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The report was prepared under the overall guidance of Roberto Martins (President, IPEA), Gobind Nankani and Vinod Thomas (Country Directors during 2000-2002), and Xavier Coll and Ana-Maria Arriagada (Sector Directors during 2000-2002), and Suman Bery and Joachim von Amsberg (Lead Economists during 2000-2002).

Volume I consists of the Policy Report, prepared by Indermit S. Gill, Andreas Blom, Ricardo Paes de Barros, Carlos Henrique Corseuil (Economist, IPEA) and Mirela Silva (Economist, IPEA).

Volume II, prepared by Andreas Blom and Indermit Gill, contains the background papers commissioned for the report, that diagnose labor market developments in Brazil, present relevant international experience, and discuss the policy implications. The authors of the papers are José Márcio Camargo (PUC-Rio de Janeiro), Francisco Galrão Carneiro (Universidade Catolica de Brasilia), Jorge Saba Arbache (Universidade de Brasilia), Ricardo Paes de Barros, William Maloney (Lead Economist, LCRCE), Wendy Cunningham (Economist, LCSPR), Norbert Fiess (Economist, LCRCE), Marco Fugazza (Consultant, CERAS, Ecole Nationale des Ponts et Chausses, Paris), Dörte Domeland-Narvaez (Consultant, Universidad Pompeu-Fabra, Barcelona), Amit Dar (Senior Economist, HDNSP) and Andreas Blom.

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TABLE OF CONTENTS

LIST OF FIGURES

List of Tables and Text Boxes

FOREWORD AND SUMMARY

The Debate in Brazil, and How This Report is Organized

1. Brazil's labor market has intrigued analysts and policymakers for decades. It has been characterized both as flexible and efficient and—at the other extreme—as segmented and inequitable, and almost everything in between. Those who say Brazil's labor market works well point to its relatively low unemployment rate, its generally pragmatic labor unions, its low minimum wage and a high rate of job turnover. For those of this view, labor reform is not a priority. Those who say it does not work well point to the high rate of informality, the frequency of litigation in labor courts, high inequality of earnings, and the limited reach of labor laws and government interventions to assist workers who need help. For such people, labor reforms are important.

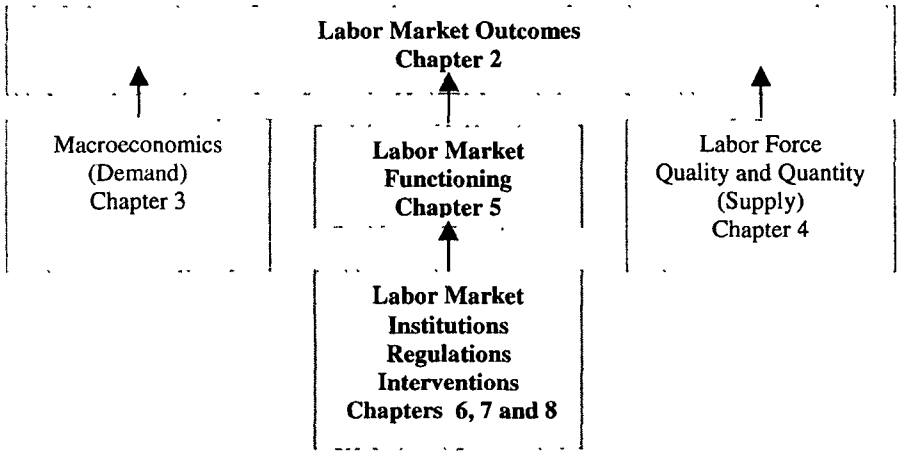
Population, 2000*	
Country	**Millions**
Brazil	170.3
Argentina	37.0
Chile	15.2
Colombia	42.3
Mexico	99.0
Spain	39.5
Portugal	10.0
Italy	57.5
Germany	82.0
Netherlands	15.9
UK	59.2
USA	275.5
Korea	47.2
Thailand	62.1

Source: ILO
* or latest.

2. This report, conducted jointly by researchers in Brazil and at the World Bank, aims to address this debate on how the Brazilian labor market functions. It does so not by focusing on labor market functioning but on its outcomes. After all, the really important questions are not whether Brazil's labor market is overly informal, or excessively litigious, or hyperactive in that people change jobs much too frequently. What is central are labor market outcomes, such as adequate employment growth so that job-seekers can find gainful employment, acceptable worker productivity levels that are fairly compensated, and reasonable income security for workers and their households.

3. This shift in focus from functioning to outcomes does, however, complicate our work. While one can study labor market functioning without paying too much attention to non-labor factors, such "partial equilibrium analysis" is impossible when the subject of study is outcomes. Employment growth depends on macroeconomic factors at least as much as labor laws; worker productivity levels depend as much or more on investments in physical and organizational capital by firms and on investments in human capital through education and training as they do on labor market institutions and interventions; and income security depends as much on factors such as trade patterns and social safety nets as it does on labor market regulations. But we believe that this added complexity is necessary for a fuller understanding of Brazil's labor market. To simplify matters somewhat, we focus here on the most relevant relationships, between labor market institutions, its functioning, and outcomes. The report is structured accordingly (see Figure 1).

Figure 1: Framework of Analysis and Structure of Volume I



Labor Markets as an Important Link

4. Because labor market issues are so controversial, it is easy to forget that the demand for labor is derived entirely from the demand for commodities and services. The latter depends a lot more on macroeconomic factors that spur economic growth than on labor markets. Again, while it is important that the labor market provides accurate signals for investment in skills, the functioning of education and training systems may be far more important for the supply of skilled labor and the quality of jobs. Labor markets serve only as a link between the factors that affect demand for labor and those that affect its supply.

Income Inequality, 2000	
Country	**Gini**
Brazil	59.1
Argentina	53.0
Chile	57.5
Colombia	57.1
Mexico	51.9
Spain	32.5
Portugal	35.6
Italy	27.3
Germany	30.0
Netherlands	32.6
UK	36.1
USA	40.8
Korea	31.6
Thailand	41.1

Source: World Bank

5. But they are an important link. Without well-functioning labor markets, economic growth may not translate into jobs, investments in education and new technologies may not translate into higher productivity and pay of labor, and incomes may remain uncertain even as economies become more stable. In an important sense, therefore, labor markets should be as passive a link as possible to qualify as well-functioning, serving to facilitate rather than influence the redistribution of resources.

6. For all these reasons, it is important to keep expectations from labor market reform realistic. It is difficult to identify the extent to which labor market functioning is responsible for less than desirable outcomes. While this report will identify the rationale for labor reform and help in prioritizing the efforts in this difficult area of public policy, it could be argued that these outcomes can be attained through other policy instruments. But if there is any doubt that the outcomes themselves are not satisfactory, consider two facts relating to efficiency and equity, respectively. Productivity levels in Brazil are low, compared with what should be expected of countries at its per capita income levels (such Chile, Malaysia and Mexico). If Brazil were a particularly equitable country, one could argue that the price in terms of lower efficiency and productivity may be worth paying. In fact, inequality in Brazil is noteworthy for being among the highest in the world. Policy reforms that increase productivity or reduce inequality should be helpful in Brazil. Labor reforms—which can do both—should therefore be seriously considered.

Box 1: Economic growth and labor reform in Argentina

Employment growth over the last quarter century in Argentina has been uneven. Employment grew 1.3 percent annually between 1974 and 1994, but at 3.4 percent between 1995 and 1999. The increase in employment growth since 1995 was because of two reasons—resumption of economic growth and reduction in labor costs. The latter included a general decrease in payroll taxes, and the introduction of a new type of contract under the *modalidades promovidas*, which allowed hiring of workers without paying labor taxes and with fewer penalties for firing. Half of all workers hired in 1996-1998 were under these special contracts. By 1998, more than 12 percent of formal employees had been contracted under the *modalidades promovidas*. Rough calculations indicate that total employment would have been 13 percent less if these reforms had not been introduced. Unemployment rates fell from almost 20 percent to less than 12 percent over this period.

The initiative amply demonstrated the positive effects of measures to make hiring and firing of workers less expensive. But the lesson learned by Argentina's government appeared to have been the opposite. In 1998, in the run-up to the elections, the *modalidades promovidas* initiative was revoked, the probationary period for standard contracts was halved from twelve months to six, and the system of collective bargaining was further centralized to placate Argentina's vocal labor unions. By 2001, this retreat from labor reform combined with falling growth rates led to unemployment rates climbing back to 1995 levels. With the economic crisis caused by the debt default, unemployment rates went up even higher in 2002.

Source: Argentina: Labor Markets in the New Millennium, World Bank, 2000.

Principal Features of Brazil's Labor Market

7. In examining Brazil's labor market, it is worthwhile to keep some simple statistics and definitions in mind. In 2000, Brazil had a labor force of about 80 million that—given that two-thirds of its population of 170 million is of working age—implies a labor force participation rate of about 70 percent. With an unemployment rate of about 8 percent, this means that employment is about 73 million. Of this, about 3 million are employers, and self-employed workers number about 17 million. The remaining 53 million is split evenly between formal and informal wage and salaried workers.

8. When referring to informal employment in Brazil, people usually add up the 17 million self-employed and the 27 million informal wage workers. In fact, these two groups have more differences than similarities. What they do have in common, though, is that neither group pays social security dues. In the vernacular, they are *sem carteira de trabalho assinada*, or without a signed working card. In contrast, formal wage and salaried workers have working cards that have been signed by their employers, who thereby agree to abide by all labor laws. These are the more fortunate or plucky *com carteira assinada*. The question of what to do about informality—often viewed as a growing problem (see Figure 2)—figures prominently in discussions about labor policy in Brazil.

9. Of the institutions that affect labor market functioning in Brazil, none is more influential than its system of labor courts, known as the *justiça do trabalho*, a special section of the judicial branch of government that employs judges, lawyers and others charged with resolving labor disputes between employers and workers. By all measures, they are extraordinarily busy—in 2000, Brazil's labor courts entertained about 2 million complaints, an order of magnitude larger than in the US (17,000) and Japan (1,500), which have larger workforces. Labor courts are believed to profoundly alter work relationships, and play a central part in the labor policy debate.

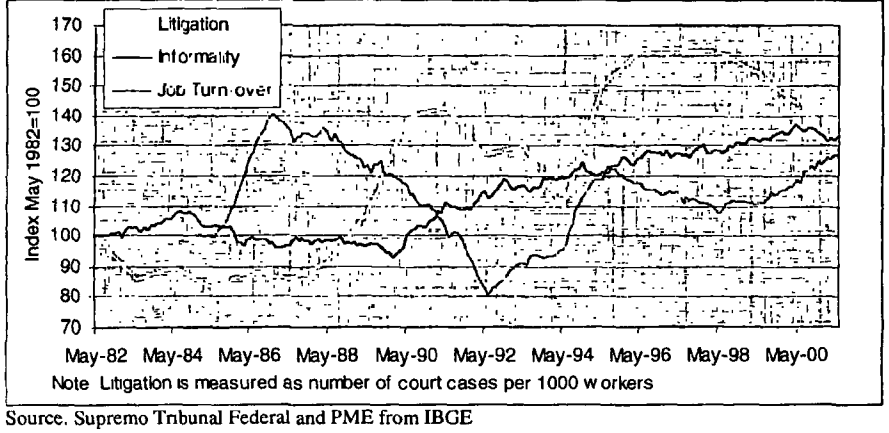
10. Among labor economists, few statistics are as widely cited in Brazil as those on job turnover. Fully one-third of the labor force changes jobs every year, a number that is presented as evidence of the dynamism of Brazil's labor market, and the ease of firing and hiring under its labor laws. But there is evidence that labor legislation may actually be increasing turnover beyond what would occur if these laws were more neutral. One of the reasons for this hyperactivity is believed to be the design of individual severance accounts system mandated since 1968, the *Fundo de Garantía por Tempo de Serviço* (henceforth FGTS).

Per Capita Income, 2000*

Country	US$
Brazil	3,570
Argentina	7,440
Chile	4,600
Colombia	2,080
Mexico	5,080
Spain	14,960
Portugal	11,060
Italy	20,010
Germany	25,050
Netherlands	2,140
UK	24,500
USA	34,260
Korea	8,910
Thailand	2,010

Source World Bank
* or latest.

Figure 2: Litigation, Informality and Turnover have Increased Since the 1980s



Note Litigation is measured as number of court cases per 1000 workers

Source. Supremo Tribunal Federal and PME from IBGE

A Road Map to the Report

11. This report addresses these labor market issues using existing research and work commissioned for this task. Volume II contains a detailed examination of the issues of interest in Brazil and the relevant international experience (see Table 1). This volume summarizes the main findings and policy implications.

12. Just as technology and skills need to be updated as economic conditions change, so do labor market institutions. The regulations that govern employment relations and the institutional framework that facilitates and supports them have seen only a few changes over the sixty years since the *Consolidacão das Leis do Trabalho* (henceforth CLT, or the consolidated labor code) was adopted. Chapter 1 argues that labor laws—that were probably more suited to conditions in the 1950s and 1960s—have begun to show signs of obsolescence. Chapter 2 shows how this is reflected in deteriorating outcomes. Key indicators—employment growth, labor force participation, unemployment rates, and income security—all point to worsening labor market functioning since the mid-1990s.

Poverty, 1998* (% of population living below US $ 2 per day)	
Country	**%**
Brazil	25.4
Argentina	-
Chile	18.4
Colombia	28.7
Mexico	34.8
Spain	-
Portugal	-
Italy	-
Germany	-
Netherlands	-
UK	-
USA	-
Korea	2.0
Thailand	28.2

Source: World Bank
* or latest.

13. The report then examines how changed macroeconomic circumstances call for changes in labor market institutions, regulations and interventions. In particular, using a characterization of the economy in which informality has a central role, Chapter 3 illustrates the correspondence between the three main macroeconomic phenomena of the 1990s—greater openness, stabilization, and fiscal adjustment—and Brazil's labor reform priorities.

14. In examining the supply side, Chapter 4 concludes that the labor market has signaled the shortage of educated workers since the 1990s, and the onus is now on the education and training systems to respond. Because of rapidly declining population growth, the current cohort aged 5-20 years will be the largest ever. Brazil faces a window of opportunity in that it can ensure a supply of skilled workers for many years to come if this generation acquires a strong education base. There are signs that the education system is responding.

15. Analysis of how Brazil's labor market functions in Chapter 5 points to evidence that indicates that Brazil's poorer workers and smaller firms are especially disadvantaged by how the labor market functions. The report identifies three sets of priorities for reform: changes in mandated non-wage benefits and minimum wage setting to price labor correctly and encourage employment growth (Chapter 6), changes in severance legislation and functioning of labor courts to better align incentives and increase productivity (Chapter 7), and improvements in interventions to increase income security for all workers (Chapter 8). Chapter 9 summarizes and highlights the main policy implications.

Box 2: Productivity—an important but difficult concept

The two most common concepts of productivity are labor and total factor productivity.

Labor productivity is most commonly calculated by dividing value added by employment. This is the measure used in this report. Because value added figures are often not available outside of manufacturing, labor productivity statistics are usually available for a small part of the workforce. Labor productivity can go up for many reasons—improvements in functioning of the labor market that improves the efficiency of labor use is just one of them. Others are higher human capital or capital per worker, increased use of natural resources, and technical progress.

Total factor productivity is the productivity of all factors (labor, capital and other inputs) combined, calculated by dividing output by an aggregate index of inputs. Increases in total factor productivity—under some assumptions such as perfect competition—can be viewed as technological change.

Productivity may go up in the event of "jobless growth" , i.e., if output increases but employment does not. We therefore use measures of employment growth alongside labor productivity growth in assessing the effectiveness of labor reform.

This Report's Main Messages

16. The next few paragraphs offer an even more abbreviated summary. Readers interested in just a summary of the findings and the principal policy recommendations can go straight to Chapter 9, which can be seen as an executive summary. For those interested in more detail, Volume II contains in-depth examination of the issues of interest in Brazil and the relevant international experience (see Table 1), on which Chapters 1 through 8 of this volume are based.

17. While Brazil's labor market displays macroeconomic flexibility—reflected in moderate unemployment (although increasing), high turnover rates, and adjustment through wages—it also reveals symptoms of microeconomic inefficiencies—low productivity and job hyperactivity. The interaction of Brazil's labor institutions—especially the labor justice system and the network of unions—with its regulations—especially for wage and non-wage benefits and for severance payments—combined with low education levels of its workforce results in low labor productivity when compared with benchmark countries, and sluggish formal sector employment growth. What makes this even worse is that labor market functioning is "regressive"—its influence on outcomes is particularly pernicious for the poor.

World Competitiveness Index, 2001

Country	Index
Brazil	49.7
Argentina	37.5
Chile	59.8
Colombia	32.8
Mexico	43.7
Spain	60.1
Portugal	48.4
Italy	49.6
Germany	74.0
Netherlands	81.5
UK	64.8
USA	100.0
Korea	51.1
Thailand	42.7

Source: IMD

18. As remedies, the report proposes more appropriate pricing of labor, reduced misalignment of incentives faced by workers and firms, and steps to improve income security for workers without unduly distorting prices and incentives. The priorities for reform are:

- Reforms to reduce the inadvertent subsidization of turnover, especially the reform of the *Fundo do Garantía por Tempo de Serviço*. (FGTS).
- Improved coverage of income security programs, especially the redirection of *seguro desemprego* (unemployment insurance) to reach informal wage and salaried workers.
- Moving negotiations from labor courts to the workplace, first by reforming collective bargaining laws (especially *unicidade sindical*) to improve representation and then by reforming the *justiça do trabalho* (labor courts)
- Lowering mandated benefits down from levels at which they distort the behavior of more than half of the workforce to levels more consistent with the quality of Brazil's workforce and the nature of its institutions.

Box 3: The themes underlying this report

There are three recurrent themes in this report, spanning economic efficiency, socio-economic equity and political feasibility concerns:

First, the effects of current design of labor legislation and institutions have begun showing up clearly in worsening economy-wide indicators of employment growth, labor force participation, unemployment and coverage of social insurance programs. Worsening outcomes during the 1990s point to the increasing urgency of labor reforms to improve *economic efficiency*.

Second, the design and enforcement of labor legislation hurts workers and firms with low productivity the most, and the reforms that have been proposed as compromises again help them the least. Labor reforms are needed to improve *socioeconomic equality*.

Third, Brazil need not reform its labor market institutions, regulations and interventions all at once. The proposed changes fall into three different areas—pricing labor correctly, better aligning incentives, and redirecting social insurance programs. Even within these areas, the reform agenda can be partitioned and undertaken with more or less vigor, so that labor reforms meet the condition of *political feasibility*.

Table 1: Contents of Volume II—Brazil Diagnostics and International Experience				
Ch.	*Author*	*Title*	*Topic*	*Nature*
1	Andreas Blom	Road Map to Volume II	Introduction	Summary of findings
2	Norbert Fiess, Marco Fugazza, & William Maloney	Labor Markets and Economic Adjustment: The Brazilian Case	Macro-Labor Linkages	Brazil diagnostics
3	William Maloney & Wendy Cunningham	Re-examining the Informal Sector	Informality	International experience
4	Jorge Saba Arbache	Unions and the Labor Market in Brazil	Collective Bargaining	Brazil diagnostics based on household-level data
5	Amit Dar & Francisco Galrão Carneiro	Economic Impact of Unions and Collective Bargaining: International Experience	Collective Bargaining	International experience
6	José Márcio Camargo	Fake Contracts: Justice and Labor Contracts in Brazil	Labor Courts	Brazil diagnostics based on administrative data
7	Francisco Galrão Carneiro	An Overview of the Effects of the Minimum Wage on the Brazilian Labor Market	Minimum Wages	Brazil diagnostics based on household-level data
8	Wendy Cunningham	The Poverty Implications of Minimum Wages in Developing Countries	Minimum Wages	International experience
9	Dorte Domeland & Norbert Fiess	Unemployment and Unemployment Insurance	Income Support for Unemployed	Brazil diagnostics based on household-level data
10	Ricardo Paes de Barros, Mauricio Cossio, & Jorge Teles	The Efficiency of Active Labor Market Policies for Poverty Reduction in Brazil	Active Labor Market Policies	Brazil diagnostics based on household-level data
11	Amit Dar	Active Labor Market Policies: Evaluative Evidence	Active Labor Market Policies	International experience
Volume II is available as a separate publication.				

1. The Role of Government in the Labor Market

19. The market for labor, like any other market, has institutions that govern its workings. The precise definition of "institutions" varies. World Bank (2001) defines them as rules, enforcement mechanisms and organizations. In contrast, for Burki, Perry and others (1998), rules and enforcement mechanisms constitute institutions, in contrast with organizations—the latter pursue their interests within an institutional structure. In this report, we distinguish between ***institutions*** (e.g., the labor courts), ***regulations*** (e.g., rules governing dismissal of workers) and ***interventions*** (e.g., unemployment insurance programs). For our purposes, this seems to be the most sensible classification.

20. The institutions that are of the most importance in Brazil are the federal constitution, the system of labor courts, and the network of labor unions. The regulations that concern us here are the mandated wage and non-wage benefits for individuals while employed, severance mandates including the FGTS, and the rules governing collective bargaining. The interventions we examine in this report are the unemployment insurance system, public job search assistance and training programs, and public work schemes.

Unemployment Rates, 2000*

Country	%
Brazil	9.6
Argentina	12.8
Chile	9.9
Colombia	20.1
Mexico	2.0
Spain	14.1
Portugal	3.8
Italy	10.8
Germany	8.1
Netherlands	3.6
UK	5.3
USA	4.1
Korea	4.1
Thailand	2.4

Source: ILO
* or latest.

Institutions Must Evolve

21. Like the technologies used by firms and the skills possessed by individuals, the institutions of countries have a "vintage". And just as changed circumstances make technologies and skills obsolete, changes in economic conditions can make institutions outdated. Brazil has changed from a high growth, public-sector dominated, closed, high inflation economy in the 1960s and 1970s to a low growth, private sector led, relatively open, low inflation country since the mid-1990s. It is hard to imagine a more changed set of circumstances. The rules, regulations and organizations that possibly served Brazil's labor market well in the 1960s and 1970s may not have helped much in the 1980s, and may have even hindered progress since the 1990s. Brazil needs to keep what is working, and change what is not. While the constitution has been changed several times, it would be no exaggeration to say that institutions governing litigation, arbitration and collective bargaining have not changed since their inception in the 1940s (see Boxes 4 and 5).

Box 4: Institutional Reform: Beware of "Best Practice"

Burki, Perry and others (1998) provide some guidelines for promoting institutional reform: paying systematic attention to the nature of prospective winners and losers, crafting compensation schemes that are politically viable, and empowering and providing choice to beneficiaries. The main lessons in World Bank (2001) for building effective institutions are to design them to complement what exists, to innovate to identify institutions that work, and to drop those that do not. This is all sensible enough. But the relevant lessons for Brazil may be even more obvious. First, while it is tempting to view foreign institutions that are performing well as models for adaptation, attempts to transplant institutions have rarely led to success. And where they have, the gains are often short-lived. Second, institutions must be updated, conservatively but constantly. Even appropriate institutions become obsolete.

Brazil's own experience with labor market institutions is not inconsistent with this... President Getúlio Vargas imported Italy's corporatist labor structures during the 1930s, driven perhaps as much by political expediency as by an objective assessment that they would match Brazilian habits and hopes. These institutions have not been changed even as economic and political changes have radically altered the relationship between employers and workers in Brazil and the rest of the world. On the contrary, many of these features have been "hardwired" into the Constitution.

Sources: Building Institutions for Markets, World Bank, 2001 and *Beyond the Washington Consensus: Institutions Matter,* by Burki, Perry and others (1998).

Regulations Should Promote Employment and Productivity

22. The principal aim of labor regulations is to ensure the smooth functioning of the market so that labor is allocated to its most productive use, and wage is as high as the quality of labor warrants. This also ensures that employment is maximized. When imbalances arise—say, the presence of more job-seekers than jobs—regulations should not impede adjustments in wages to correct imbalances. But such aggregate efficiency should not be the only objective of labor regulations. They should also ensure (i) a degree of fairness in that employment contracts that are entered upon voluntarily are honored by both employers and workers, (ii) that the market is competitive in that employers and workers do not collude or discriminate in negotiating contracts; and (iii) that conditions of work meet minimum safety standards. Societies generally go further and try to legislate minimum pay and job security. Thus we have minimum wage laws, restrictions on ending contracts and—where contracts must be terminated—stipulations for payment of severance benefits.

Costs of Dismissal, 1999 (Average)

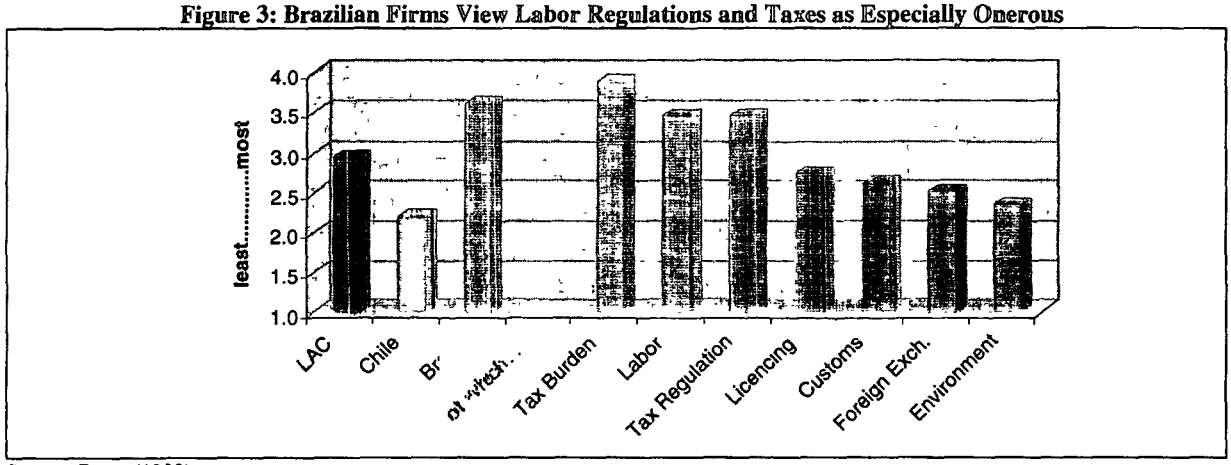
Country	Monthly wage
Brazil	12.9
Argentina	3.0
Chile	3.4
Colombia	10.7
Mexico	3.2
Spain	3.2
Portugal	4.5
Italy	3.2
Germany	1.1
Netherlands	0.9
UK	1.4
USA	0.0
Korea	3.6
Thailand	-

Source: Heckman and Pages(2001)

23. It can be argued that the aim of regulations should not be to guarantee job security but to facilitate employment and productivity growth, and that a well-functioning labor market is the best instrument for income security, and not job-security regulations that lock the worker into his/her current position. But we do not wish to enter that debate here. Nor is it necessary. Regulations in Brazil do not entirely promote employment and productivity, nor guarantee income security. Unsustainable regulations show up in the form of high informality among the wage and salaried, a preference for self-employment among others, and low productivity and employment growth in regulated labor markets. Figure 4 shows that firms in Brazil view labor regulations as burdensome; and that labor taxes also are a significant portion of the tax burden.

24. The reform of regulations in Brazil is especially difficult because many of the rules have been "institutionalized"—Brazil is one of the few countries where labor laws are written into the constitution. Changes in labor laws often require constitutional reform, and attempts to change the CLT without changing the constitution lead to inconsistencies that exacerbate litigation, further straining labor courts. This has led reformers to contemplate using the labor unions to circumvent this problem, e.g., by allowing workers to collectively bargain away some of their constitutionally guaranteed rights as individuals. As we will see in Chapter 6, however, this is neither easy nor without the risk of collateral damage.

Figure 3: Brazilian Firms View Labor Regulations and Taxes as Especially Onerous



Source: Batra (1999)

Interventions Are Needed, Even in Efficient Labor Markets

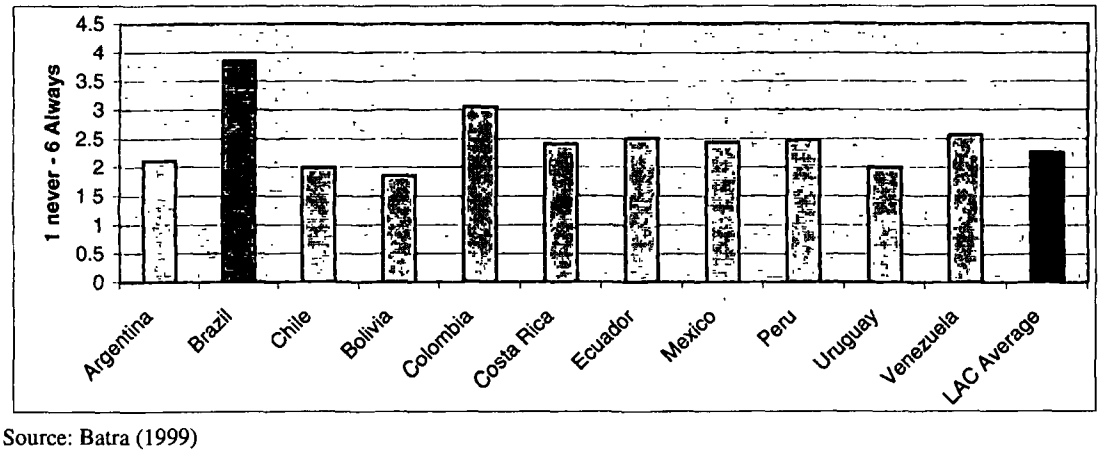
25. Appropriate institutions and regulations improve labor market functioning and result in better outcomes, but this does not imply that government interventions, like training and unemployment insurance are unnecessary. Interventions may be a second best option to remedy market failures, such as the absence of credit to micro and small enterprises. Further, as we will see in chapters 3 and 4, labor market outcomes depend also on macroeconomic policies and the state of the education and training systems. Interventions may be necessary to improve employment and productivity if it is difficult to improve macroeconomic policies, or if education and training system improvements are slow to yield fruit. An example of such interventions is public training schemes to assist the unemployed.

26. In fact, interventions may be needed to promote earnings security even if education and macro policies are fine. The failure of financial markets to provide insurance against the loss of income due to unemployment—while understandable because of information asymmetries—is perhaps the most important reason for government intervention in well-functioning labor markets. Government initiatives to provide instruments for workers to augment their insurance, precautionary saving, and self-protection efforts can raise the well-being of workers.

27. While a tradeoff between employment creation and income security objectives is unavoidable, these interventions should not unduly raise costs of employment nor inadvertently restrict productivity growth. Striking the right balance is difficult. In the case of remedial interventions such as micro-credit programs and adult literacy and training schemes for the less educated, there is probably no alternative but to constantly evaluate the impact and adjust the design while addressing the root causes of the problem. For interventions to correct chronic market failures, the principle for efficient design should be to provide an instrument that the market would provide if it had not failed. Thus, providing a saving vehicle that is protected from risks of inflation and fraud such as FGTS accounts may be appropriate if the incidence of unemployment is high. And providing an instrument such as *Seguro Desemprego* to pool the risk of earnings loss may be justified if unemployment is a relatively rare event.

28. Brazil has not yet arrived at a mix of regulations and interventions that balances the objectives of employment, productivity and security well. A survey of Latin American firms found that labor institutions, regulations, and interventions are viewed as especially onerous in Brazil (see Figure 3).

Figure 4: The Brazilian State Intervenes Frequently
(Question: How Often does the Government Intervene in Firm Decisions?)



Source: Batra (1999)

Box 5: The CLT—Interventionist Principles Remain Intact From the 1930s

Brazil's labor code, the CLT (*Consolidação das Leis do Trabalho*), became effective on May 1, 1943. It consolidated existing labor laws implemented during President Getúlio Vargas' first term in power in the 1930s. The core principle of the code is a benevolent state that regulates almost all aspects of the relation between employer and employee. The legislation was influenced by corporatism, the dominant political thinking of the depression era. When the CLT was passed, workers obtained rights previously unheard of, such as a maximum of 8 hours of work per day and the freedom of association. However, at the same time, the law curtailed the room of maneuver of the labor movement, e.g., requiring state approval of leaders of labor unions and their spending.

During its 60 years of existence, the CLT has been modified occasionally. After two decades of rising union militancy, the military junta that took power in 1964 reinforced state intervention in labor relations. The government started decreeing national-wide wage increases and heavily suppressed strikes, which eradicated the role of civil society in job relations. Labor protests in the late 1970s succeeded in gaining more influence in the collective bargaining process and the constitutional revision in 1988 further opened the opportunities for labor's self-determination of regulations. The amendments abolished both the prohibition of cooperation among trade unions and the government's right to dissolve a union in case it was found to be inhibiting the government's economic policy.

Despite these changes, the CLT still determines many specific terms of employment with little space for negotiations between the worker and the employer. The Constitution has several articles, which accord workers rights that cannot be negotiated—not even by mutual consent—and that are enforced by a system of labor courts. The CLT allows for only one union for each occupation in a given municipality. A union levy is collected from all (formal) workers regardless of union membership, of which 60 percent is transferred to the designated union. Unions have neither the incentive nor the opportunity to improve working conditions of the workers.

Sources: Arbache (2002), Barros et. al (2001), Camargo (2002), Carneiro (2002) and Salewicz (1993).

Table 2: Labor and Other Constraints Faced by Firms in Brazil

Constraints	By Size			By Sector		Overall
	Small	Medium	Large	Manuf.	Services	
Taxes and Regulations	3.6	3.7	3.4	3.6	3.6	3.61
○ **High Taxes**	**3.8**	**3.9**	**3.7**	**4.0**	**3.8**	**3.88**
○ **Labor Regulations**	**3.3**	**3.5**	**3.3**	**3.5**	**3.5**	**3.46**
○ Tax Regulation/Admin.	3.4	3.5	3.2	3.6	3.4	3.46
Policy Instability	3.4	3.5	3.5	3.5	3.5	3.48
Exchange Rate	2.3	3.0	3.2	3.1	2.9	2.94
Crime and Disorder	3.3	2.7	2.5	2.8	2.7	2.74
Inflation	2.6	2.8	2.6	2.6	2.7	2.70
Financing	2.5	2.8	2.3	2.8	2.6	2.69
Corruption	2.6	2.8	2.4	2.8	2.3	2.62
Judiciary	2.3	2.5	2.8	2.5	2.6	2.54
Anti-competitive Practices	2.3	2.5	2.5	2.2	2.5	2.43
Organized Crime	2.8	2.4	2.1	2.5	2.4	2.42
Infrastructure	1.6	2.2	2.5	2.0	2.2	2.20

Ranking: 1=no obstacle, 2=minor obstacles, 3=moderate obstacle, 4=major obstacle

Source and Sample: This table is from a survey of private enterprises conducted in Brazil in August 1999, summarized for this report by Geeta Batra. The survey was administered under the supervision of the World Bank Group and the Inter-American Development Bank (IDB) by Gallup Inc. to a sample of 201 firms.

2. The Need for Labor Market Reform in Brazil

29. The debate on labor reforms in Brazil revolves a lot around issues such as high informality, the high frequency of labor disputes, and the high rate of job turnover, and the interconnections between these phenomena. To be sure, these are pertinent issues. But it can be argued that these are not necessarily bad things; as long as the welfare of workers and the profits of firms are reasonable, how the labor market *functions* is a secondary issue. However, it is difficult to decide what "reasonable" welfare and profit levels are, so we rely on other measures that reflect labor market ***outcomes***. In this report we propose that ***employment, productivity, and income security*** provide a parsimonious set of indicators of labor market outcomes. And their evolution over the last two decades provides cause for concern.

Annual GDP Growth, 1990-2000

Country	%
Brazil	2.9
Argentina	4.3
Chile	6.8
Colombia	3.0
Mexico	3.1
Spain	2.4
Portugal	2.6
Italy	1.5
Germany	1.5
Netherlands	2.9
UK	2.5
USA	3.4
Korea	5.7
Thailand	4.2

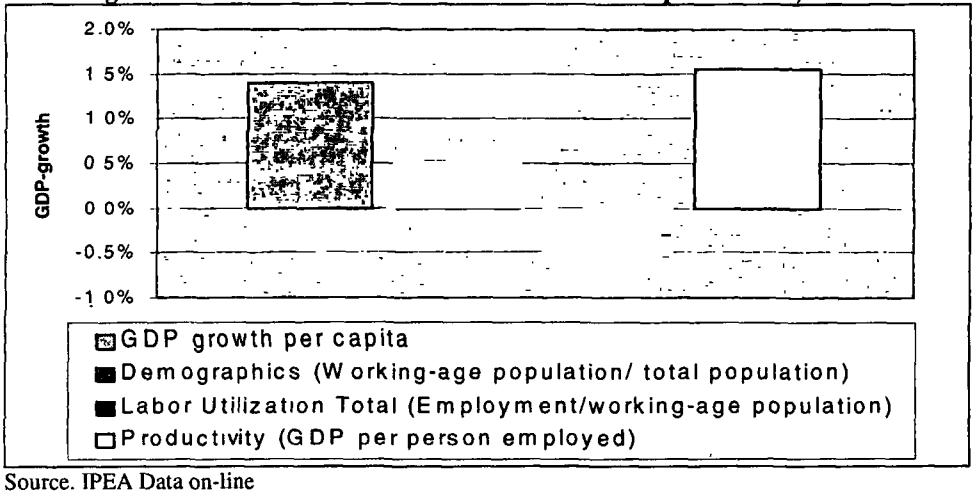
Source· World Bank

The Outcomes of Interest

30. A word on why we use these measures is necessary. The reasoning goes as follows. The per capita income of countries is a good reflection of the well-being of their citizens, and its growth perhaps an even more reliable measure of how this is changing. The labor market principally affects per capita growth through population growth, labor utilization and productivity. Labor utilization is jointly determined by the level of employment and the participation of the population in the labor market. Productivity depends upon on a series of factors, including investments in capital and skills, and thus in factors such as turnover. Although these labor outcomes depend upon many factors unrelated to the regulation and functioning of the labor market (such as macro-economic changes and educational attainment of the labor force, which will be discussed briefly in Chapter 3 and Chapter 4, respectively), this parsimonious set of indicators allows us to reliably assess labor market performance. Figure 5 accounts for how these factors affected income for the average Brazilian from 1993 to 1999.

31. We believe there is another aspect of the economy that workers care about—income or earnings security. To put it simply, most individuals prefer a steady stream of earnings of R$500 per month to another in which income fluctuates randomly between 0 and R$1,000 but averages R$500. And if we care especially about people falling below some poverty line, the case for paying attention to income security around this level is even stronger.

Figure 5: Contribution to Growth of Brazil's Per Capita Income, 1993-1999



Source. IPEA Data on-line

Insufficient Job Creation

32. For the labor market to promote prosperity, it should assure that demand for labor is met by supply at a price that is acceptable for both parties. This coincidence of wants is what creates employment. The benefits of steady increases in the labor force and employment can be substantial. During the 1990s, for example, higher labor force participation in Ireland and Netherlands raised national income by more than 1 percent of GDP annually, while Sweden and Finland saw declining employment that reduced annual GDP growth by more than 1 percent (OECD, 2001). Job creation is not only important from a economic point of view, but also from a social and ethical point of view. Being without a job can undermine the self-esteem of workers and the well-being of their families, even if they are provided financial support.

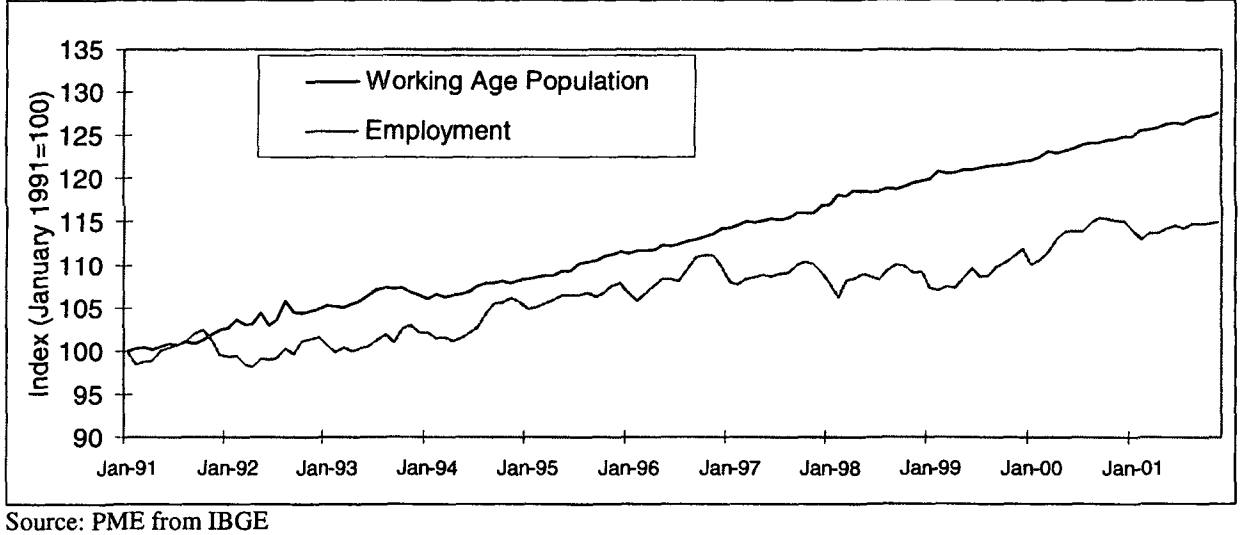
Labor Force Growth 1980-2000*	
Country	%
Brazil	77.5
Argentina	69.9
Chile	64.3
Colombia	-
Mexico	82.4
Spain	26.0
Portugal	11.9
Italy	6.2
Germany	-
Netherlands	-
UK	8.9
USA	31.5
Korea	45.0
Thailand	51.9

Source: ILO
* or latest.

33. Figure 6 presents the evolution of employment and the economically active population for the main metropolitan areas during the last decade. The labor market created 2.3 million new employment opportunities—an increase of 15 percent—which fell short of the 7.1 million increase in the economically active population. The picture is not very different when national data are used instead of metropolitan. There has been no change in the trend rate of growth of the economically active population. The changes have been in employment growth. Until 1996, the labor market appeared to have created sufficient jobs for the expanding population. But since then, job creation has been insufficient to provide employment for the growing labor force.

34. Clearly, some of the drop in employment growth does not have much to do with labor market functioning. In 1998, for example, unemployment rate rose from 6 to 9 percent in the course of 4 months—labor market functioning could hardly change so quickly. What is more worrying is that it has not come down to its pre-1998 level. Despite the resumption of job creation in the last two years, the unemployment rate remains 2 percentage points above the unemployment rate prevailing prior to 1998. Put in more alarmist terms, this corresponds to an increase of 25 percent in "structural" unemployment over the decade.

Figure 6: The Working Age Population Has Risen Faster than Employment During the Last Decade



Source: PME from IBGE

Declining Participation in Work and Rising Unemployment

35. Labor utilization is equally determined by the size of the potential labor force and its participation in production. Urban Brazil—comprising more than three fourths of the population—experienced a marked decline in labor force participation during the 1990s, implying that fewer workers must sustain the living standards of the population. Labor force participation in Brazil's metropolitan areas—the percentage of 15 to 65 year olds who worked or searched for employment. In 1991, 61 out of 100 participated in the labor market. By 2001, this had fallen to 56 out of 100, Ramos (2002). At the national level, a large inflow of women seems to have counterbalanced the falling participation in metropolitan areas. Overall, participation remained constant at 70 percent.

36. But declining participation in work can be because of both good and bad reasons. People may postpone entry to invest more in education, so that when they do enter the labor force they are more productive. Alternatively, people in the relevant age group—15-65 years—may now view work to be less rewarding relative to other pursuits. Analysis of the data indicates that increased enrolment in secondary and tertiary education does in fact partially explain the decline, and this is encouraging. But this is not the whole story. There has also been a decline in labor force participation because of "bad" reasons. This component of reduced participation in work could be interpreted as an indictment of the performance of the labor market, broadly defined to include the design of the social security system. In the most alarming terms, if we assume that labor force participation had remained constant at its 1991 level, metropolitan unemployment rates would be 15 percent in 2001, as depicted in Figure 7.

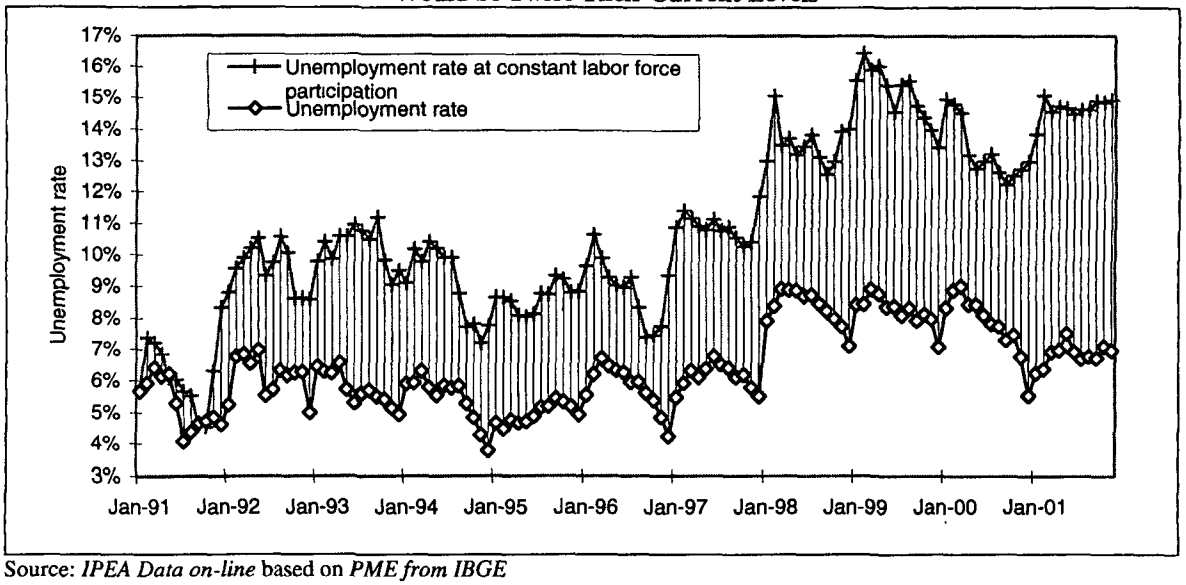
37. If even half of the decline in participation rates is because of an exodus from the labor market due to a judgment by workers that the quality of jobs has fallen, the unemployment rate would now be in double digits.

Labor Force Participation Rates, 2000*

Country	%
Brazil	70.9
Argentina	64.5
Chile	59.9
Colombia	71.8
Mexico	62.5
Spain	63.9
Portugal	70.6
Italy	59.8
Germany	72.2
Netherlands	73.6
UK	76.3
USA	77.2
Korea	63.9
Thailand	76.7

Source: ILO
* or latest.

Figure 7: Had Labor Force Participation Not Fallen During the Last Decade, Urban Unemployment Rates Would be Twice Their Current Levels



Source: *IPEA Data on-line* based on *PME from IBGE*
Note: The shade area illustrates the share of the work force that would have been unemployed if the participation rate had remained at the 1991-level (61 percent).

Low Productivity Levels

38. Productivity is a difficult concept to interpret. In one sense, it is the flip side of the employment coin: if output increases by 10 percent but employment increases by 5 percent—say because labor is expensive compared to capital due to distorted labor markets—productivity goes up. But this can hardly be a good thing. Again, because of increases in investment in education and training, labor productivity levels generally increase. While this is good, these productivity increases cannot all be attributed to well-functioning labor markets. The productivity measure that is appropriate for our purpose, viz., as a ***desirable labor-related outcome***—must capture the concept of ***microeconomic efficiency*** of labor use. That is, it should provide a quantitative indicator of how well-matched workers are to jobs. Job-specific investments by firms and workers that improve how well the work is done will add to productivity. A well-functioning labor market therefore not only ensures that job-seekers find gainful employment and get reasonable income security, it also allows workers to be allocated to their best use by firms. This implies higher productivity for the firms, and higher wages for workers with growing employment levels.

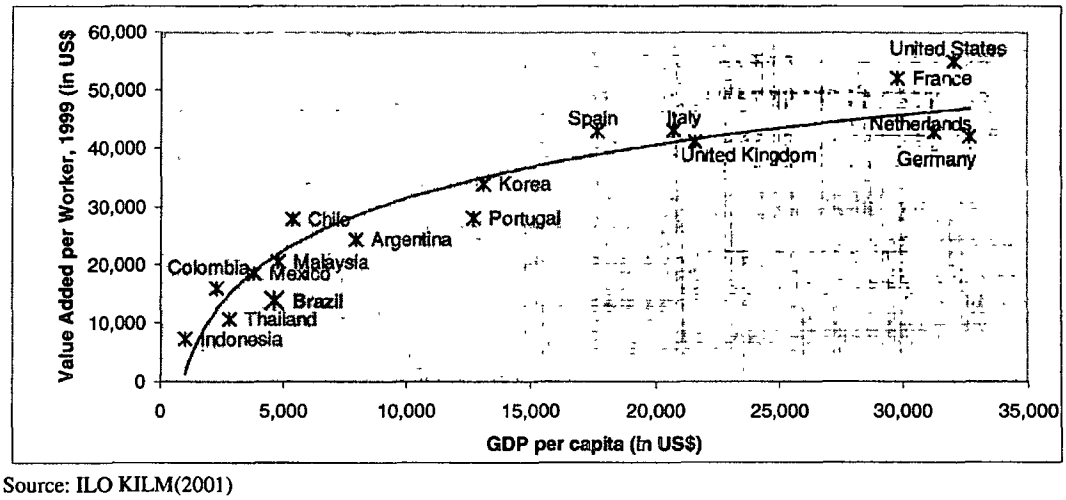
Growth in Value Added Per Worker, 1980-2000*	
Country	
Brazil	-3.7
Argentina	4.9
Chile	44.7
Colombia	17.9
Mexico	-0.9
Spain	38.6
Portugal	35.6
Italy	38.2
Germany	-
Netherlands	6.4
UK	40.8
USA	31.0
Korea	196.2
Thailand	115.8

Source: ILO

39. By most measures of productivity, Brazil is not doing well. Value added per worker was actually lower in 2000 than it was in 1980; in contrast Chile's value added rose by almost 50 percent, Thailand's more than doubled, and Korea almost tripled over the same period. Per capita income growth over this period in Brazil thus seems to have come from increased use of resources (capital and raw materials) and not from improved productivity of workers. Increases in income levels are almost always an unmixed blessing, but these numbers indicate that it will be difficult for Brazil to sustain these increases over time unless more is done to increase productive efficiency in the workplace.

40. Another revealing exercise is to compare labor productivity levels in Brazil today with other countries, after factoring in the obvious advantages of workers in richer countries (e.g., better infrastructure, higher education levels, more capital per worker). We can do this somewhat crudely by estimating what value added per worker in Brazil should be given its level of per capita income, which reliably proxies the advantages that come with greater wealth (see Figure 8). By this measure, Brazil has a "labor productivity shortfall" of between 33 and 50 percent compared with countries such as Malaysia and Mexico which have similar income levels.

Figure 8: Brazil Has a 50 Percent Shortfall in Labor Productivity
(Industrial value added per worker, 1999)



Source: ILO KILM(2001)

Inadequate Income Security

41. Adequate employment opportunities for workers at growing productivity and wage levels are two of the most desirable policy goals. The third is income security.

42. Like productivity, this is a complex concept. But the complexity arises more from misinterpretation rather than mis-measurement. ***Income*** security is often equated with ***job*** security, but their labor policy implications could not be more different. Policies to increase job security include more incentives and opportunities for workers to upgrade their skills, or disincentives to employers to dismiss workers even if their skills or work habits no longer warrant continuing in the job. In general, the emphasis of labor policy has been the latter, in the form of restrictions or penalties on firing workers that increase with tenure in the firm. Income security as a goal has different policy implications, with the emphasis being on income replacement or consumption smoothing. Policies appropriate for increasing income security are "passive" programs such as saving accounts, unemployment insurance and assistance, and "active" programs such as job search assistance, training programs, public works, and support for self-employment. So while job security policies mostly take the form of ***regulations***, income security policies are more in the nature of ***interventions***.

43. With good programs, variability in incomes and consumption will be more dampened than GDP growth volatility. During the last two decades, Brazil's GDP growth volatility has been no higher than its Latin American neighbors, but considerably higher than countries of the OECD. What is more troubling, though, is that while consumption growth volatility is lower than GDP growth volatility in OECD countries, this is reversed in countries such as Brazil (De Ferranti, et. al., 2000). This hints at the relative ineffectiveness or absence of income support programs in developing countries.

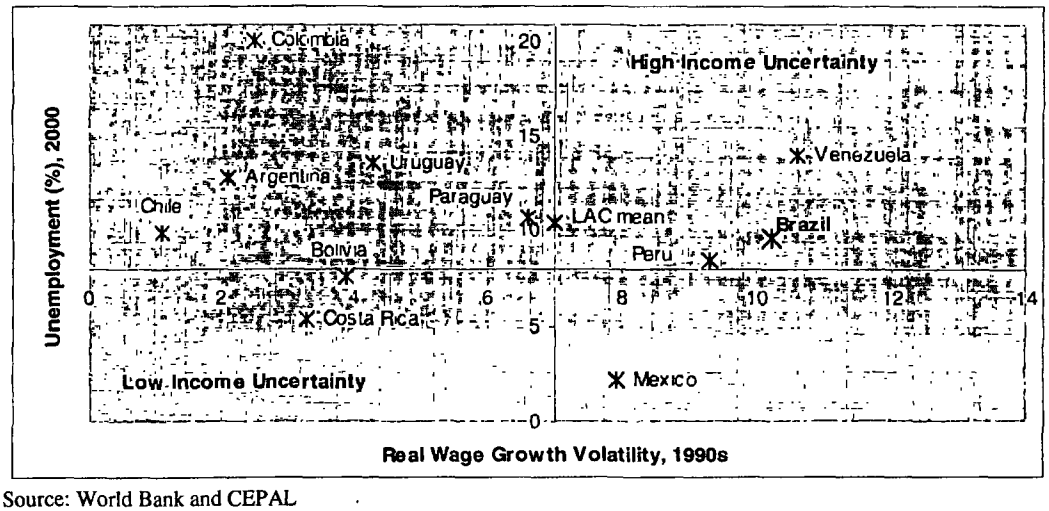
44. Also revealing for the nature of income insecurity in Brazil as compared with other countries is the importance of wage insecurity as relative to employment insecurity, as measured by unemployment (see Figure 9). Brazil has experienced relatively high wage volatility compared with the likelihood of unemployment. To the extent that this is due to the high level of informality in Brazil (where incomes are more variable than employment), this points to the need to extend income security programs to the informal sector.

GDP Growth Volatility, 1980-1999
(Variance of GDP growth)

Country	%
Brazil	3.0
Argentina	5.1
Chile	3.8
Colombia	3.0
Mexico	3.6
Spain	1.7
Portugal	1.8
Italy	1.0
Germany	1.9
Netherlands	1.1
UK	1.8
USA	1.5
Korea	4.9
Thailand	6.6

Source: IMF

Figure 9: Brazilian Workers Cannot Count on Future Earnings
(Indicators of Income Uncertainty for Latin America)



Source: World Bank and CEPAL

3. Macroeconomics and Labor Demand

45. While labor market institutions have not changed much in Brazil over the last decade, the economic environment in which they operate has been radically altered since the late 1980s. Three main changes have taken place: inflation rates are now down to single digits, barriers to international trade and investment have been reduced, and an ongoing fiscal adjustment is reducing the economic weight of government. All this implies that labor demand has changed considerably. In the next chapter we will see that the nature of labor supply in Brazil has also seen important changes over the last two decades. If labor market outcomes had not deteriorated, there would still be little cause for concern. But Chapter 2 outlined how employment, productivity and income security indicators now display stagnation or deterioration. This chapter examines the possible implications of macroeconomic changes for Brazil's labor reform agenda.

Increase in Unemployment, 1990-2000

Country	%
Brazil	2.8
Argentina	7.7
Chile	1.4
Colombia	9.2
Mexico	-0.5
Spain	-2.1
Portugal	-0.7
Italy	1.5
Germany	3.1
Netherlands	-3.1
UK	-1.5
USA	-1.6
Korea	-
Thailand	-

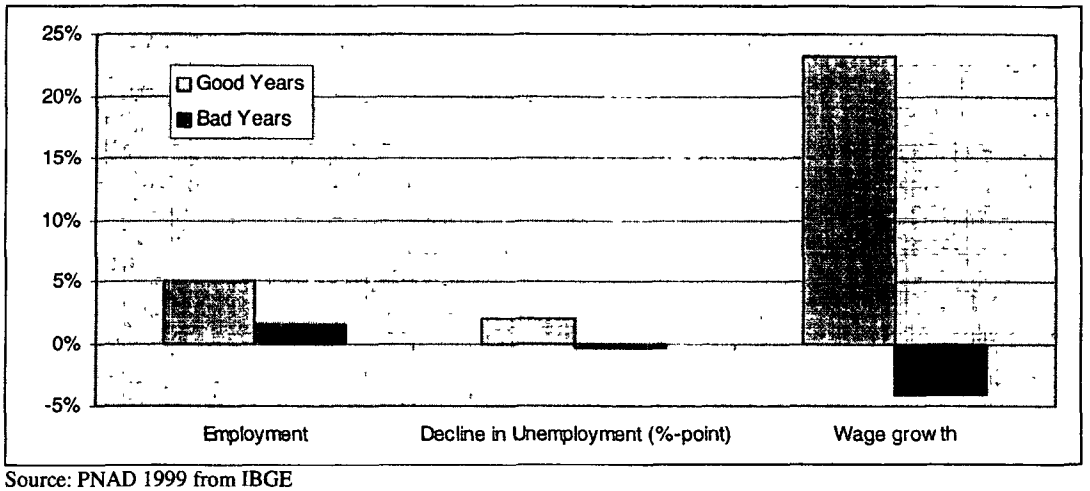
Source: CEPAL and ILO
Note: For Latin American countries: urban unemployment

Macroeconomic Fluctuations Affects Labor Demand

46. It is well-known that the temporary ups and downs of the economy strongly influence labor demand independently of labor market policy. Figure 10 shows how employment and earnings changed with the economic cycle in Brazil. Using GDP growth, periods of economic expansion (1984-1986, 1993-1996 and 2000) and contraction (1983, 1990-1992 and 1998) are distinguished. Employment growth, decline in unemployment, and wage growth take place in good times; in bad times, the brunt of the adjustment is borne by wage decreases, with employment growth staying positive, while unemployment increases only marginally. This is the finding that leads many observers to give labor market reform low priority. This report provides evidence that this "macroeconomic flexibility" masks a microeconomic rigidity that results in low productivity levels and poor income security. But more on that in Chapters 6, 7, and 8.

47. It is important to understand that the labor market outcomes–in the short run—are dictated by business cycle fluctuations, but in the long run are determined by changes in macroeconomic regimes, or what are commonly called structural reforms. The rest of this chapter focuses on the how macroeconomic reforms that the government of Brazil have undertaken have permanently altered labor demand and the functioning of the labor market.

Figure 10: At the Aggregate Level, Brazil's Labor Market Has Adjusted Well to Economic Fluctuations



Source: PNAD 1999 from IBGE

Stabilization and the Labor Market

48. Three major shifts in Brazilian macroeconomic policy took place during the late 1980s and the 1990s—greater openness, stabilization, and fiscal adjustment. The Collor government initiated the trade reforms in the late 1980s, while the successful inflation stabilization begun in 1994 under the Cardoso government, which equally embarked on fiscal adjustment in 1998.

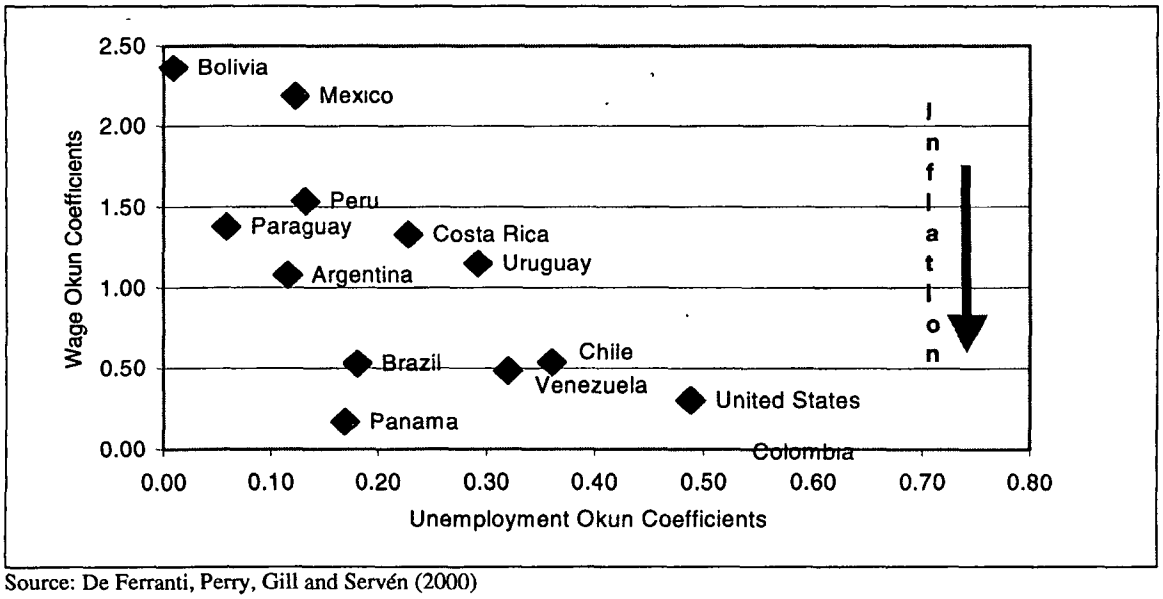
49. Figure 11 below shows how the inflation stabilization affects labor demand. It displays how the labor market adjusts to changes in economic activity in several countries in the hemisphere. Adjustment in employment, "Employment Okun coefficients", show how much a given change in output changes employment, while adjustment in wages, measured by "Wage Okun coefficients", indicate the degree to which the change in output results in changes in real wages. As we move from countries that have high inflation to those with more stable price levels, the reliance on adjustment through quantities increases. The reason is not complicated—by obviating the need to reduce nominal salaries, which is difficult (Brazilian labor laws forbid this for individual contracts), inflation facilitated reduction in real wage levels in response to economic contractions. When inflation falls, this channel of adjustment is narrowed and employers have to respond by cutting jobs.

50. The analysis indicates that the labor reform priorities during a period of successful stabilization such as the Real Plan are the institutions and regulations that impede downward wage flexibility. During the late-1990s, however, there was no reform of collective bargaining institutions, no change in regulations forbidding nominal wage adjustments, and a substantial increase in real minimum wage levels in Brazil. As growth slowed, both labor market functioning and outcomes have changed in response—employment growth has slowed, unemployment has risen, and the share of informal (self-employed and wage) workers has increased.

Decline in Inflation (Average 1984-1993 to Average 1994-1999)	
Country	**In %-point**
Brazil	340.9
Argentina	344.7
Chile	13.6
Colombia	8.3
Mexico	31.7
Spain	4.1
Portugal	9.6
Italy	3.3
Germany	1.0
Netherlands	-0.7
UK	2.4
USA	1.3
Korea	1.6
Thailand	-0.7

Source: IMF

Figure 11: Falling Inflation Implies More Labor Market Adjustment Through Employment and Less Through Real Wages



Source: De Ferranti, Perry, Gill and Servén (2000)

Trade Opening and the Labor Market

51. The opening of the Brazilian economy began in the late 1980s. In less than five years since 1990, all non-tariff barriers were removed and the average import tariff fell from 32 percent to less than 13 percent. The Real Plan also used the exchange rate as a stabilization tool a deliberate choice by the government aimed at increasing the competitive pressures in the market for tradable goods. Imports were to play the role of adjusting aggregate demand to aggregate supply. And intermediate and consumption good imports duly increased after 1995.

Share of Exports in GDP, 1999*	
Country	%
Brazil	10.6
Argentina	9.8
Chile	29.0
Colombia	18.0
Mexico	31.0
Spain	27.6
Portugal	31.0
Italy	25.5
Germany	29.2
Netherlands	60.6
UK	25.8
USA	11.1
Korea	42.1
Thailand	58.5

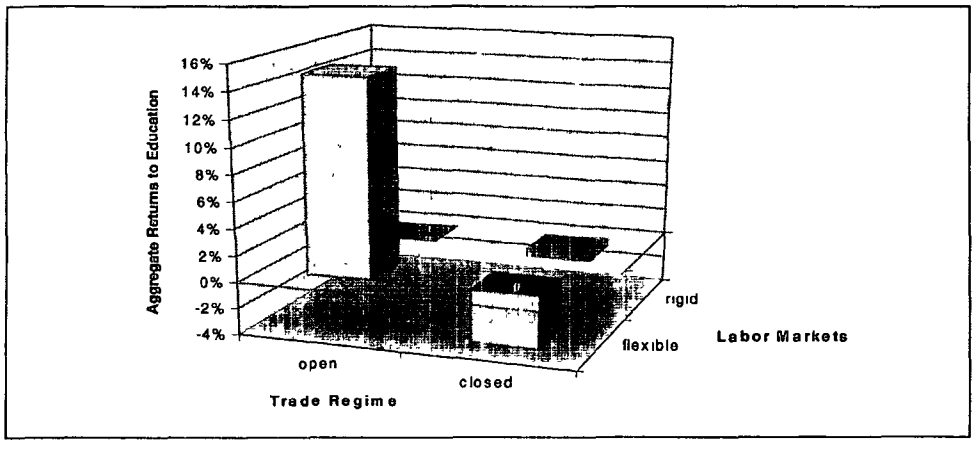
Source: World Bank
* or latest.

52. These changes had three main effects. The first was a rise in the price of non-traded goods—principally services but also construction—relative to traded goods originating in the manufacturing, mining and agriculture sectors which were exposed to the discipline of world markets. The second, related, effect was the rise in informality—both for wage- and self-employed workers. The third effect was a rise in productivity in the tradable goods sectors, driven mainly by lower employment rather than improved production techniques.

53. This last finding is important. In countries that have improved their international linkages through trade reform, the demand for educated workers has generally increased, as new technologies are adopted which are complementary with skilled workers (Sanchez-Paramo and Schady, 2002, and Arbache, 2001). But this has increased more in countries that carry out trade reform with labor markets that facilitate this reallocation of workers (see Figure 12 from Cohen, 2001). As we will see in the next chapter, compared with Chile and Mexico, for example, the increase in demand for educated workers in Brazil has been quite muted. The finding highlights the complementarity between trade and labor reform, two politically charged public policy issues in Brazil.

54. The rise in informal employment has not outweighed the fall in formal sector employment in the traded goods sectors and—despite a fall in labor force participation rates—unemployment has risen from an average of 6 percent in the early 1990s to about 8 percent since 1996. Not surprisingly, the rise in joblessness is greater in industrial states such as São Paulo and Minas Gerais. The increased exposure to external influences may also have increased insecurity of tenure due to an increase in informality, a rise in competitive pressures in formal manufacturing sector jobs and, possibly, an increase in GDP growth volatility. But it is not clear whether these are permanent changes or temporary adjustments during the transition from a closed to an open economy.

Figure 12: Trade Openness and Labor Market Flexibility are Complements



Macroeconomic Adjustment and Labor Policy Go In Tandem

55. Greater openness appears to leave the functioning of the labor market relatively unchanged, but demands greater employment flexibility. Opening the economy to external competition exposes differences between the traded and non-traded goods sectors. Generally, this implies first a reduction in (unskilled) employment in tradable goods sectors, and then an increase in demand for (skilled) workers as these industries begin to compete. Since the degree of informality varies between the traded and nontraded sectors, there will also be a shift in the formal-informal "fault-line". The evidence indicates that only the first change has taken place so far—Figure 13 hints at the decrease in the share of formal (tradable sector) employment relative to the non-tradable sector. But if the labor market is integrated or were made more so, flows between the sectors would bridge this rift. Accordingly, labor policy priorities during trade reform are to reduce the burden of severance payments on firms, strengthen income support programs in the formal sector, and extend coverage of social protection programs to the informal sector.

56. Stabilization, on the other hand, changes the functioning of the labor market because—unless accompanied by labor reform—it reduces real wage flexibility. As discussed above, this exposes the difference between sectors where downward wage adjustments are not permitted (e.g., the formal sector) and where these adjustments are commonplace (e.g., among the self-employed and in family firms) Accordingly, labor policies should aim to reduce these differences through measures that can broadly be classified as "deregulation": liberalize unionization rules, eliminate legislation that restricts downward wage adjustments, and reassess minimum wage setting mechanisms.

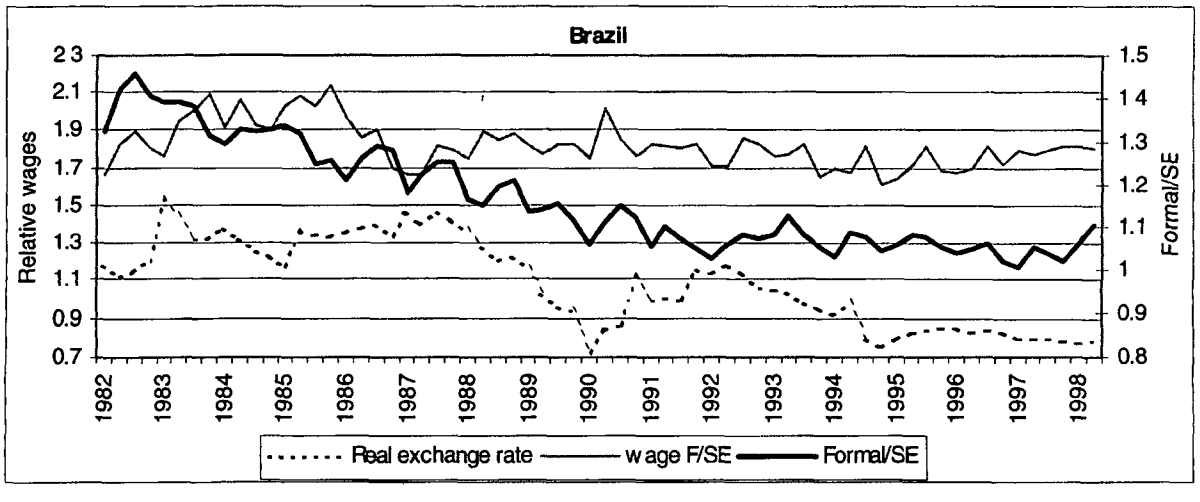
57. Fiscal adjustment highlights the divide between the taxed and untaxed sector. Labor taxes form a significant part of the tax revenues (about 8 percent of GDP, or almost 30 percent of tax revenues—see OECD 2001), and social security programs form a large part of government expenditures (about a third of current non-interest spending, and responsible for about a quarter of accumulated debt—see World Bank, 2001). Labor reform priorities during a period of fiscal adjustment can be classified as "formalization": reform of payroll tax funded programs combined with increased enforcement of labor laws and, perhaps, temporary micro-credit programs for small firms, given the high interest rates at this stage of adjustment.

Budget Surpluses (Average 1995-2000)

Country	%
Brazil	-6.3
Argentina	-1.9
Chile	1.0
Colombia	-4.7
Mexico	-0.9
Spain	-3.2
Portugal	-2.8
Italy	-3.8
Germany	-2.0
Netherlands	-0.9
UK	-0.8
USA	-0.8
Korea	-0.4
Thailand	-

Source: IMF (2002) and World Bank database

Figure 13: Real Exchange Rates and Labor Market Segmentation in Brazil



58. The analysis done for this report indicates that labor reform has become more pressing since the 1990s. The analysis also provides guidelines to determine labor policy priorities at each stage of macroeconomic adjustment, since it is possible to determine the specific labor policy reforms needed to complement each of the stages of macroeconomic adjustment by tracing the effects of macroeconomic changes in the labor market (see Table 3). Labor policy has, however, has not been high on the reform agenda of the Cardoso government. Because it has been through three structural macroeconomic reforms but has not made any progress in labor policy, one could say that Brazil today faces a large "backlog" of labor policy reform.

59. But while policy reform in trade or monetary policy in a vigorous democracy such as Brazil is difficult, it is even harder to undertake durable reform of policy in contentious areas such as labor markets. Despite this reform backlog, therefore, it would be unwise to expect Brazil to change its labor policies in a hurry or all at once. Fortunately, it appears that this rushed, all-or-nothing approach is not necessary. This report proposes that even a piecemeal approach to labor reform—if reasonably well thought-out—can be effective in improving outcomes.

Table 3: Labor Policy Priorities in Different Macroeconomic Scenarios

Macroeconomic Policy	**Trade Liberalization**	**Price Stabilization**	**Fiscal Adjustment**
Macroeconomic changes	Exchange rate closer to market and reduced tariffs and quotas	Lower money supply growth and expected inflation	Lower government spending or higher tax revenues
Interest rate effects	Ambiguous effects	lower real interest rates	Falling interest rates as government borrowing requirement falls and repayment credibility rises
Wage effects	Indirect: Wages will reflect labor intensity of new product mix	Direct: Real wage flexibility declines as inflation falls	Indirect: Cost of labor rises relative to capital
Employment effects	Direct: Reduced employment in noncompetitive sectors	Indirect: Employment falls in sectors with rigid real wages	Direct: Reduced public employment as government expenditure falls
Relevant informal sector feature	Production of non-tradeables	Downward wage flexibility	Evasion of taxes on income and labor
Emphasis of Labor Policy	Compensatory (subsidies)	Cost (wage costs)	Compliance (non-wage costs)
Labor Policy Priorities	**Lower severance costs, strengthen income support programs**	**Collective bargaining reform; eliminate wage adjustment rules; assess minimum wage setting**	**Payroll tax reform; social security reform, improve enforcement of labor regulations**

4. Quantity and Quality of Labor Supply

60. Just as demand for labor changes over time, so do offered labor services. Two facets of the Brazilian labor supply are especially noteworthy. The first is a rise in female labor force participation, which increases specialization of labor and thereby improves labor market outcomes. The second is low attainment of education, which leads to low employability and impedes productivity improvements. This chapter explores the interactions between labor quantity and quality in Brazil. It also tries to answer the question: Do changes in labor supply require a change in the way the labor market is regulated?

A Diversified Labor Supply Requires a Spacious Labor Market

61. It would not be an exaggeration to characterize the existing labor code as being designed for a labor force consisting of full-time employed (male) household heads who work under a formal contract eight hours a day in a manufacturing firm. However, the labor force continuously grows more diverse in terms of working hours, job-status, gender and sector of employment.

62. In Brazil, women have increasingly entered the job market. In 1976, less than four out of ten women in the working age earned a salary. Currently, the labor force participation exceeds 59 percent (see Figure 14a). This compares to 86 percent for men. The large increase in female LFP has primarily occurred outside of the metropolitan areas, where LFP decreased substantially in the last decade, see chapter 2. As in other countries, Brazilian women often search for more flexible, less career-oriented, part-time jobs in the service sector that allow them to take care of household responsibilities (**Volume II, Chapter 3** and Figure 14b). These changes are important for economic development, since they increase family earnings and national production.

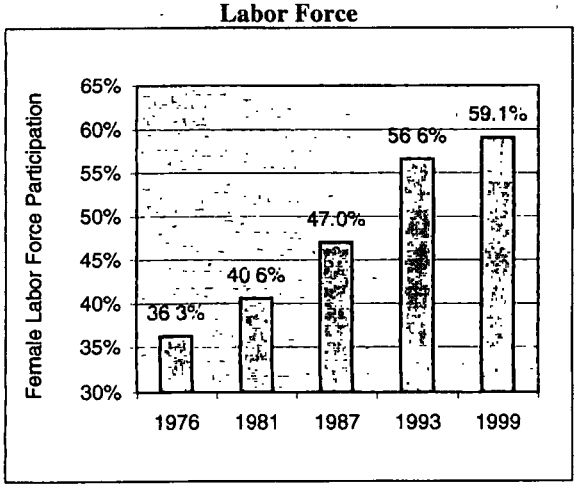
63. As job-relations becomes increasingly diverse, the need for labor market regulations to follow suit and become more flexible increases. As will be argued in chapter 6, the existing regulations are designed for a narrow spectrum of workers and often push other workers into informality, where it is difficult to design interventions to help increase income security. The need for a more spacious labor market grows ever stronger.

Female Share of the Labor Force, 1999*

Country	%
Brazil**	35.5
Argentina	33.2
Chile	33.6
Colombia	38.7
Mexico	33.2
Spain	37.2
Portugal	44.0
Italy	38.5
Germany	42.3
Netherlands	40.6
UK	44.1
USA	46.0
Korea	41.4
Thailand	46.3

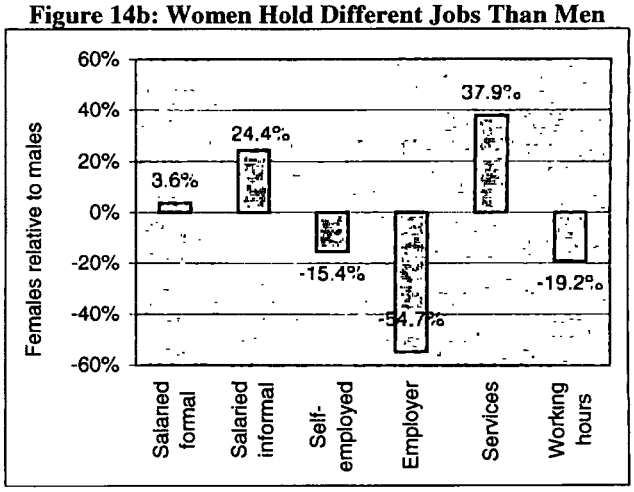
Source: ILO
* or latest
** In the national household survey, PNAD, from 1999, the female share of the workforce reaches 40.7 percent.

Figure 14a: Women Have Increasingly Entered the Labor Force



Source: PNAD from IBGE various years

Figure 14b: Women Hold Different Jobs Than Men



Source: PNAD 1999 from IBGE

Strong Labor Market Signals: Quality of Labor Supply Matters

64. The human capital aspects of Brazil's labor supply remain underdeveloped and fragile. According to Barro and Lee (2001), the average Brazilian has completed less than five years of schooling. The low education level of workers places an effective upper limit on labor market outcomes. In Brazil, graduates from higher education are 20 percent more likely to participate in the labor market than workers with elementary schooling only. They are also 38 percent less prone to experience unemployment and in such an event, six times faster in finding a new job (Volume II, Chapter 9). Moreover, it is a well-known fact that productivity and innovation crucially depend on availability of educated people (for the case of Brazil see Arbache and Sarquis, 2001). Does the Brazilian labor market function in such a way that these and a long list of other important social benefits from education are not transferred to the individual workers and therefore to blame for the inadequate human capital level?

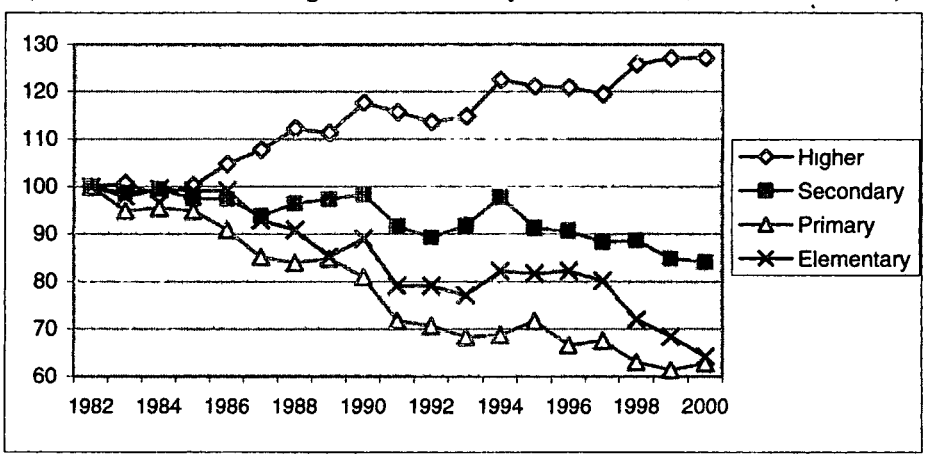
Schooling Level, 2000
(population above 25 years)

Country	Years of schooling
Brazil	4.6
Argentina	8.5
Chile	7.9
Colombia	5.0
Mexico	6.7
Spain	7.3
Portugal	-
Italy	7.0
Germany	9.8
Netherlands	9.2
UK	9.4
USA	12.3
Korea	10.5
Thailand	6.1

Source: Barro and Lee (2001)

65. The answer to this question is unambiguously 'no'. Brazil's labor market strongly signals the high and rising value of education: the private return to an additional year of education has risen to about 12 percent and the demand for advanced skills has risen by about 30 percent since 1982 (see Figure 15). What is interesting, however, is that the ratio of wages of workers with some college has risen relative to those with secondary school education much less in Brazil since 1990 than in countries such as Mexico and Colombia (see Figure 16, from Sanchez-Paramo and Schady, 2002). This is despite a fall in the relative supply of workers with tertiary education. These trends emerging from the job market are hardly subtle, and suggest that the reason for under-investment in education lies outside of the labor market—Brazil's inability to engender rapid technological progress, and its inability to increase the supply of more educated workers. Upgrading the quality of labor supply through educational reform is an integral strategy for improving the main labor market outcomes—employment, productivity and income security.

Figure 15: Higher Education, Higher Wages
(Private returns to schooling in Urban Brazil by education level, indexed 1982=100)



Source: Blom, Holm-Nielsen and Verner (2001) based on PME-data

A Closing "Window of Opportunity" for Labor Quality

66. Income inequality is notoriously high in Brazil. As the following chapters will show, the labor market institutions, regulations and interventions reinforce rather than diminish the existing disparities. So improvements in labor policies will help to reduce income inequality. Nevertheless, as Paes de Barros *et. al.* (2001) argue, the inequalities generated by labor market functioning are far exceeded by the unequal distribution of education and other assets in the population.

67. The benefits of education are so far-reaching that—as this report later argues—it can even negate the adverse effects of some labor policies that are not suited for Brazil. Minimum mandated non-wage benefits are more binding for unskilled workers. As workers become more skilled and productive, these laws become less distortionary. The problem of course is that it takes a long time to raise education levels in the work-force (see Box 6).

68. Besides, education is not the only instrument for increasing the skills of workers—on-the-job training is another. There are good reasons to believe that labor laws in Brazil do not encourage investments in training, and the functioning of the system of tax-financed but ostensibly employer-led training in Brazil is a subject of some debate. Brazil pioneered what is now known as 'S' system of in-service training—for example SENAI, SENAR, and SENAC, the network of training institutions administered by employer confederations for industry, agriculture, and commerce respectively. An assessment of this system was outside the scope of this report. But it is now well-established that while employers often make claims that appear to indicate substitutability between education and in-service training, they in fact treat education and training as complements—study after study has shown that more educated workers receive more firm-sponsored in-service training.

69. Good education policies should be seen as a complement to good labor market and training policies, not a substitute.

Share of young population (less than 15), 2000	
Country	**%**
Brazil	28.8
Argentina	27.7
Chile	28.3
Colombia	32.9
Mexico	33.2
Spain	14.6
Portugal	17.0
Italy	14.3
Germany	15.5
Netherlands	18.3
UK	18.8
USA	21.5
Korea	21.5
Thailand	25.2

Source: ILO

Box 6: Earnings Inequality, Education Inequality and Cohort Size

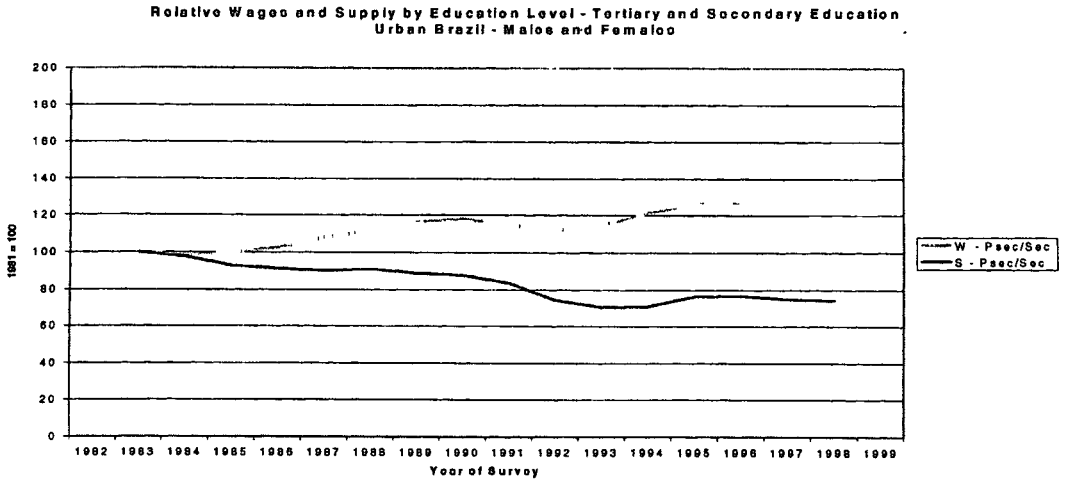
A recent World Bank report on inequality in Brazil shows that reductions in inequality through improved distribution of education occur via the entry of cohorts of school graduates into the labor force because younger generations have less unequal distributions of education. But because of a decrease in population growth over time, younger cohorts are smaller. The improvement on overall inequality thus depends upon two factors, the size of the entering generation (*quantity*), and this generation's equality of schooling (*quality*).

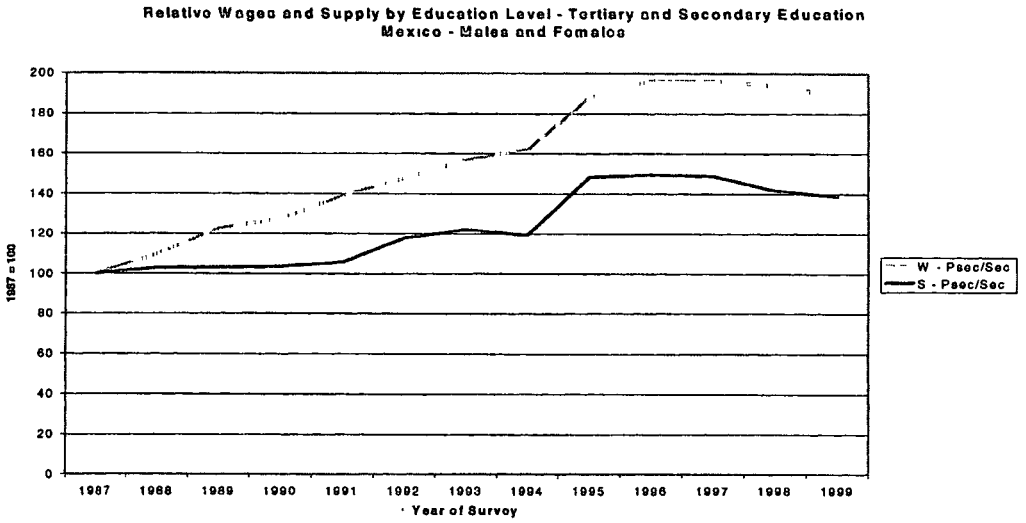
This is both good news and bad news. The good news is that (basic) schooling has become increasingly egalitarian during the Cardoso years. The bad news is that current and future generations of school-leavers count less as a share of the workforce, because of decelerating population growth. The reduction in disparities will therefore take longer time to occur. At best, reduced inequality of schooling will take two decades to noticeably affect the existing income gap between the rich and poor.

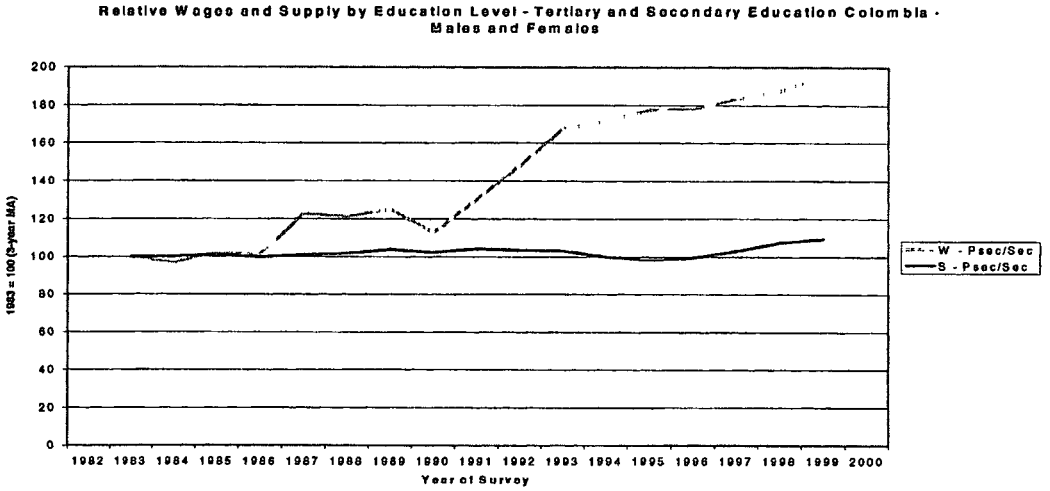
However, the window of opportunity is fast closing. Demographic patterns indicate that the diminution of successive cohorts of labor market entrants will accelerate over time. The longer time it takes the education system to provide every Brazilian child with equal schooling opportunity, the smaller will the benefiting generations be, and the more sand will run into the hourglass before Brazil's income inequality is reduced to socially sustainable levels.

Source: Brazil Inequality Report, World Bank (2002)

Figure 16: The Rise in Wage Premiums to More Educated Workers Has Been Muted in Brazil Compared with Other Latin American Countries Such as Mexico and Colombia
(Dark line is supply of college educated workers relative to secondary educated workers, light line is relative wages)







5. How Brazil's Labor Market Functions

70. This chapter discusses the main features of Brazil's labor market (informality, turnover, and litigation), relates them to outcomes, and flags the policies that may require reform in order to improve functioning and outcomes.

Salient Features of the Brazilian Labor Market

71. Several developments in labor market indicators deserve notice. The first is that the sectoral composition of labor has changed radically over time. Most countries have seen a shift in employment first towards industry from agriculture and then towards services, and Brazil is no exception. As Figure 17 shows, employment in services has been considerably greater than in industry since the 1960s, and has exceeded agricultural employment since the 1980s. Today, it exceeds employment in industry and agriculture combined. And it appears that this trend will continue (see sidebar). The second, related, change is that the share of the urban labor force has risen. The third change is that unionization rates have fallen, especially during the last two decades.

Share of Services in Total Employment, 2000*

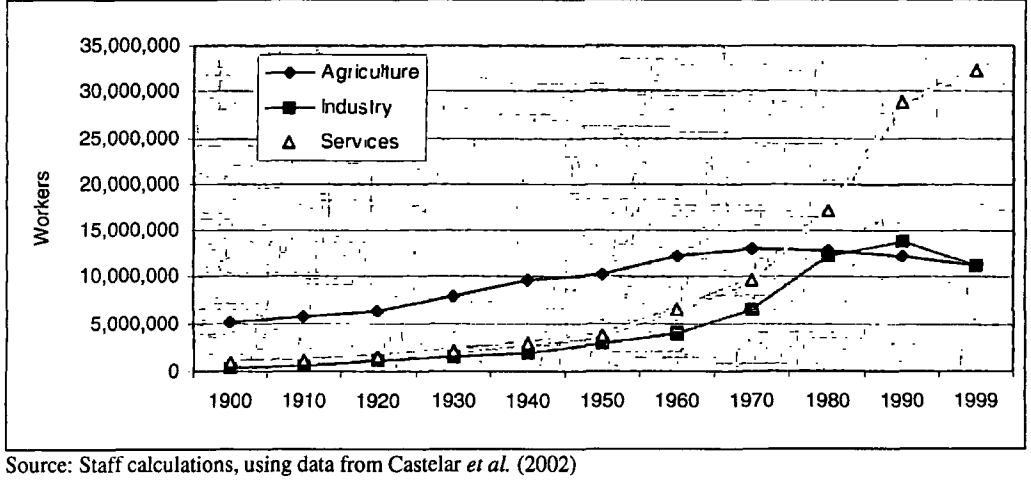
Country	%
Brazil	56.5
Argentina	74.0
Chile	60.0
Colombia	74.5
Mexico	53.4
Spain	61.9
Portugal	52.2
Italy	62.2
Germany	62.6
Netherlands	72.8
UK	72.8
USA	74.5
Korea	61.1
Thailand	33.1

Source. ILO
* or latest

72. These developments are not unique to Brazil. But labor market functioning in Brazil is somewhat unique. The likely reason is that countries differ in their institutions, and the regulations and interventions that result because of these institutional differences. Regulatory reform in Brazil has not kept pace with changes in the nature of work. The following example is revealing of the slowness with which regulations have adapted to these changes. In 1998, pressured by farmers, the government introduced a special contract in agriculture where the harvests can be labor-intensive but planting and growing are not—the *contrato de safra*—which allows farmers to hire workers at terms different from those in the CLT. This is the only sector where the law government recognizes by law that the standard contract do not suit work conditions in every part of the economy.

73. By the logic of the *contrato de safra*, a new "standard contract" should be formulated to regulate service sector work as well. Of course, given the heterogeneity of service sector employment, this is close to impossible. In the meantime, the "standard contract" in services is the one arrived at informally. Even in industry, it appears that more and more workers and employers are finding the standard legal contract unreasonably restrictive.

Figure 17: More than Half of All Jobs Are Now in Services
(Employment by Sector 19o0-1999)



Source: Staff calculations, using data from Castelar *et al.* (2002)

Is Labor Turnover in Brazil Too High?

74. Labor turnover is an integral part of the labor market. Lifetime employment is now rare, since workers' skills and firms' labor demand change during the 40-odd years that a worker typically participates in the labor market. Job turnover arises due to job-separation and job-creation, which is part of the creative destruction of a well-functioning market economy that constantly seeks to match available skills with demand and thereby increase productivity.

Job Tenure in Manufacturing, late 1990s* (Years with same employer)

Country	Years
Brazil	6.3
Argentina	8.9
Chile	-
Colombia	-
Mexico	-
Spain	10.9
Portugal	10.4
Italy	11.2
Germany	10.8
Netherlands	10.3
UK	9.0
USA	9.2
Korea	-
Thailand	-

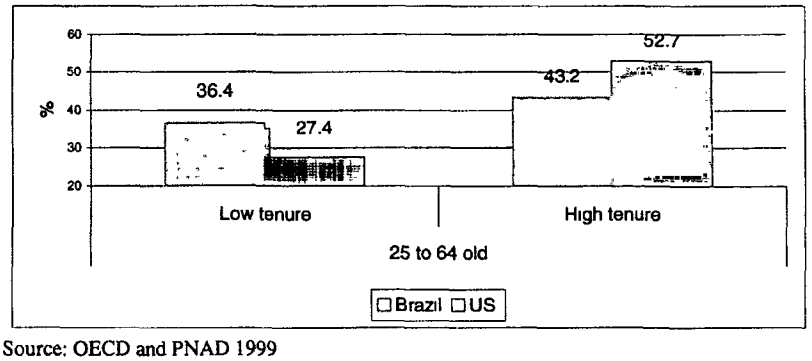
Source: Maloney (1998) based on OECD and CEPAL
* or latest.

75. Nevertheless, job-separation entails a cost for employers and employees. Job-specific knowledge and skills that an employee acquires during employment are lost by job-separation, which can lead to lower productivity and wages. Furthermore, if employers expect high turnover, this reduces the incentive for the employer to invest in the skills of the individual worker (Ramos and Carneiro, 2002). Second, frequent job-loss may also increase income insecurity. This aspect of high job turnover is perhaps best accommodated through well-designed social security programs. The starting point, though, should be to determine whether government policies and programs are inadvertently subsidizing or encouraging turnover.

76. While the ideal rate of labor turnover for welfare is unknown due to both positive and negative welfare implications, it is desirable that labor market regulations are neutral in the sense that they avoid distorting the behavior of workers and employers. Labor turnover in Brazil does seem to be unusually high. One out of three workers changes jobs every year. Moreover, labor turnover has increased by 60 percent from the recession in 1992 to 2001. A comparison with international statistics confirms this "hyperactivity" in the functioning of the Brazilian labor market. The question this report attempts to answer is whether turnover in Brazil is made artificially high by labor market functioning. Paradoxically, in most other countries the question is usually the opposite, since labor regulations that make dismissals costly for employers are generally believed to "freeze the market" or lead to artificially *low* turnover.

77. Many reasons may be behind this pattern, such as a younger population. But as Figure 18 shows, the proportion of the Brazilian labor force with low tenure for the 25-65 year-old workforce is markedly below even that found in the US, the most active labor market among developed countries. The tendency of Brazilian workers to frequently change employers—confirmed by many studies, e.g., Paes de Barros *et al.*(1999) and Maloney (1998)—indicates that a Brazil-specific institution or regulation increases turnover. As will be further developed in Chapter 7, the design of the severance fund, the FGTS, seems indeed to subsidize labor market turnover and thus lead to a hyperactive labor market partially explaining Brazil's poor performance in labor productivity.

Figure 18: Job Tenure in Brazil and the US



Source: OECD and PNAD 1999

Is Labor Litigation in Brazil Extraordinarily Frequent?

78. In Brazil many job separations result in disputes between the employer and the employee, and end up in court with the workers claiming that their rights as listed in the CLT were not honored. The system of labor courts, a special branch of government called the *Justiça do Trabalho*, is charged with conciliation, arbitration and judgment. Scholars debate whether labor courts also have the power to make labor policy (*poder normativo*) instead of simply interpreting the law, and whether the court strictly upholds precedence. The fee paid to the court is low, but is always borne by the employer. Employers bear the burden of providing proof that the standard contract was honored. The system works as follows: after a worker files a lawsuit, the case goes to conciliation. If not settled, the case goes to the judge. The average length of time to reach a decision is 31 months (Castelar *et al.*, 2000, and **Volume II, Chapter 6**). Parties to the lawsuit can appeal the verdict twice, and many do (see Figure 19).

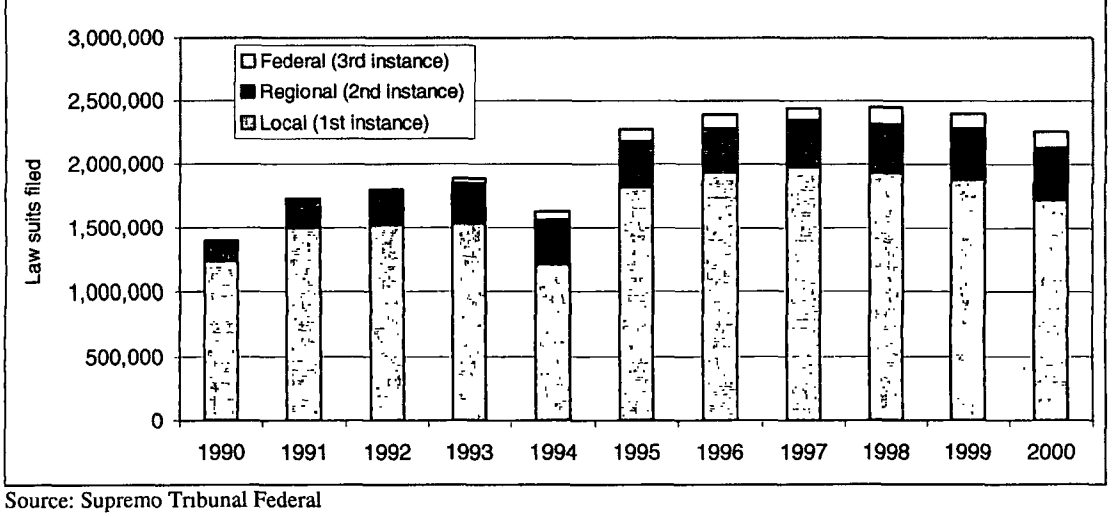
79. Labor courts exist in most countries, but nowhere does the labor justice play as prominent a role as in Brazil. Every year, about 2 million lawsuits are filed against current or former employers by workers. That is, more than six percent of all salaried workers go to court every year (Figure 19). Four out of five court cases that companies are involved in are labor-related. Workers have resorted to legal action with increasing frequency: lawsuits have increased by 60 percent over the last decade. These figures are high even when compared with countries thought to be overly litigious, such as the US.

80. Given the high incidence of labor litigation, it is of no surprise that the labor justice significantly influences the outcomes of the labor market. The courts impose both direct and indirect costs to the users. The direct costs of the extraordinarily frequent litigation are fees payable to the state and the lawyers, which are shouldered by the firms. These costs are non-negligible. However, the indirect costs through changed behavior are far greater and fall upon both employees and employers. The frequent litigation implies that the costs of labor in terms of future pay, fines, and costs of lawyers is uncertain to the employer at the time of employment. The real price of labor is only known five years after job-separation—after which the justice system no longer accepts claims. Faced with this uncertainty, employers react rationally and are cautious in hiring new workers, increasing screening efforts and raising costs of hiring as well. While there is no systematic evidence, it is likely that this has reduced employment (**Volume II, Chapter 10**).

Labor-Employer Relations are (1=generally confrontational, 7=generally cooperative)	
Country	**%**
Brazil	4.3
Argentina	4.3
Chile	4.6
Colombia	4.4
Mexico	4.5
Spain	4.6
Portugal	4.5
Italy	4.4
Germany	5.3
Netherlands	6.1
UK	5.4
USA	5.0
Korea	3.5
Thailand	4.8

Source: Global Competitiveness Report (Employer survey) by Harvard University and WEF (2001)

Figure 19: A Busy Labor Justice System



Source: Supremo Tribunal Federal

Is Informality in Brazil Unusually Elevated?

81. A large fraction of the Brazilian labor force works outside of the formal labor market, where mandated benefits in the CLT such as the 13th salary, paid vacations and overtime bonuses are not necessarily honored, and nor are social security dues paid on behalf of the worker. This is where most jobs have been created during the last decade, adding to the large army of informal workers.

82. Traditionally, informality has been viewed as an inferior, low productive option, where workers only accepted employment if there were no jobs in the formal sector. Recent research contests this view, suggesting that some informal workers may deliberately choose to be in the unregulated sector because it offers greater independence, for example, in term of working hours. Surveys of informal workers in Brazil and other Latin American countries show that both the traditional, dualistic view and this opposing view are right. What is wrong is to think of informal workers as a homogeneous lot. Supporting this view, roughly four out of every five ***self-employed*** Brazilians prefer an informal job to one in the formal sector. But the traditional view is not without merit: informal ***wage workers*** appear to be rationed out of regulated employment, and would—if they had the opportunity—rather work in the formal sector. (**Volume II, Chapter 3** of this report).

Informal Salaried as Share of Total Employment, 2000* (metropolitan areas)

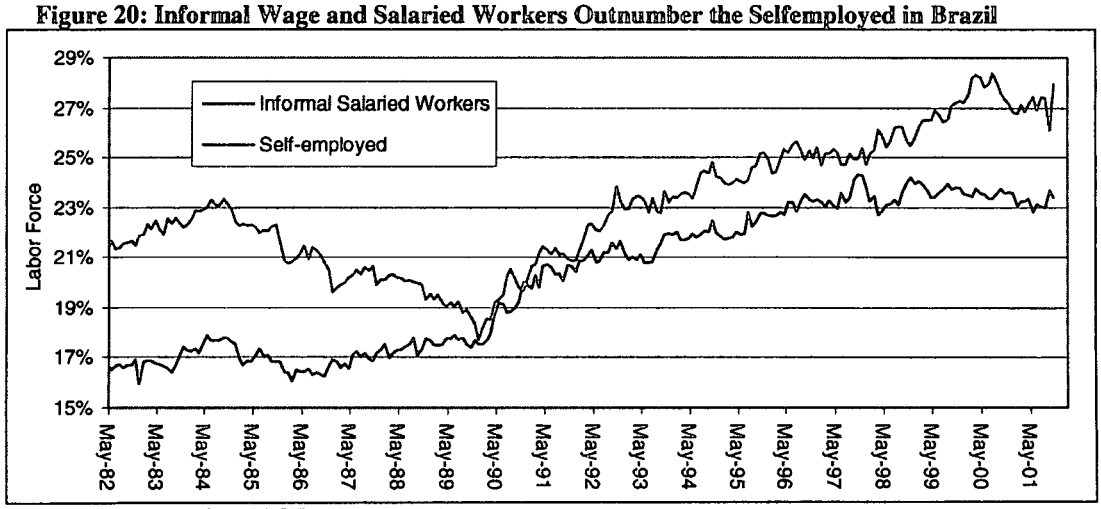
Country	%
Brazil	27.5
Argentina	15.0
Chile	13.4
Colombia	-
Mexico	13.8
Spain	-
Portugal	-
Italy	-
Germany	-
Korea	-
Thailand	-

Source: ILO
* or latest.

83. Being an informal worker always has one major drawback: little or no access to income support programs such as *abono salarial* and unemployment insurance. Informal workers hence face higher income insecurity (**Volume II, Chapter 8** of this report). This excessive insecurity is a prominent feature of the Brazilian labor market, and implies lower welfare levels for workers.

84. More than half of the labor force works outside the regulated sector, with the informal salaried at 28 percent of the labor force and the self-employed at 23 percent (Figure 20). Both types of informality increased noticeably through the 1990s from a low of 17 percent each in 1990 to the current levels. Today, while the share of self-employment in Brazil is normal when compared with countries at similar income levels (see **Volume II, Chapter 3**), the share of informal salaried is double that found elsewhere in Latin America. The extraordinarily large share of informal wage and salaried workers suggests that the regulations are either undesirable for a large and growing fraction of the workforce have significantly reduced the demand for formal contracts (Carneiro, 1997).

Figure 20: Informal Wage and Salaried Workers Outnumber the Selfemployed in Brazil



Source: PME-data from IBGE

6. Pricing Labor Correctly

85. The CLT and the Constitution are clear on what constitutes an acceptable employment contract. When employers sign the working card (*carteira de trabalho*), they are seen by the Ministry of Labor as accepting a "standard contract". Under this contract, employers must pay at least the legal minimum wage; they must give a mandatory Christmas bonus, a month of paid vacations, an allowance for the education of children, and so on; and they must contribute to a worker's severance account and the national social security system. Workers may negotiate "nonstandard" contracts through individual or collective bargaining, but the law stipulates that these contracts must be at least as generous *in every single dimension* as the standard contract. This chapter provides some evidence that these regulations may well be hurting the least productive workers in terms of job opportunities and income security, and provides a graded set of recommendations to improve outcomes.

Tax-Wedge
Total Cost of Contracting a Worker: Percentage above Salary)

Country	%
Brazil	66
Argentina	-
Chile	-
Colombia	-
Mexico	14
Spain	52
Portugal	38
Italy	68
Germany	66
Netherlands	60
UK	26
USA	33
Korea	18
Thailand	-

Source: OECD (2001) "Taxing Wages" and Volume II of this report.
Note. Calculation for OECD countries based on a married couple with two children and two earners.

Mandated Minimum Wage and Non-Wage Benefits

86. The main wage-related mandates on employers for individual contracts are minimum wage laws (*salário mínimo*), compulsory payment of a thirteenth salary (*décimo terceiro salário*) to all workers at the end of the year, payment of a family/education allowance (*salário família*), contribution to workers' training (*salário educação*); other laws forbid reductions in nominal wages, and mandate higher wages for overtime and night-time work. For collectively bargained contracts, employers must pay at least what is mandated in the individual labor code; another law forbids new contracts from reducing wage and benefit levels agreed to in the previous collective contract. Because these benefits are constitutionally guaranteed, they cannot be waived even by mutual consent. Nor can they be bargained away by labor unions. For a typical contract, these benefits amount to about 35 percent of the basic salary (see Table 4).

87. The main non-wage mandates are paid vacations, contributions to the *FGTS* severance fund accounts (for most employees, other than, e.g., household workers), and employer contributions to the national social security system. For the typical worker, these cost the employer another 35 percent of the basic salary. In case of firing, workers always get a month's notice and often are paid a fine of 50 percent of the FGTS account balance (discussed more in Chapter 7). All of these mandates add up to between 70 and 90 percent of the basic salary.

Table 4: Mandates Raise the Cost of Hiring Workers by 65 Percent

Component	*Percent*	*Total*
Basic Wage		100.0
Annual Bonus (*décimo terceiro salário*)	8.3	108.3
Paid vacations	11.3	119.6
Severance Fund (FGTS)	8.5	128.1
Other mandatory benefits	10.0	138.1
Social Security Contributions (INSS)	20.0	158.1
Other Contributions (Work Injury etc.)	4.7	162.8
Employer associations (In-service Training etc.)	3.1	165.9

Source: Volume II, Chapter 6.

Mandates Price Low Wage Workers out of Formality

88. This calculation assumes that the worker's productivity warrants a wage greater than or equal to the minimum wage. If the worker's productivity is valued at less than the minimum salary, these mandated benefits add more than 80 percent to the basic salary. For example, for workers with productivity levels 20 percent below the legal minimum wage, these mandates would add 125 percent of the workers productivity. Similarly, for an employee with a productivity level that warrants a salary 33 percent less than the minimum wage, these mandates would amount to 170 percent of the basic salary. The lower the productivity level of the worker, the more onerous is the burden of the legislation on the employer. Under these circumstances, it would not be surprising to see low productivity workers being pushed into informality. And the data seem to provide support: Figure 21 shows that, in fact, more than a third of the informal workers in Brazil earn less than the legal minimum wage. While this is not the only reason for informality (e.g., self-employment may be a desirable option for many skilled workers), it is a plausible explanation for the high informality among wage and salaried workers.

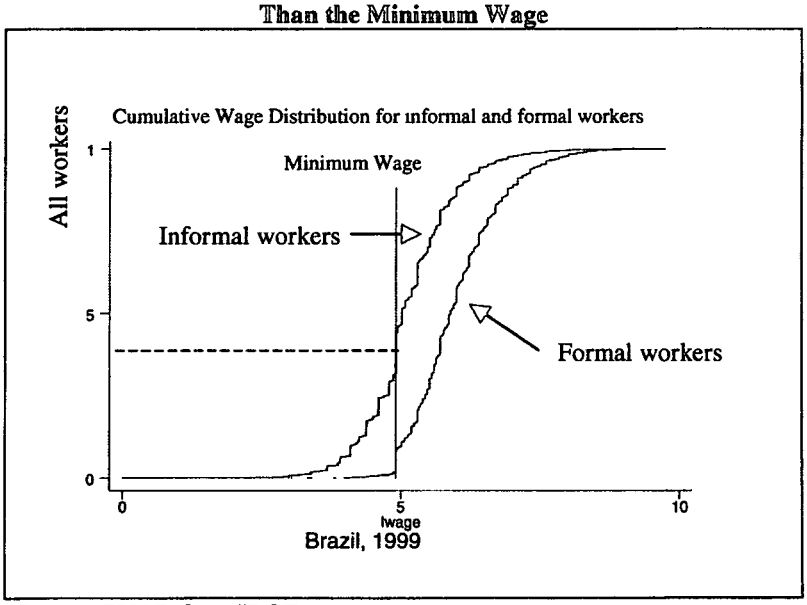
Social Security Contributions as Share of Payroll, 1997*

Country	%
Brazil	25
Argentina	35
Chile	21
Colombia	27
Mexico	22
Spain	29
Portugal	28
Italy	34
Germany	34
Netherlands	37
UK	17
USA	14
Korea	13
Thailand	-

Source: OECD and Packard (2001).
* or latest.

89. For relatively high productivity workers, minimum wage legislation is not binding. So employers can adjust the wage level so that the overall amount (wage plus non-wage benefits) is appropriate. But there are some mandates that imply a cost for the employer, but are valued at less than this cost by the employee. Social security contributions are the most important in this regard, and there may be others (such as the contributions to SENAI/SENAC, FAT, PIS/PASEP contributions, and so on). This is another plausible reason for informality, and it is likely that the recent social security reform—which tightens the link between contributions and benefits—will improve matters. But it will remain an important factor contributing to informality since the total (employer plus employee) social security contributions add up to a sizeable 30 percent of wages. International experience suggests that contribution rates above 15 percent are associated with noticeably higher rates of evasion.

Figure 21: More than a third of all Informal Workers Earn Less Than the Minimum Wage



Source: PNAD from IBGE

Regionalizing Minimum Wages May Reduce the Problem

90. The first legal minimum wage was established in 1940. Originally, there were 14 different regional minimum wages, and by 1963, this rose to 39 levels. In the 1970s and early 1980s, Brazil had an activist wage policy, and the minimum wage was used to guide adjustments in wages. (**Volume II, Chapter 7**). In 1984, the minimum wage level was standardized nationwide, at the (higher) levels prevailing in the south and southeast. In 1987, the role of the minimum wage as a benchmark for the determination of other wages was officially revoked in order to give minimum wage policy a poverty-reducing focus. But the practice has continued informally, and there is some evidence—nicknamed the "lighthouse effect"—that minimum wage adjustments still influence other wages. And in 1988, a (largely non-contributory) pensions program that uses the minimum wage as a benchmark was also instituted.

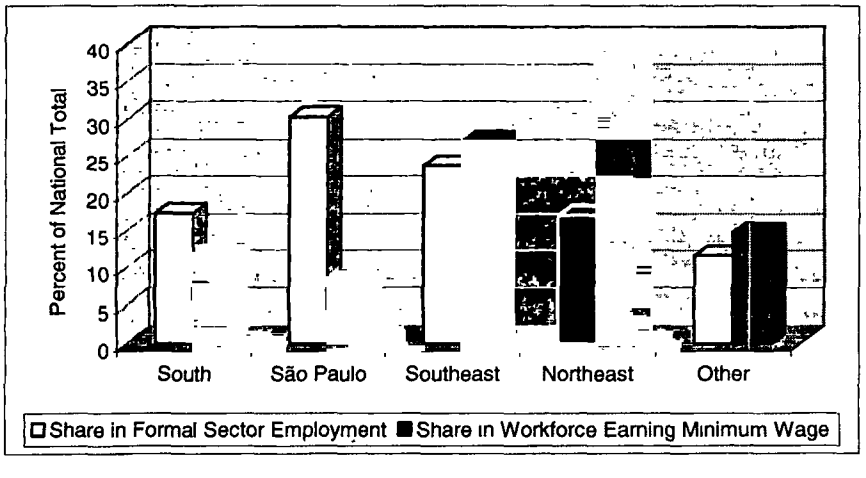
Ratio of Minimum Wage to Average Wage	
Country	%
Brazil	24
Argentina	27
Chile	32
Colombia	40
Mexico	32
Spain	35
Portugal	47
Italy	73
Germany	57
Netherlands	58
UK	40
USA	38
Korea	-
Thailand	-

Source: Maloney and Nuñez(2001)

91. The debate on minimum wages in Brazil has revolved around the question of its effectiveness as a poverty-reducing policy. Three chapters in Volume II of this report aim to shed light on this issue. In general, the international evidence is not conclusive: there are few if any examples of effective use of minimum wage policy as a poverty-reducing policy (**Volume II, Chapter 8**). Principally, this is because of the employment-reducing (especially in developed countries) and informality-causing (especially in developing countries) effects of minimum wage increases. Brazil's own experience is consistent with that of other countries (**Volume II, Chapters 7 and 10**).

92. Since 2001, minimum wage policy has reverted to the principle of having different values for each region, with a federally set minimum. This is a welcome change, because minimum wages reasonable in the South and Southeast are too high for the poorer Northeast (see Figure 22). But the effectiveness of regional minimum wages in bringing poorer workers into formality depends on keeping the federal minimum low. The real minimum wage increased from R$120 to R$180 between 1995 and 2001 (in November 2001 prices). The impact of this on the deficit in Old Age Pensions has been a help in face of populist pressures to raise the level even more—each R$1 increase in the minimum wage increases the social security expenditure by about R$160 million (**Volume II, Chapter 7**), so the R$60 increase has cost the government almost R$10 billion. Given the "natural restraint" built into this linkage, and the effectiveness of the pension program in lowering old age poverty, this report does not recommend de-linking the minimum pension benefit from the minimum wage.

Figure 22: Minimum Wages are More Binding in the Poorer Northeast



Allowing Unions to Negotiate the Mandated Minimum May Help

93. The most serious of the proposals to make labor markets more flexible in Brazil is the recent initiative to allow collective bargaining agreements to supersede the labor code. Very simply put, the proposal would allow unions to negotiate wage and employment conditions "from scratch", i.e., unconstrained by the individual labor code or by their own previous agreements. The aim of this proposal is to make contracts reflect enterprise-specific conditions rather than straitjacketing every firm and worker to conform to the mandated minimum.

Union Density, 1995*	
Country	**%**
Brazil	17
Argentina	25
Chile	16
Colombia	7
Mexico	31
Spain	19
Portugal	-
Italy	39
Germany	29
Netherlands	26
UK	34
USA	16
Korea	-
Thailand	-

Source: OECD
* or latest.

94. This discussion is a useful one, but there are two caveats. The first is that this would only help if collective bargaining laws are changed. Under the CLT as originally formulated, unions were to be responsible for harmonizing relations between labor and capital, and to help in implementing the government's economic policies (for a detailed account of the evolution of collective bargaining in Brazil, see **Volume II, Chapter 4**). These principles implied close links with government, but weakened union links with workers and firms. Labor unions were organized by occupation, but employer federations by economic sector. In 1988, some restrictions on union formation were lifted, but the law continues to give unions monopoly power: only one union in a municipality is recognized as legal for an occupation, and every worker pays a mandatory union fee more than half of which is transferred to these unions whether or not the worker is a member of the union. These regulations imply that unions have less incentive to represent labor's economic interests through mutually beneficial bargaining with employers. So the proposal to allow collective agreements to supersede the individual labor code would make the labor market more efficient only if the monopoly power of unions (*unicidade sindical*) is revoked and if payment of unions dues is made voluntary.

95. The second caveat may be even more troublesome. While the experience with minimum wage regulations in Brazil is similar to that in other countries, Brazil's collective bargaining institutions are unique in some key features (**Volume II, Chapters 4 and 5**). About 17 percent of the workforce is unionized, down from 22 percent in 1986—both the level and trend is not unusual for developing countries. Unlike other countries, however, union members in Brazil are both more educated and otherwise skilled: while 47 percent of union workers have at least a secondary degree, this ratio is just 27 percent for non-union workers, and unionization rates among managers (30 percent) and professionals (42 percent) are higher than for other occupations—see Figure 23. In terms of its economic effects, unionization raises earnings by about 10-15 percent in Brazil, again not unusual given international experience,

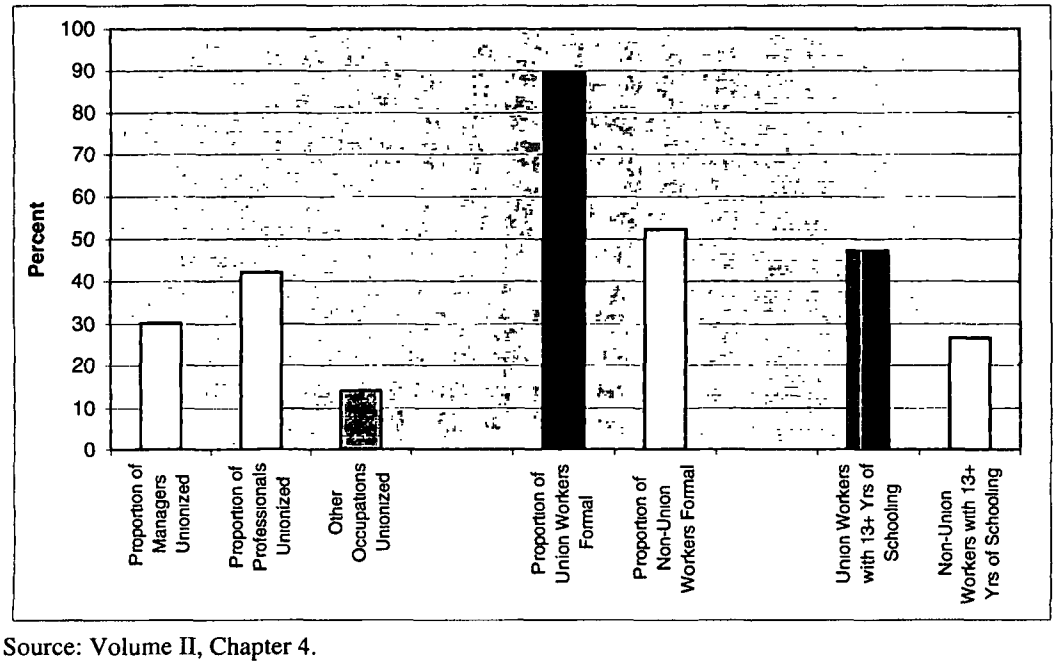
but inconsistent with Brazil's own law that automatically extends collectively bargained contracts to non-union workers. Unlike other countries, wage dispersion in Brazil's unionized workforce is greater than among the non-unionized.

96. These results suggest that at least in the foreseeable future, unions