the stability and predictability of formal jobs by accepting lower wages.

Three types of policies should guide government responses to informal labor markets. First, antilabor biases, whether against agricultural or formal sector employment, should be removed. Second, the tax and regulatory burden on formal activity should be set at moderate, enforceable levels. Third, there is scope for public action, especially in urban infrastructure provision. Policies that subsidize credit for some farms over others should be avoided as well. Small firms see lack of credit as a constraint, but the experiences of East Asian countries and, more recently, Bolivia show that small firms can develop despite real interest rates on the order of 40 percent—as long as they have access to credit and markets. Price stability seems to be the necessary condition for credit to spread to the small firms and farms sector (Mosley 1993).

The special case of Caribbean countries

The Caribbean countries, with a population of 20 million in 1992, represent about 5 percent of the region's total population. This area contains the richest country of the region in terms of GNP—the Bahamas—and the poorest—Guyana and Haiti. As a group these countries differ significantly from the rest of Latin America. The Caribbean countries have high trade-to-output ratios. The most open countries have trade ratios that exceed 80 percent, and even the least open (Haiti) has a trade ratio of more than 25 percent. As a result these economies often experience large external shocks.

Changing labor market conditions in Latin America, 1960–95

Output and labor productivity grew adequately in the region between 1965 and 1980, but the debt crisis of the 1980s marked the beginning of a sharp downturn as international credit dried up (Figure 5). Countries that introduced economic reforms began to recover in the 1990s (Chile, Argentina), while those that did not continued to lag (Brazil and others). Is the recovery sustainable? The answer depends on whether reforms are continued, particularly at the microeconomic level. Domestic macroeconomic policies and external conditions also will have important impacts.

The debt crisis, and the adjustment period that followed, hurt employment and real wages. Urban unemployment in the region typically rose in the early 1980s and declined thereafter (Table 4). Figures are hard to compare across countries (data come from survey questionnaires), but some trends are apparent. Argentina, Nicaragua, and Peru have seen unemployment rise in the 1990s, while in Bolivia, Chile, Colombia, Guatemala, and Venezuela it has fallen.

In Argentina and some other countries unemployment is closely linked to economic restructuring and sectoral shifts. Pessino and Giacchini (1994) find evidence of an increasing duration of unemployment. This finding suggests that, at least for some of the unemployed, the gap between their supply price and market wages has risen, making them less likely to accept job offers. This may reflect changes in the market value of some skills, which is consistent with economic restructuring, and the introduction of unemployment benefits.

**Latin America saw labor productivity fall during the debt crisis**

Figure 5. Regional differences in the growth of GDP per worker, 1965–93

(source: World Bank data and estimates.)
The resumption of growth in Latin America has generally brought a recovery in real wages, although in Argentina, Peru, and Uruguay real wages in 1993 were still below their 1980 levels (Table 5). In some countries higher levels of schooling have contributed to higher wages. In Argentina, Brazil, Chile, and Mexico market-oriented reforms and trade liberalization have been accompanied by increases in the relative wages of workers with more schooling. Data for Colombia and Costa Rica suggest that other factors also play a role in boosting real wages. The challenge of poverty alleviation

Access to basic education, rural and urban infrastructure, and public goods affects the capacity of households and individuals to perform in the market economy. Thus the government's role in opening up market opportunities for all citizens is increasingly important. It is also essential that the social programs that accompany market-oriented reforms be designed to spread economic opportunities, especially among the poor (Box 1).

### Table 4. Average annual urban unemployment in selected Latin American countries, 1984–94 (percent)

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</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>4.6</td>
<td>6.1</td>
<td>5.6</td>
<td>5.9</td>
<td>6.3</td>
<td>7.6</td>
<td>7.5</td>
<td>6.5</td>
<td>7.0</td>
<td>9.6</td>
<td>11.2</td>
</tr>
<tr>
<td>Bolivia</td>
<td>6.9</td>
<td>5.8</td>
<td>7.0</td>
<td>7.2</td>
<td>11.6</td>
<td>10.2</td>
<td>9.5</td>
<td>7.3</td>
<td>5.8</td>
<td>5.4</td>
<td>5.8</td>
</tr>
<tr>
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.. Not available.
a. Preliminary.

### Table 5. Average real wages in selected Latin American countries, 1984–94 (1980=100)

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<td></td>
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<td></td>
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<tr>
<td>Rio de Janeiro</td>
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<td>..</td>
<td>..</td>
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<td>Costa Rica</td>
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<td>Mexico</td>
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<td>77.8</td>
<td>79.4</td>
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<td>41.6</td>
<td>41.3</td>
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<td>Uruguay</td>
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<td>71.7</td>
<td>75.0</td>
<td>76.0</td>
<td>75.8</td>
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<td>78.2</td>
<td>79.2</td>
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</tbody>
</table>

.. Not available.
a. Preliminary.
Box 1. Reaching out to the poor

An important survival strategy for poor families is to increase the number of household members working to support the group, including children. Child labor remains prevalent in Latin America despite legal restrictions. In Brazil, for example, it is estimated that about 18 percent of children between the ages of ten and fourteen work. The incidence of child labor is high among low-income families and among poor female-headed households. But it is also high where the demand for child labor is high and the quality and availability of schooling are low. Enforcement of labor regulations may eliminate child labor, but it also may worsen the situation of some poor families. Reaching out to the poor to increase their opportunities in the market economy requires a comprehensive approach that takes into consideration the interaction between labor market conditions, schooling availability, child labor, and poverty.

Poverty also manifests itself in street children—typically teenagers—in many countries. Recent studies in Brazil found that street children differ from working children in several ways. They typically have broken off ties with their families, particularly their fathers. They also tend to have behavioral problems, to have dropped out of school, and to be addicted to drugs. For years nongovernmental and religious institutions have been reaching out to these children, providing shelter, basic needs, and schooling. Preventive action is considered most effective in keeping children off the streets.

Poverty is pervasive and severe in Latin America's indigenous population (see Box Table 1). Poor indigenous groups tend to be concentrated in rural areas, isolated by bad roads and lack of communications, and to have limited access to formal schooling and health care. Projects to ease the isolation and deprivation of indigenous people can benefit from their participation in the design and implementation.

Addressing these diverse social policy matters requires a multifaceted approach that combines legislation and specific programs with the participation of nongovernmental organizations and other civic groups. Several countries in Latin America have begun to recognize the merits of targeting and of decentralized programs. This approach recognizes the advantage of funding private solutions to constantly changing social problems. The effectiveness of the approach rests on the division of responsibilities: while private organizations focus on problem solving, the public sector pays attention to measurable results and cost-effectiveness.


<table>
<thead>
<tr>
<th>Country</th>
<th>Indigenous</th>
<th>Nonindigenous</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bolivia</td>
<td>64.3</td>
<td>48.1</td>
</tr>
<tr>
<td>Guatemala</td>
<td>86.6</td>
<td>53.9</td>
</tr>
<tr>
<td>Mexico</td>
<td>80.6</td>
<td>17.9</td>
</tr>
<tr>
<td>Peru</td>
<td>79.0</td>
<td>49.7</td>
</tr>
</tbody>
</table>

A number of countries in the region are moving in this direction. A renewed interest in increasing enrollments, especially at the primary level, explains recent reforms from Argentina to Nicaragua. Correcting problems in land markets is part of the policy agenda in Colombia, Ecuador, and Peru and was central to agriculture's recovery in Chile in the 1980s. Yet in most countries the formal labor market still is not open to active participation and negotiated wages, working conditions, and collective contracts. For example, hourly contracts are not permitted under Ecuadorian legislation, leaving a large number of workers in the informal sector.

The link between labor policy and labor demand

Current labor legislation in many countries determines not only basic legal rights, but also detailed conditions of the labor contract (wages, job security, number of vacation days, employer obligations, and so on) for all workers. Such burdensome requirements discourage formal labor contracts, leaving informal workers with no legal protection. The requirements also constrain formal employment creation and have negative effects on the use of labor. As the dynamic theory of labor demand emphasizes, hiring and firing decisions have three distinct characteristics: they entail sunk costs, they take place in an uncertain environment, and they need to allow for some flexibility in timing (Hamermesh 1993). Onerous job security regulations and an unpredictable system of worker representation and dispute resolution add uncertainty to estimates of labor costs. This uncertainty has a direct negative impact on employment levels, as well as on the speed of adjustment (Dertouzos and Karoly 1992). Reforms should aim at establishing basic rights, reducing distortions and uncertainty, and enhancing the incentives for private employers to create formal sector jobs.
Chapter 3

Policy Reforms and International Integration

International trade offers opportunities for efficient specialization but also brings new risks. How can the region avoid the exchange rate volatility of the past? The answer lies in strengthening the domestic economy and expanding the role and efficiency of factor markets.

The debt crisis made countries in Latin America and the Caribbean review their economic policies and consider more seriously the advantages of an export orientation. But it took some time for policy reforms to be implemented. On the external front terms of trade deteriorated and economic activity in industrial countries slowed in the late 1980s. But Latin American and Caribbean countries were able to borrow at low real interest rates, and growth returned to the region in the 1990s. The combination of easy finance and tough competition in international goods markets represented a danger for some countries. For example, in countries other than Brazil output grew by more than 15 percent during 1990–94; as a result, investment and consumption grew sharply and net exports deteriorated in relative terms. Current account deficits grew despite export expansion in most countries because imports increased even more. Exports and growth have not always been positively correlated. In Argentina and Paraguay export volumes fell despite substantial economic growth. In Brazil and much of the Caribbean economic growth has been substantially slower than export growth.

International trade brings immediate gains through cheaper imports and long-term gains as resources are used more efficiently. Workers can take advantage of better job opportunities as the economy grows. In fact, during the past two decades real wages rose at an average annual rate of 3 percent in developing countries where the growth of trade (exports as a share of GNP) was above average, but stagnated in countries where trade expanded least (Figure 6). This correlation does not necessarily mean that increased exports are a sufficient condition for faster economic growth, but it does suggest that they are part of the story. Trade brings mutual gains to all countries, but it can also have important distributional effects within national boundaries, benefiting workers whose products are more in demand and hurting others who lose out to new competitors.

Countries pursuing an export-led growth strategy will be induced to specialize in different ways. The growth path that each country takes will depend on its initial endowments and strategic choices. As real wages rise, all countries see a shift from agriculture and primary production to manufacturing and services—first labor-intensive goods and then increasingly skill-intensive products. But countries that are richer in natural resources will remain net exporters of primary products longer: they will have to attain higher levels of skills and of capital per worker before they start to specialize in manufactures. Many countries in Latin America will likely follow such a path. The experience of more industrialized countries shows that even where natural resources are abundant, production patterns change, particularly in the use of labor. This is mainly a reflection of the required balance between rising real wages and rising labor productivity. As the newly industrialized economies of East Asia

Figure 6. Real wages and exports in developing countries, 1975–93

<table>
<thead>
<tr>
<th>Average growth in manufacturing real wages</th>
<th>Average growth in export–GNP ratio</th>
</tr>
</thead>
</table>
show, countries that are able to expand domestic capacity by investing in human and physical capital are better prepared to adopt new technologies when market conditions are appropriate.

**Trade reform**

Tariff reduction has proceeded rapidly in many Latin American and Caribbean countries, but it is still at a relatively early stage for most of the countries (Table 6). It is therefore premature to assess the impact of reforms on growth or labor demand. Still, some conclusions can be reached. If we group countries according to the classification in Table 6 and estimate average labor productivity growth, we find that the early reformers outperformed all other groups in the 1980s and early 1990s (Table 7). We also note that average productivity growth among recent reformers has been negative. This result is driven by Mexico, where average labor productivity fell at an annual rate of 1.6 percent in the 1980s and continued to fall at an annual rate of 0.75 percent in the early 1990s.

Greater exposure to international markets brings new opportunities for private investors and major changes in the way business is conducted. Attention to timing, quality, and reliability becomes critical. The exposure to more competition and to international trade is helping to improve labor-management relations. It is now clear that there is no fixed amount of "rents" to fight for and that workers and employers are better off working together for a more successful enterprise. But industrial relations are very much influenced by the methods of the past and by a legal framework that discourages cooperation between managers and workers. Such legislation requires reform.

**The real exchange rate and capital inflows**

After the major effort associated with tariff reductions and the difficulties brought about by large devaluations in the early stages of reform, a number of countries have allowed their real exchange rate to appreciate substantially. Changes in domestic policy and international market conditions have brought large flows of capital into the region in the 1990s. But the real exchange rate appreciation has hurt exports and employment creation.

Real exchange rates in most countries have appreciated by 10 to 30 percent since 1990. There is a strong correlation between currency appreciation, capital inflows, and current account deficits. Adjusted for inflation, capital flows to the region were larger in 1992 and 1993 than they had been at their peak during the 1970s. The surge was also much more abrupt. Evidence from ten countries indicates that external factors played an important role in the recent episode, which means that capital inflows are less likely to persist.

**Using capital flows most effectively**

Latin America has not been the only region to receive sizable capital inflows in recent years. A study by Calvo, Leiderman, and Reinhart (1993) found remarkable similarities in the relative size of capital inflows between ten Latin American countries (Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, and Venezuela) and eight Asian economies (Indonesia, Malaysia, the Philippines, the Republic of Korea, Singapore, Sri Lanka, Taiwan (China), and Thailand). Capital account inflows amount to 3.3 percent of GDP in the Latin

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**Table 6. The opening of Latin America, selected countries and years, 1985–92**

<table>
<thead>
<tr>
<th>Country</th>
<th>Average tariff protection</th>
<th>Average coverage of nontariff barriers</th>
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<tbody>
<tr>
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<td></td>
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</tr>
<tr>
<td>Bolivia</td>
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<tr>
<td>Chile</td>
<td>36.0</td>
<td>11.0</td>
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<tr>
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<td>Mexico</td>
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<tr>
<td>Uruguay</td>
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<td>12.0</td>
</tr>
<tr>
<td>Very recent reformers</td>
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<td></td>
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<td>28.0</td>
<td>15.0</td>
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<tr>
<td>Brazil</td>
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<td>21.1</td>
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<tr>
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**Table 7. Annual rate of growth in labor productivity by country group, 1965–94**

<table>
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<tr>
<th></th>
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<tr>
<td>Nonreformers</td>
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<tr>
<td>Total</td>
<td>3.09</td>
<td>-1.24</td>
<td>0.56</td>
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</table>

**Note:** Weighted averages based on population in 1995.

American countries and 2.7 percent of GDP in the Asian countries. Across countries and regions there is a marked increase in international reserves. In the early stages of the capital inflows there were sharp increases in stock prices, and in both regions capital inflows have been accompanied by accelerated economic growth.

What distinguished the Latin American countries from Asia was the degree of appreciation in the real exchange rate and the savings response to the capital inflows. While the Asian countries increased their savings ratio by 3 percentage points, the Latin American countries, on average, reduced it. Yet the causal relation between domestic consumption and the real exchange rate is not clear. The Asian countries were more aggressive in sterilizing capital inflows to limit monetary growth. Asian countries also received a larger share of capital inflows in the form of foreign direct investment, which makes sterilization less important since there is less volatility associated with those flows. The optimal policy response to capital inflows depends on their anticipated persistence and the nature of domestic credit markets. If capital inflows are easily reversible, the conservative approach is to sterilize 100 percent of the inflows. That is what Indonesia did to maintain macroeconomic stability during the oil boom. The aim is to avoid a situation where real exchange rate appreciation hurts the export sector and leads to unsustainable current account deficits, or where a sudden reversal of capital inflows leads to a domestic financial crisis.

**Labor market effects**

Real exchange rate appreciations represent an increase in real wages relative to tradable goods—an increase that can be sustained only if real incomes are rising. Policymakers are often tempted to ride on the popularity of a real exchange rate appreciation, especially when they believe that they can take corrective action later. But real exchange rate appreciations also reduce the international competitiveness of exports. Where the exports sector is small, policymakers may avoid these complaints. Yet evidence shows that the cycles generated by real exchange rate instability create enormous dislocations in the economy, particularly in the labor market. These cycles are particularly dangerous in countries that are emerging from years of failed policies. Mexico’s recent experience with capital outflows indicates that there are important lessons to be learned with respect to monetary management.

But much more is going on as well. There are still major problems with the operation of land and water markets, with labor management techniques, and with a tax system that continues to subsidize certain sectors. To avoid large swings in the real exchange rate, the domestic economy must be strengthened, especially through better functioning of factor markets. Economic adjustment can occur faster if individuals can take advantage of changes in market conditions by switching employment, selling and buying assets, and starting new activities.

Economic adjustment can also go faster if firms make decisions about location, activity, and use of factors that respond to the economy’s comparative advantages. An efficient response by agriculture to the new opportunities brought about by trade reforms rests on a functioning land market (Box 2). In countries such as El Salvador and Nicaragua revolution and war have generated disputes over property rights, and governments are only beginning to address the problem. Land markets in Latin American and Caribbean countries are notoriously repressed and often distorted. In some cases a substantial amount of land is held in large, capital-intensive farms that employ very little labor, but that gain from credit and other subsidies. Half-hearted land reforms that sought or threatened to give land rights to tenants only sharpened landowners’ bias toward labor-saving production practices. In Colombia, for example, potential crop land is used for ranching because policy biases favor large farms.

**Broadly based reforms: The key to success**

Successful reformers such as Chile and New Zealand have demonstrated that the best response to the opportunities offered by trade liberalization is a broadly based approach. In Chile reforms introduced in the mid-1970s have focused on enhancing the role of the private sector in a market-based approach to economic development. Policymakers’ short-term priority was to reestablish macroeconomic stability, which required reducing a substantial public deficit. The long-term goal was to reestablish the economy’s growth potential, which required eliminating gross distortions in the allocation of resources. The first stage of policy reforms included freeing retail prices, lifting interest rate controls, regularizing public sector accounts, introducing better tax monitoring systems, establishing financial discipline, privatizing state-owned enterprises, and reducing import barriers.

The second phase of reforms redefined the role of the state and its interaction with the private sector. The “seven modernizations” included labor law, social security law, education, health services, land and water rights, judicial reform, and administrative reform. The result was a modern regulatory framework that guarantees free entry and property rights and that expands the realm of possible transactions. For example, land could be rented, leased, divided, bought, and sold, increasing opportunities for landowners and the value of land. In the social sectors careful targeting and decentralization constituted an extraordinarily complex institutional, administrative, and political task. Programs were restructured, complex legal issues were addressed, and opposition from those who had benefited from previous system subsidies had to be overcome.

In the early 1980s the Chilean economy suffered a major setback. In circumstances remarkably similar to the Mexican
Box 2. Making the land market work: Reforms in Colombia, Ecuador, Mexico, and Peru

Limited rights over land, including the virtual abolition of tenancy, explain to a large degree the lack of land improvements and the low demand for agricultural labor in many Latin American countries. Recent efforts to reverse these constraints have met with tremendous opposition and require a good dose of political will.

In Colombia a series of legal measures since the 1930s has had the effect of reducing incentives for large landowners to lease land to tenants. The right of landowners to employ sharecroppers was formally outlawed in 1968. A steep fall in rural employment—3.9 percent a year—occurred between 1970 and 1975. Throughout the 1970s there was a wave of illegal occupations of farms, affecting 1,500 to 2,000 farms and roughly two-thirds of Colombia’s departments. This avenue for land acquisition was closed in 1988, and the poor began to occupy steep hills or marginal land at the edge of the rain forest. The limited opportunities for the poor to farm are undermining the sustainability of farming for all and have incited rural violence.

Colombia passed a new reform law in 1994 that is designed to increase the role of the market in transferring land to the rural poor. Eligible applicants will receive a subsidy of 70 percent toward the purchase of a plot of land sufficient to support a farm family; credit would be provided to cover the remaining 30 percent of the purchase price. It is intended that the beneficiaries of the subsidy will group together in cooperatives to negotiate purchases from owners of large holdings. The new program also gives title to established squatters located on frontier lands and introduces land improvement measures for indigenous communities. This law is a step in the right direction, but it fails to reform the adverse tenancy restrictions.

The recently passed (1994) Agricultural Law in Ecuador defines the necessary framework for the proper functioning of the land market by increasing the flexibility of land sales, defining water rights, and limiting the expropriation of private land. A drive for the proper registration of land, combined with a reduction in agricultural subsidies that now favor large farmers, would have beneficial effects for the poor.

Under the 1969 Agrarian Reform, 85 percent of Peru’s privately held rural land was converted into cooperatives. Although former workers got the mandate to administer the land themselves, they could not use it as collateral, rent it, transfer it, or sell it. These reforms inhibited investment, and agricultural production stagnated during the 1970s. While a 1980 law broke up most of the cooperatives into individual landholdings, it was only in 1991 that restrictions on sale and rental were removed and land could be used as collateral.

Peru also has implemented a new law that greatly facilitates the registration of rural property that was held in cooperatives, and of urban land that had been “invaded” in previous years. Peru has made notable efforts in recent years to reestablish property rights and markets, but the process has been mired in politics, in particular the opposition of those who benefited from the rents generated under the old law governing registration.

In 1915 the government of Mexico gave 80 percent of its agricultural land to ejidatarios. Ejidos are made up of individuals and communal lands intended for pasture. Land could not be used for sharecropping and could be passed on only to another member of the ejidatarios family. In 1992 an amendment to the constitution officially ended the restrictions on land use and distribution, and ejidatarios obtained more rights on their property. Sales, for example, are permitted within the ejido, but sale to an outsider must be approved by the community.


experience of the early 1990s, large capital inflows found their way into the Chilean banking system in the late 1970s, creating a lending boom. Aggregate demand and real wages rose, resulting in an unsustainable overvaluation of the peso. The capital inflows stopped in 1982 at the onset of the debt crisis, and a large devaluation of the Chilean peso followed soon after. In the third phase of reforms Chile responded by increasing the independence of monetary authorities, vesting in them responsibility for maintaining stability in the monetary aggregates.

The three waves of reforms reduced policy-induced uncertainty, increased competitive pressures on the investment side, and encouraged investors to exercise their options. But it took more than ten years for economic growth to catch up with the dynamics of labor supply. Reforms began in the mid-1970s, and unemployment stayed above 10 percent for the second half of the decade. In the early 1980s unemployment reached 20 percent. Mexico’s recent experience with reversal of capital inflows shows remarkable similarities. But assuming steady progress in implementation of reforms, its recovery may be quicker because of concerted action by the international financial community. Chile has experienced average annual growth of 7 percent since 1987. Employment growth has been substantial (unemployment is down to 5 percent), and real wages have risen strongly.
Agriculture and mining have attracted significant investments, helped along by productivity improvements in transportation and communications, demonstrating that the opportunities offered by international integration induce responses from all sectors of an economy (Box 3).

**International migration**

While many countries have liberalized their trade, nearly all continue to manage migration, though the case for labor mobility seems as compelling from an economic standpoint as the case for free trade. Managing migratory flows effectively is difficult because restrictions on migration can create scarcity rents that encourage illegal flows (Box 4).

International migration extends the market for some occupations beyond national frontiers. This is particularly important in border areas (United States–Mexico, Venezuela–Colombia, Nicaragua–Costa Rica, Chile–Argentina), but it takes on greater importance for the labor market of small economies, such as the Central American and Caribbean countries. A large portion of migratory flows is linked to seasonal agriculture, and the direction of the flows responds closely to the economic conditions in each country. International migration and remittances provide a stability cushion to the domestic economy. If a large share of the labor market is integrated with the labor market of other countries, workers' supply price is less influenced by local conditions. Therefore, understanding the determinants of real wages and unemployment in such countries as Costa Rica, Jamaica, Nicaragua, Panama, and other, smaller countries in the Caribbean requires a set of variables that goes beyond labor supply and demand in the domestic economies.
Box 4. Seasonal jobs + restricted access to temporary-immigrant visas = illegal immigration

For the first time in forty-eight years, the 1992 apple harvest work force in the Eastern Panhandle of West Virginia did not include workers brought in from Caribbean islands as nonimmigrant, temporary foreign workers. This was the culmination of years of controversy over the employment of nonimmigrant workers not only in West Virginia but in many parts of the United States.

The official admission of temporary nonimmigrant agricultural workers to the United States began about seventy-five years ago in response to fears of agricultural labor shortages brought about by the combination of World War I and changes in immigration policy. Successive waves of immigrant groups have met the labor needs of fruit, vegetable, and horticultural specialty agriculture. The Bracero Program established formal temporary non-immigrant worker status for Mexican agricultural workers in the 1940s and stayed in effect until 1964. All temporary nonimmigrant visas since then, referred to as H-2 visas, have been offered under the conditions of the 1952 Immigration Act.

One of the largest programs under the H-2 provision has admitted agricultural workers from the Caribbean islands—the BWI program. While the Bracero Program was intended for western growers, the BWI program was used primarily on the East Coast. Over the years, however, BWI workers have been employed in shade tobacco in Connecticut, truck farming in New Jersey, cherry picking in Wisconsin, sweet corn in Idaho, tomatoes in Indiana, asparagus in Illinois, peas in California, sugar cane in Florida, and apple picking in eastern states.

The governments of the sending countries were heavily involved in the early stages of this program, and the U.S. government took responsibility for ensuring transportation from point of recruitment and back, a minimum wage, guaranteed employment for a number of months or a minimum subsistence allowance, and free housing and medical care. But as time went by agricultural employers established direct contracts with foreign workers or labor contractors and paid the transportation costs themselves. Growers and the Department of Labor became at odds as their objectives grew ever further apart. Growers want to secure able and willing workers during the peak season, the Department of Labor wants to make sure that this is not done against the interests of domestic workers. But what happens when access to temporary immigrant visas is limited?

Because the certification process has been made more burdensome and litigation surrounding the use of foreign labor in West Virginia has mounted, growers have turned to the use of unauthorized workers. Heppel, Spano, and Torres (1993) found that many Jamaican workers in West Virginia had provisional work cards that were soon to expire. Workers with these provisional cards were afraid to leave the United States for fear of later being denied entry. Having established work relationships, they are more likely to stay in the United States as illegal immigrants when the best option would be to return to Jamaica for the off-season.

A role for governments in setting wages?

Government policy has affected wages through indexation—in countries with a tradition of inflation—and minimum wages. With few exceptions, minimum wages have declined throughout the region in the past few years and have largely become a nonbinding restriction. Ecuador sets basic wages for more than one hundred occupations. But given the components that are added to the basic salary, basic wages represent a small share of the minimum monthly pay required by law. There have recently been proposals to rationalize the minimum wage in Ecuador. This would be a step in the right direction.

In other countries seniority criteria dominate personnel management. Rigid structures established in collective contracts determine who is trained, promoted, and given management responsibilities and how their functions are delimited. In Mexico, for example, chapter 4 of the Federal Labor Law establishes that collective contracts must contain a structure of jobs according to seniority.

Dealing with wrongful dismissals

Latin American labor legislation has a long tradition of protecting job security. Measures include severe limitations on temporary hiring and substantial costs—in the form of severance payments—for unjust dismissals. The labor market impact of employment protection laws depends largely on how firms and workers perceive them. If specific rules, such as severance payments, are seen as a delayed payment scheme, their effects on hiring and other decisions will be minimal. But most Latin American legislation that determines employer liability in cases of dismissal makes severance payments equivalent to a tax on dismissals, discourages voluntary quits, and has detrimental effects on labor-management relations.

Most employment protection legislation in the region severely restricts temporary contracts and differentiates between severance payments for "justified" and "unjustified" dismissals (Table 8). Justified cases require serious misconduct

Labor policy includes government mandates on contributions to social security, support for the collection and dissemination of information, special programs for employment creation, subsidies for worker training, and more (Box 5). Labor market policy reforms can help to strengthen the domestic economy. Labor policy also establishes an enforcement framework for individual and collective labor contracts, along with basic labor standards. The law typically grants individual workers conditional rights to form unions—conditions typically include a minimum number of members or a minimum percentage of workers in a plant—and unions are granted conditional rights to represent workers in collective bargaining. Employers' conditional obligations to bargain with unions are also established.

The most serious labor market distortions in Latin America result from government intervention in setting wages; the high costs of dismissal, which reduce flexibility and make a firm's restructuring difficult and slow; high payroll taxes, which reduce formal employment and inhibit the international competitiveness of local firms; and the nature of labor-management relations, which encourage confrontation and costly settlement procedures.

In a market-oriented economy, where employers are guided by cost-benefit considerations, workers cannot be paid above their marginal contribution to production. Preestablished minimum wages will either be irrelevant (if workers' contribution is higher) or result in fewer jobs. More workers would then have to be self-employed or find alternative work in the informal sector. Worker power in wage determination does not typically increase as a result of legislated minimums or adjustments, but as a result of alternative job opportunities that allow individuals to choose. The combination of rational macroeconomic policies and open trade orientation promises economic recovery and increased labor demand, but labor policies do not leave enough room to establish efficient contracts (individual or collective). A reduction of the government presence in wage determination is required.

16
Box 5. Enforcement mechanisms for sovereign labor laws

With rising pressure for links between trade agreements and labor practices, it has become increasingly important for developing countries to have clear and enforceable labor laws. Labor conditions, like poverty reduction and overall development, are a legitimate area of international concern. Many current labor laws grant privileges to a few at the expense of the many. In response to international pressure to deal with social problems, developing countries must establish standards that make sense for their development levels and devise mechanisms for their implementation.

Following the signing of the North American Free Trade Agreement (NAFTA) in 1994, the governments of Canada, the United States, and Mexico signed the North American Agreement on Labor Cooperation. This document establishes procedures for dealing with disputes that arise in the application of the labor laws of each of the three countries. Differences in the interpretation of the laws will be taken to a committee of experts, and ultimately to a panel of specialists, who will establish a plan of action. The parties are committed to promoting a set of principles within each country's labor law.

International labor conventions are adopted by the International Labor Conference after consultation with International Labour Organization (ILO) member countries. The International Labor Conference is attended by delegations of government representatives, employers, and employees representing each country.

When a member state ratifies a convention, it commits to reporting regularly on the application of the convention in law and in practice. Employers and workers organizations have the right to provide information as well. In essence the ILO conventions apply international pressure for countries to abide by their own labor laws. While each country is sovereign and can choose its own laws, there is generally a correlation between the text of a country's labor law and the ILO conventions that that country has ratified and put in force. The average number of conventions in force varies significantly by region, the largest being in the member countries of the OECD (Box Figure 1).


Box Figure 1. Average number of ILO conventions in force

<table>
<thead>
<tr>
<th>Region</th>
<th>Number of Conventions</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>100</td>
</tr>
<tr>
<td>East Asia</td>
<td>80</td>
</tr>
<tr>
<td>South Asia</td>
<td>60</td>
</tr>
<tr>
<td>Africa</td>
<td>40</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>30</td>
</tr>
<tr>
<td>Europe and Central Asia</td>
<td>20</td>
</tr>
<tr>
<td>Latin America and the Caribbean</td>
<td>10</td>
</tr>
<tr>
<td>OECD</td>
<td>8</td>
</tr>
<tr>
<td>Spain</td>
<td>6</td>
</tr>
</tbody>
</table>

and for the most part exclude economic considerations such as financial distress and increased foreign competition. In other words, firms undergoing restructuring are penalized. Mass dismissals often are contested in court. Another salient aspect of labor protection legislation is that severance payments are directly related to the worker's tenure in the firm, typically in the form of a certain number of months' salary for each year of service.

Job protection legislation in many Latin American countries is attempting to achieve two policy objectives—punishing wrongful dismissals and providing unemployment insurance—with the same instrument. The problem is that neither objective is well served. Firms devise ways of reducing the costs of mandated severance payments, and employees attempt to transform voluntary quits into dismissals in order to receive severance payments. The law has the effect of making labor a fixed factor. Because of this, hiring and firing decisions are subject to delays and temporary contracts are informal.

Reducing the payoffs associated with litigation and transforming severance payments into a deferred compensation scheme would greatly increase the efficiency of Latin American labor markets. Reducing litigation payoffs requires defining employer liability in cases of dismissal for economic cause as well as in cases of dismissal without "cause." Argentina and Chile have allowed this distinction in their laws. Some countries have begun to transform severance payment schemes into deferred compensation plans. In Bolivia, for example, workers have access to the same severance payment in all cases of separation (quits and layoffs) after five years on the job. Other countries, including Brazil, Colombia, and Peru, have replaced traditional severance pay arrangements with a time-of-service fund, which accumulates a fraction of each employee's salary (8 percent in Brazil, 8.33
Table 8. Job protection legislation in ten Latin American countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Restrictions on temporary contracts</th>
<th>Probationary period</th>
<th>Notice required before dismissal</th>
<th>Severance pay for justified dismissal</th>
<th>Severance pay for unjustified dismissal</th>
<th>Severance pay for dismissal caused by economic factors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>2 years, nonrenewable</td>
<td>3 months</td>
<td>1–2 months</td>
<td>None</td>
<td>WT^b</td>
<td>0.5(WT)^b</td>
</tr>
<tr>
<td>Bolivia</td>
<td>renewable once</td>
<td>3 months</td>
<td>3 months</td>
<td>None</td>
<td>Fund</td>
<td>WT</td>
</tr>
<tr>
<td>Brazil</td>
<td>2 years, nonrenewable</td>
<td>12 months</td>
<td>1 month</td>
<td>Fund</td>
<td>1.4(fund)</td>
<td></td>
</tr>
<tr>
<td>Chile</td>
<td>1 year, nonrenewable</td>
<td>12 months</td>
<td>1 month</td>
<td>None</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Colombia</td>
<td>3 years, nonrenewable</td>
<td>2 months</td>
<td>45 days</td>
<td>Fund^d</td>
<td>Fund + (15 to 40 days’ wages)T^e</td>
<td></td>
</tr>
<tr>
<td>Ecuador</td>
<td>2 years, nonrenewable</td>
<td>3 months</td>
<td>1 month</td>
<td>0.25(WT) + fund</td>
<td>0.25(WT) + fund + 3T if T &lt; 3</td>
<td></td>
</tr>
<tr>
<td>Mexico</td>
<td>No restrictions</td>
<td>—</td>
<td>1 month</td>
<td>3T</td>
<td>(20 days’ wages)T</td>
<td></td>
</tr>
<tr>
<td>Nicaragua</td>
<td>2 years, nonrenewable</td>
<td>12 months</td>
<td>1–2 months</td>
<td>WT</td>
<td>2(WT)</td>
<td></td>
</tr>
<tr>
<td>Peru</td>
<td>2 years, nonrenewable</td>
<td>3 months</td>
<td>—</td>
<td>Fund</td>
<td>Fund + WT^a</td>
<td></td>
</tr>
<tr>
<td>Venezuela</td>
<td>renewable once</td>
<td>3 months</td>
<td>1–3 months</td>
<td>T(10 to 30 days’ wages)</td>
<td>2(10 to 30 days’ wages)T</td>
<td></td>
</tr>
</tbody>
</table>

Note: W represents a monthly wage. T represents years of tenure on the job.

a. The legislation generally lists a number of reasons that make a dismissal “justified.” These include serious misconduct (absenteeism, drunkenness) but do not include technical requirements or economic factors.
b. The law establishes a maximum W.
c. A minimum severance payment equivalent to 45 days’ wages is payable in case of dismissal.
d. The law establishes a maximum T.
e. The burden of proof is on the employer. Failure to prove allegations of just cause may increase the penalty by up to 50 percent over the normal severance (WT).

percent in Peru) to be made available in case of separation (“justified” layoffs and quits). In Chile workers can choose this type of arrangement rather than the traditional severance payment after seven years on the job. Employers are required to deposit one month’s salary in a savings account in the employee’s name.

A reformed system of severance payments provides insurance for laid-off workers. A national unemployment insurance scheme—for formal sector workers—would do the same. The systems are of equal merit so long as each is financed by the potential beneficiaries. This is generally done through payroll taxes on formal sector workers. In the United States “experience ratings” create a direct link between employers’ contributions and the probability of unemployment. The practical implication is that the unemployment insurance tax rate goes up for employers whose unemployment insurance reserve has been used up by their former employees. If severance payment systems in Latin America and the Caribbean were changed to defined contribution funds, accessible in case of quits or layoffs, their economic effect would be virtually the same as that of the U.S. system.

**Contributions to social security**

In most Latin American countries employers are required to contribute to the social security system, which generally provides workers with pensions, health care, and accident insurance. Such programs were very attractive in their early years, but as programs have aged some benefits have been rationed or eliminated. Until recently all formal sector business firms were required to contribute to the social security system, forcing users to rely on the public system.

In terms of economic cost and equity, most social security systems in the region have problems. First, most pension funds encourage early retirement, generating a serious economic burden.
if retirees are still in their most productive years. Second, pension benefits are often unrelated to individual contributions to the system. Higher-income individuals, in particular, often benefit out of all proportion to their contributions. Third, social security systems tend to encourage expensive health care services that emphasize curative rather than preventive care. In most countries contributions to the health component of the social security system are independent of marital status, family size, and age. Benefits, however, automatically extend to dependents. As the age structure of the population has changed, the economically active population has become less willing to support these systems—as in Peru. Finally, the poor segments of society are often excluded from social security. In Brazil, for example, only 18 percent of the poorest income groups—which account for more than 40 percent of the population—are covered by social security.

Whether levies such as social security contributions are perceived as pure taxes or as delayed compensation depends on the link between individual contributions and expected future benefits. In most Latin American countries social security benefits—pensions and health care provision—are unrelated to individual contributions to the system. Mesa-Lago (1991) and Cox Edwards (1993) argue that this lack of balance causes people to view contributions as a pure tax and benefits as entitlement (Box 6). Furthermore, the social security systems in many of these countries are financially insolvent, imposing increasing costs on the economy as a whole.

In addition to solvency problems, pay-as-you-go social security systems distort labor markets because of the heavy burden of payroll taxes on formal sector firms. Basic pension benefits are extended to all retirees, while only a fraction of active labor force participants contribute to the social security system. Uruguay's system dependency rate (the ratio of pensioners to contributors) stands at 53 percent and its benefit ratio (average benefit over average wage) at 84 percent, while Brazil's ratio of retirees to active labor force participants has risen from 10.4 percent in 1965 to 16.1 percent in 1995. Thus social security reform is urgent in such countries as Brazil and Uruguay. Almost all countries in the region would benefit from pension system reform while their systems are still solvent.

There are several reforms that could improve the efficiency of social security systems. Pay-as-you-go schemes with no link between contributions and benefits should be replaced by a combination of individual accounts and minimum benefits ensured by the government (World Bank 1994). This type of system has been used in Chile since the early 1980s and is being implemented in Argentina, Colombia, Mexico, and Peru.

Programs that provide compensation for work-related injuries and occupational illnesses have a long tradition. The two basic types of systems are social insurance systems that use a central public fund and various private arrangements that are required by law. About two-thirds of the countries that have these systems operate them through a central public fund. Among the countries that rely on private arrangements, about twenty—including the United States—require employers to insure their employees against the risk of injury on the job. In about half of these, only private insurance is available. In the rest, a public fund exists, but employers are allowed to opt out of the public system.

The premiums charged by private or mutual insurance companies for work-injury protection vary according to the history of accidents in different industries. Some countries (notably Norway and Sweden) have eliminated the risk factor, and all employers contribute to the program at the same rate. In most Latin American and Caribbean countries safety standards are often the responsibility of the ministry of labor. Risk premiums are set by industry.

An alternative arrangement could provide benefits—in the form of lower insurance premiums—to employers who comply with safety regulations. In most countries in the region these premiums are determined by sector, meaning that, for example, all construction companies pay the same amount for workers' accident insurance. Reforms can expand the role of specialized insurers in the provision of such insurance. In Chile, for example, such specialized agencies are more knowledgeable about safe practices and set insurance premiums according to safety standards.

Labor-management relations

Most labor legislation in Latin America predates the region's recent market-oriented reforms and suffers from two deficiencies. First, most workers are not able to choose their representation in labor disputes, since the right to representation is assigned to official unions by the government. This has stunted the development of labor organizations, which need to adjust to a more demanding labor market. Second, collective bargaining is too cut off from market forces. Except for Chile, where labor reform was implemented in the early 1980s, the process is similar across the region. Unions propose a collective contract, and employers must respond. The state is a part of the negotiations from the start, and the final agreement applies to all workers represented.

The case of autoworkers negotiating with General Motors in Brazil in April 1995 is representative. When negotiations between management and the union broke down, the case was mediated by a labor court, which had to make a judgment and recommend a pay increase. This is a case of "interest" arbitration, whereby the arbitrator determines the terms and conditions of a new collective agreement. Court rulings are bound by labor statutes and, often, by constitutional rights over aspects of the labor contract.

Strikes traditionally have been allowed as an expression of political pressure—albeit with an economic impact on individual firms. In theory each party should have something to lose dur-
Box 6. Payroll taxes and their impact on workers

Taxes on labor distort the allocation of resources because they reduce the value of working time relative to leisure, increase the cost of labor, and increase the cost of production. They also have distributional effects since payroll taxes and revenue benefits are likely to fall unevenly on different income groups. Payroll taxes are typically high in industrial countries, particularly European countries, ranging from 20 to 50 percent of gross wages (Box Figure 2). But they are also high in some developing countries, notably in Latin America, where they are as high as 40 percent of gross wages. Such taxes reduce the net wage that firms pay to workers by the full amount of the tax less the value employees attach to the benefits provided.

Payroll taxes are generally earmarked to finance programs that benefit workers. The most common use of payroll taxes is the funding of pensions, followed by health care programs (generally limited to workers or targeted to the poor, but in some cases extended to the entire population). Third in importance is the funding of workers' compensation for work-related accidents. In some countries payroll taxes also fund unemployment insurance programs. In a number of countries in Latin America and the Caribbean payroll taxes fund training institutes.

Payroll taxes are often justified on the grounds that workers would not otherwise save for retirement or health insurance and that employers would not insure against the risk of work accidents or provide training programs. These mandates typically have three components: a forced savings component, an insurance premium component, and a distributional component.

The most enforceable systems combine insurance policies with mandatory savings programs to provide a basic set of benefits. Overly ambitious programs that require high contributions are likely to distort the labor market and reduce formal employment. For example, in pay-as-you-go pension systems payroll taxes are paid over a lifetime of work. Pension levels are based on the contributions made in the five years before retirement. Workers do not consider their monthly contributions to the social security system as part of their compensation. Relative to a no-tax situation, this tax raises the cost of labor for employers and reduces take-home pay for workers.

Box Figure 2. Payroll taxes as a percentage of gross wages

![Payroll Taxes as a Percentage of Gross Wages](image)


**Table 9. Dispute resolution legislation in ten Latin American countries**

<table>
<thead>
<tr>
<th>Country</th>
<th>Judicial procedure</th>
<th>Employee rights</th>
<th>Employer rights</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>To strike</td>
<td>To wages while on strike</td>
<td>To renounce union membership and return to work</td>
</tr>
<tr>
<td>Argentina</td>
<td>Civil courts</td>
<td>No, if workers fail to accept arbitration, Ministry of Labor determines legality.</td>
<td>No, unless the strike is illegal.</td>
</tr>
<tr>
<td>Bolivia</td>
<td>Labor courts</td>
<td>No. Strike suspends labor contracts.</td>
<td>Yes</td>
</tr>
<tr>
<td>Brazil</td>
<td>Labor courts</td>
<td>No. Strike does not suspend labor contracts.</td>
<td>Requires prior authorization.</td>
</tr>
<tr>
<td>Chile</td>
<td>Labor courts have jurisdiction over questions of application of the law.</td>
<td>No. Strike affects more than half of workers or interrupts essential work.</td>
<td>Yes, from the first day of the strike if the last offer is equivalent to the previous contract adjusted for consumer price index. Only after 1.5 days otherwise.</td>
</tr>
<tr>
<td>Colombia</td>
<td>Ministry of Labor may call for arbitration within two days of a declared strike.</td>
<td>No. Strike suspends labor contracts.</td>
<td>No, unless there is a risk of serious damage to the facilities.</td>
</tr>
<tr>
<td>Ecuador</td>
<td>Labor Inspectorate</td>
<td>Yes. Strike declared illegal.</td>
<td>No, unless the board declares the strike is &quot;imputable&quot; to the employer.</td>
</tr>
<tr>
<td>Mexico</td>
<td>Labor courts</td>
<td>No, unless the board must declare it legal.</td>
<td>No</td>
</tr>
<tr>
<td>Nicaragua</td>
<td>Civil courts</td>
<td>If agreed by head-count majority, does not have to occur in the context of collective bargaining.</td>
<td>Workers can go back to work, but wages are paid in any case.</td>
</tr>
<tr>
<td>Peru</td>
<td>Ministry of Labor</td>
<td>No. Strike suspends labor contracts.</td>
<td>Yes</td>
</tr>
<tr>
<td>Venezuela</td>
<td>Labor Inspectorate</td>
<td>No. Strike suspends labor contracts.</td>
<td>No</td>
</tr>
</tbody>
</table>

processes. Labor, keen to ensure continued competitiveness, did not insist on past privileges but cooperated with management in this process.

In less competitive environments unions attempt to capture economic rents and ally themselves with employers and politicians who help to perpetuate those rents. This kind of behavior by unions is evident in industrial countries, where union wage premiums are highest in regulated sectors and concentrated industries. In developing economies union opposition to trade liberalization and privatization is a rational strategy for maintaining higher wages for unionized workers in the short run at the expense of nonunion workers. If the state imposes regulations on minimum wages and restrictions on hiring and firing, the nonunion sector will operate much less effectively as a constraint on unions' wage demands. Promoting domestic competition and openness to international markets will therefore help to curtail these negative effects.

Labor regulations and the system of industrial relations
Union behavior is conditioned by the structure of union organization and the coverage of collective agreements. A key principle in industrial relations is to ensure that the parties engaged in bargaining absorb the costs of their actions rather than shift them to third parties. But in some countries legislation requires that workers be paid even when they are on strike—a clear disincentive to compromise. Moreover, many governments refrain from providing loans or deferring tax payments for firms during strikes or lockouts, and firms are not allowed to hire temporary workers. Negotiations between unions and public enterprises show how unions are able to achieve distorted outcomes when third parties bear the cost of negotiated agreements. When a public enterprise can turn to the government for subsidies or easy credit when it is in financial difficulty, the burden of high settlements falls on those who pay higher prices or higher taxes to cover the enterprise's increased costs, not on the workers or enterprise managers who negotiated the increase.

Legislating limits on the number of unions per enterprise is viewed as an infringement of workers' rights. When workers have the right to choose their own union, unions act as a genuine representative of the worker in collective negotiations. Furthermore, if the union is contestable (that is, if a new union can be set up at any time), unions will be compelled to bargain with employers to improve working conditions. Union fragmentation and rivalry can be disruptive, however, and bargaining costs rise if workers have many representatives. These issues are often dealt with through cooperation between unions and employers.
CHAPTER 5

The Changing Role of the State

Latin American and Caribbean countries have not yet addressed the problem of poorly performing bureaucracies. Efforts at decentralization often have devolved responsibilities without granting the authority to raise revenue or control hiring and wages. The problem of public services and employee performance goes beyond organizational changes, downsizing, and better reward systems. Government agencies must learn to see a direct connection between their revenues and their responsibilities.

There are many ways to achieve this goal. All combine some level of greater autonomy for agencies with clearly defined tasks, centrally established budgetary allocations, and a defined policy on raising additional revenue. More autonomy would allow agencies (or local governments) to pursue the most efficient ways of providing public goods and services. This will mimic the operation of private institutions, where goods and services are purchased or contracted out unless there is a comparative advantage to producing them in-house. In addition, measurable goals and incentives that reward workers and management are preconditions for good public sector performance.

Public sector employment and wages

In delivering public services central governments have no choice but to rely on the administrative capacity of local managers. These managers need to be given autonomy in hiring, promoting, training, and firing employees. But in most cases they are not. More often, job positions are predetermined, salaries are paid directly by the central government, and promotion criteria are established by statute. This makes personnel management decisions somewhat irrelevant to local operations. Breaking these molds requires more than legal changes to the statutes governing individual agencies. It also requires significant political will, because public sector unions have the power to paralyze entire administrations.

The principal problem posed by public sector unionism is that disputes tend to be costly because the markets involved are generally monopolistic. For this reason, it is natural to seek alternatives to strikes and lockouts. Arbitration by third parties is the obvious alternative, and the mechanism recommended is "final offer" arbitration, which compels the arbitrator to choose either management's final offer or the union's.

Successful reform requires finding ways to isolate agencies from political forces. Their mandate has to be clear and their performance measurable. Naim (1995) observes that many countries have been successful in isolating key public agencies from political maneuvering, making them an island of efficient management and attention to results. These include national oil companies such as Petroleos de Venezuela, Colombia's National Coffee Company, Chile's state-owned copper company, and some Central American agencies that oversee banana exports.

Much can be accomplished by granting more autonomy to public agencies. But this approach cannot be generalized to the entire public sector. The previous section discussed the personnel management restrictions that are embodied in collective contracts throughout the region. In addition to these, there are often special labor statutes for workers in the social sectors (education, health, and so on). As the experience of the 1980s showed, even the most protective legislation cannot shelter workers from recessions or budgetary cuts. The experience also showed workers that they may be better off in a system that rewards them for being productive. In short, achieving more effective delivery of public services requires a pragmatic approach that recognizes the importance of local management, understands the incentives each agency faces, and finds ways to correct incentives so that social objectives are consistent with those of the local agency. New Zealand's recent experience with reforms in public sector management offers an interesting benchmark with which to compare practices in other countries.

Setting priorities and choosing better policy instruments

Social expenditures are always limited by budgetary constraints. Moreover, the most important consideration for any social expenditure is how efficiently funds are allocated, measured by results in relation to starting goals. Latin American countries maintain elaborate bureaucratic structures and complex legislation that govern the delivery of social services. These countries should initiate efforts to rationalize their social service institutions. Governments should limit themselves to policy design, control, evaluation, supervision, and financing, leaving execution of the programs to decentralized agencies such as municipalities, local governments, and private organizations.
In terms of financing, subsidies that respond to demand have several advantages over indirect, supply-side subsidies. Demand subsidies are easier to target to the neediest groups and are more likely to attract cofinancing. This principle applies to all areas where the public sector has been heavily involved in the financing and production of services. Two cases that are of particular importance for this report are education and worker training.

Funding education
Higher education has traditionally been subsidized on the supply side in Latin America. This choice benefits those who qualify for a university education, irrespective of their capacity to pay. That reduces the resources available to the poorest segments of society. There is little doubt that education has to improve in order to continue the export-oriented drive of the last few years. Changing the way that public funding for higher education is allocated would help expand coverage. Most university graduates acquire an earning capacity that would enable them to pay for their education. Extending access to public funding to new institutions would give the state more for its money as old and new institutions compete for funding. Establishing scholarship and loan systems would improve access to university training while permitting cost recovery. Chile adopted this principle to change the formula for grant funding to universities. There has since been significant growth in the higher education system's coverage.

Worker training
Public training institutions in Latin America and the Caribbean, with the exception of Argentina and Mexico, are based on the Brazilian SENALs model of an autonomous public agency financed by payroll contributions of 1 to 2 percent and managed jointly by government, workers, and employer representatives. These institutions played an important role during the period of import-substitution industrialization, and most continue to provide the same training they always have.

But countries have made drastic changes in their economic policies, there have been significant changes in technology, and demand for trained personnel has become less predictable. Training institutions must adapt to be effective. Some have started to change. In some cases pressures from legal reforms have deprived them of traditional sources of funding (Bolivia, Colombia, and Costa Rica); in others, pressures came from greater exposure to competition for public funding (Chile). Entrepreneurs have been asked to participate more closely in program development, as in Brazil, or to take over the management of the system, as in Peru (de Moura Castro 1994).

Labor requirements are changing rapidly, yet most institutes continue to offer traditional training in electricity or mechanics. Most of the system's students over the past decade have become independent contractors or joined the informal sector. Thus the system's funding has become a tax on modern sector labor and a transfer to the informal sector. Chile eliminated this earmarked tax and uses broadly based income taxes to subsidize training. In the formal sectors firms receive a tax credit of up to 1 percent of payroll if they spend that amount on worker training. This training can be organized on the job or through public and private training institutions.

Some traditional training institutes are transforming themselves into centers of technology transfer. Several schools have assumed this function and offer a range of courses for private entrepreneurs. Traditional training courses remain as part of the broader curriculum. This trend is not only an important way of spreading technological innovations; it is also a useful tool for training institutes to anticipate enterprise needs. These additional activities have expanded the sources of funding for these institutes, increasing their autonomy and creating clear links between revenues and responsibilities.
The Outlook for Workers

Many Latin American countries have initiated reforms that will produce important gains for workers in the years to come. Among the more advanced reformers, some (Chile, Colombia) are showing signs of sustained progress for workers.

Opening the formal labor market requires:
- Replacing job security legislation with a system that protects workers as they change jobs. This does not necessarily require establishing new unemployment insurance programs; it can be accomplished by improving the system of severance payments in countries that lack the administrative capacity to run an unemployment insurance scheme.
- Recontracting social security, lowering payroll taxes, and making pensions a function of individual savings. This does not mean that the state should break promises made to those who have contributed to the system or to those who depend on pensions. And reform is not inconsistent with the establishment of transfer programs for the elderly poor. But reform can encourage employees to save for their retirement.
- Establishing freedom to choose labor representation and dispute resolution mechanisms that enhance negotiations at the plant level.
- Transferring education and training subsidies to the demand side. This change will create training institutes that are better able to respond to rapidly changing labor requirements, particularly in countries that are integrating with the world economy. Many countries concentrate their investment in training on secondary school graduates, so public support to training is generally not pro-poor. Subsidies based on demand not only can accommodate on-the-job training, they also can be targeted to specific groups.

Two global scenarios, developed for World Development Report 1995, illustrate what is possible and the dangers ahead for each of the world’s main regions. The first scenario, based largely on past trends, projects current policies over the long term. This scenario, which suggests a widening of differences between some regions and a widening of inequality within some countries, is one of slow growth and divergence. A second scenario of inclusion and convergence explores the potential of strong domestic policy action in all parts of the world combined with deeper international integration. Both scenarios are illustrative only—the projections are based on many assumptions and certainly are not a forecast. But they are a plausible guide to the consequences of success and failure, and they take into account likely trends in both economywide effects and international integration.

The divergence scenario assumes that recent investment trends will continue or that investment will deteriorate, that a sizable share of those enrolled in schools will drop out prematurely, and that the overall productivity of labor will not rise rapidly. The convergence scenario assumes that investment rates will pick up, that enrollment rates will stabilize at current levels and dropout rates will decline, and that investments in infrastructure, technological transfers, and improvements in the quality of governance will contribute to labor productivity.

The convergence scenario must be supported by higher savings rates, lower fiscal deficits in the industrial countries, and reasonable amounts of international capital flows, including development assistance.

In the divergence scenario we assume that protectionism will not go away, and that countries will either drag their feet in implementing the Uruguay Round agreement or offset gains in one area with protectionism of another sort. Here, export growth will be slow and there will be little change in the international division of labor. In the convergence scenario the Uruguay Round is fully implemented and there is further progress in trade liberalization—including in agriculture—at regional and multilateral levels. Global integration will interact with domestic investment in capital and people to bring large net gains. Latin America will capitalize on its improved skills mix in the expanding global market, will recover its strength in mining and agriculture, and will move into the production of more technologically demanding goods (Table 10).

Both scenarios assume that the technological bias favoring skilled workers will continue. Under the divergence scenario this bias reinforces slow accumulation and stagnating world trade and results in slow GDP growth in most regions and rising inequality among and within regions, including in Latin America and the Caribbean. By contrast, the convergence scenario finds incomes rising and inequality falling. Rapid accumulation of skills reduces the pool of unskilled workers and so increases the demand for their services. Furthermore, rural areas gain from external conditions and demand for unskilled labor in agriculture and services rises. These factors all contribute to a reduction in inequality.
LABOR AND ECONOMIC REFORMS

The success of these efforts will depend on both domestic policies and international conditions. Labor policy has generally been overlooked, and this is a mistake. The capacity of an economy to modernize, turn toward exports, adapt new technologies, improve service delivery, and so on rests on a better use of resources and a more efficient productive sector. Better understanding of the link between government policy and private sector development will improve the chances for sustained recovery in the region and for a more effective war against poverty. Labor markets must be liberalized in order to expand employment opportunities in all sectors.

The convergence scenario shows incomes rising and inequality falling

Table 10. The outlook for Latin America and the Caribbean, 1994–2010
(percent, except where otherwise specified)

<table>
<thead>
<tr>
<th>Variables</th>
<th>Actual</th>
<th>Divergence scenario</th>
<th>Convergence scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inputs in the growth process</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Investment share in GDP</td>
<td>(1992)</td>
<td>20.0</td>
<td>22.0</td>
</tr>
<tr>
<td>Average years of schooling</td>
<td>(1992)</td>
<td>4.9</td>
<td>5.6</td>
</tr>
<tr>
<td>Annual growth in TFP</td>
<td>(1960–87)</td>
<td>0.0</td>
<td>0.6</td>
</tr>
<tr>
<td>Annual growth</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP per capita growth</td>
<td>(1970–90)</td>
<td>1.7</td>
<td>1.4</td>
</tr>
<tr>
<td>Export growth</td>
<td>(1980–90)</td>
<td>2.4</td>
<td>3.8</td>
</tr>
<tr>
<td>Total increase in wages</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unskilled wages</td>
<td></td>
<td>-3.0</td>
<td>58.0</td>
</tr>
<tr>
<td>Skilled wages</td>
<td></td>
<td>45.0</td>
<td>62.0</td>
</tr>
</tbody>
</table>

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