A regular series of notes highlighting recent lessons emerging from the operational and analytical program of the World Bank’s Latin America and Caribbean Region

**TRADE LIBERALIZATION AND LABOR REFORM IN LATIN AMERICA AND THE CARIBBEAN IN THE 1990s**

Indermit S. Gill, William F. Maloney and Carolina Sanchez-Paramo

**Labor Reform at a Crossroads**

Latin American labor markets performed below expectations during the 1990s in terms of both formal employment creation and poverty reduction. Three different explanations have been proposed for this underperformance (these explanations need not be mutually exclusive): (i) trade liberalization; (ii) macro-restructuring; and (iii) labor market rigidities.

The first explanation considers increases in unemployment and informality as a product of the globalization process, and is concerned about the ‘low quality’ of the new jobs generated in the trade-fueled sectors, such as ‘maquilas’ and tourism. As a result, proponents of this view contend that the poor have not benefited from trade openness as much as the rich and that this has led to increasing income inequality in the region.

The second explanation attributes the observed increases in unemployment to the labor reallocation associated with macro restructuring, macro-stabilization and to other crises unrelated to trade liberalization.

The third explanation emphasizes the role of labor market rigidities in preventing the economic growth induced by the reforms from translating into higher employment creation in the formal sector.

This note synthesizes the findings of research on trade and labor in the region, including World Bank studies on: (i) trade and job quality (De Ferranti, Perry, Lederman and Maloney, 2001), (ii) informality (Maloney 2001) and (iii) labor policies in the region (Gill, Montenegro and Domelund, 2001). First, the evidence on the relationship between trade liberalization, macro-restructuring and labor market outcomes during the 1990s is reviewed. Second, labor market rigidities will be analyzed and the extent to which reform efforts facilitated formal employment creation.

Finally, based on lessons learned from the 1990s, a new agenda for labor market reform is proposed which reflects more closely the new environment in which Latin American governments now operate.

This year’s flagship report for the Latin American and Caribbean Region, From Natural Resources to the Knowledge Economy Trade and Job Quality, addresses three concerns about the structure of trade in Latin American and Caribbean economies. The first is whether natural wealth and exports of natural resource-intensive commodities hampers economic development. The second concern is that natural resources create a concentrated export structure which exacerbates economic volatility and thus reduces growth. The third concern is that international trade might eliminate jobs. The wide-ranging report cites the experience of Australia, Canada, Finland, Sweden, and the United States, as well as some Latin American countries, to show how successful economies have been built on the basis of primary commodity exports.
Links between Trade, Market Restructuring and Employment

There is no clear link between the effects of trade liberalization and increases in unemployment or informality. Although several countries in the region experienced low employment creation and growing unemployment during the 1990s, over the long run there seems to be no relation between these developments and trade openness. Considering long-term trends, unemployment levels were not substantially higher in the 1990s than in the 1980s and 1970s, which cannot be characterized as periods of substantial trade liberalization (Figure 1).

Empirical evidence suggests that high levels of unemployment in the last decade reflect the long transition periods associated with macroeconomic reforms, rather than their final outcomes. Chile required ten years to achieve sustained employment and wage growth after reforming, but since 1985 has been the best performer in the region (i.e. with the lowest unemployment rate, together with Mexico - another early reformer). Similarly, it was the countries which failed to fully tackle the issues of macroeconomic stabilization and labor market rigidities (e.g. Argentina and Colombia), rather than those that opened up the most, that did not succeed in bringing unemployment down and fostering employment creation.

Paired with poor formal employment creation most countries experienced substantial increases in informality over the 1990s\(^2\). However, there is no evidence that this was due to subcontracting in global production chains and little evidence that it was more generally due to trade liberalization.

In many countries, increases in informality at the beginning of the 1990s were driven partly by the expansion of opportunities in non-tradeable sectors, such as construction and services, which tend to be informal (e.g. Argentina, Brazil and Mexico).

Macro-adjustments and labor legislation are much more closely related to the increase in informality than trade liberalization. Although in other countries there was evidence of labor market segmentation, with employment in the informal sector being a fall back option rather than an attractive opportunity, this segmentation could not be attributed to trade reforms in most cases. For instance, in Colombia it was the combination of rising minimum wages with the economic downturn that rationed many workers out of formal sector employment. Similarly in Argentina labor market segmentation had begun in the early 1980s, long before trade liberalization, probably as a result of the existing rigidities that plagued the economy and encouraged workers to go off the books.

In addition, the jobs created in the emerging sectors appeared to be better than similar jobs in other sectors. In particular, jobs in Export Promotion Zones, new agricultural sectors, tourism and tele-services compared favorably to work in more traditional sectors in terms of pay and benefits. Statistical comparisons and interviews with Mexican workers suggest that those employed in the maquila and the new agricultural sectors do at least as well in these sectors as in alternative ones. Moreover female labor force participation and relative wages were also high in these sectors, thus giving women more leverage in household.

Figure 1: Average Unemployment Rate in Latin America Caribbean Region

![Figure 1: Average Unemployment Rate in Latin America Caribbean Region](image)

Source: SIMA Database for the 1970s and 1980s, and UN and ECLAC for the 1990s.
Finally, although wage inequality did worsen in several countries, numerous studies failed to find direct links to trade liberalization. Rather these studies suggest this trend results from skill-biased technological change as well as from insufficient growth in the supply of skilled workers relative to their demand (technological progress). In fact, average wages in the region rose at historically high levels during the 1990s and more open sectors appeared to pay higher than average wages. Moreover increases in inequality reflected the fact that the new jobs being created are demanding more from the region’s workers in terms of skills and were neither permanent (i.e. inequality rose and then fell in Chile and Mexico), nor did they translate into higher overall inequality at the household level.

**Labor Market Rigidities**

As a result of market developments, Latin American governments turned their attention more directly to the functioning of labor markets in the region, in an attempt to understand why economic growth induced by macroeconomic stability and trade liberalization had not translated into higher employment creation in the formal sector. Although part of these developments were simply due to the costs of transition, a closer look into the labor market suggested that excessively rigid legislation could also have contributed to poor formal employment creation.

Increasing labor market flexibility became the main goal of any labor reform, based on the belief that deregulating labor markets would lower labor costs and enhance compliance, resulting in more labor-intensive production, higher job creation in the formal sector, and an overall improvement in the quality of jobs. However, proposals to increase labor market flexibility often faced substantial opposition, making them difficult to implement. In fact, while most countries in the region had carried out profound trade and financial reforms, only a few actually introduced substantial changes to their labor legislation during the 1990s. Some reforms were indeed implemented and these were reviewed paying special attention to their effect on employment, unemployment and informality.

**A. Cost and Cause of Dismissal**

Latin American labor legislation traditionally imposed high firing costs on employers to achieve job security and employment stability. These costs included the stipulated severance pay and possibly other forms of compensation depending on the cause of dismissal. However, in practice employers also needed to take into account transaction costs associated with workers’ appeals and lengthy court procedures.

High firing costs are considered a barrier to job creation in Latin America, and empirical work has explored the effect that job security and severance pay have on employment. The evidence on job security is somewhat mixed at both the regional and country levels, although it suggests that job security has a generally negative effect on employment creation.

Overall, severance pay reforms seemed to favor more disadvantaged workers. This contrasts to situations where severance pay was increased, or where tenured workers were made better off relative to untenured workers. For instance, workers with higher tenure benefited relatively more from a ceiling increases in Chile, and from steeper severance pay–tenure profiles in Colombia, the Dominican Republic and Peru. However, these changes increased the cost of formal employment relative to informal employment.

**B. Unemployment Insurance and Compensation Funds**

Severance pay systems do not seem to be an adequate way of providing unemployment insurance due to the distortions and high costs associated with them. These problems can be partly avoided by relying on a system where workers forgo a small share of their earnings while employed and then use those funds in case of unemployment, independent of the cause of job separation. However, adoption of alternative compensation systems did not tend to come hand in hand with a reduction in severance pay. Rather these new systems were generally introduced on top of existing labor legislation, thus putting additional stress on labor taxes and introducing substantial inefficiencies. In general, alternative compensation systems were characterized by strict eligibility criteria and poor coverage of the overall unemployed population. Access to funds is often conditional on the cause of dismissal or requires a certain number of months of contributions to the unemployment fund. As a result coverage is low and sometimes poorly targeted.

**C. Temporary Contracts**

Prior to the 1990s labor legislation in the region prohibited the use of temporary contracts for permanent activities, restricting their use to work that was temporary in nature, such as harvesting or construction. These contracts frequently involved high administrative costs (e.g. labor union consent on a case-by-case basis). The restrictions had negative effects on formal employment creation and encouraged low compliance and informality, especially among small businesses that depend on flexible arrangements. Although each country’s experience was somewhat different, the adoption of temporary contracts generally translated into higher employment creation. These reforms however were often accompanied by higher worker turnover.

While legislative changes implemented to increase flexibility were fairly similar across countries, there was
substantial variation in the way these same countries tackled the worker protection issue. In particular, some continued to rely on severance pay systems to protect workers in case of unemployment, whereas others experimented with alternative compensation systems. These alternative compensation systems were an improvement on severance pay-based systems. Despite the economic benefits associated with some of the reforms, they were generally unpopular; sometimes so much so that certain governments were forced to backtrack on some of the changes (e.g. Argentina in 1998).

**Policy Prescriptions**

Based on the findings regarding trade liberalization effects and labor market rigidities, several changes in policies and in designing operations are suggested to enhance the efficiency of labor markets in the region. The first is a move from reducing stipulated firing costs to reducing transaction costs associated with firing. The second recommendation is a transformation of the compensation systems to emphasize portable benefits and effective safety nets rather than market-based mechanisms. A third proposal for designing interventions is a change in approach from seeking to foster labor market flexibility to conceptualizing labor as a flexible production input. Finally, the review calls for a change in regarding ‘informality’ as a disadvantage to viewing it as largely voluntary and heterogeneous phenomenon.

**New Opportunities After Liberalization**

In the early 1990s it would not have been an exaggeration to characterize labor reform as the forgotten reform. As mentioned above, most countries had by then put in place successful macroeconomic stabilization programs, and many had already launched financial sector reforms. By the middle of the decade, however, the labor policy agenda could be upgraded from forgotten to unfinished, and governments in the region seem committed to continue working on labor reform during this new decade. This paper suggests new directions for labor reform efforts, emphasizing the need to create dynamic labor markets and effective safety nets to fight vulnerability and foster productivity, rather than to perpetuate a culture of job stability and protection of the employed. Although a substantial change of direction has been suggested, a second round of reforms would not be possible without the changes that took place in the 1990s.

**References**


**Notes**

1 Indermit Gill and William Maloney are Lead Economists in the Latin America and the Caribbean Region of the World Bank. Ms Sanchez-Paramo is an Economist in the Poverty Unit of the Region.

2 CEPAL estimates that 6 of every 10 new jobs were created in the informal sector.

Learn more about our work

http://www.worldbank.org/lac

To Subscribe to “en breve” please send an email to “en_breve@worldbank.org” or write to:

Editor, En breve
MSN 16-604
The World Bank
1818 H Street NW
Washington D.C.

“en breve” might also be of interest to:

Name:

Institution:

Address:

E-mail: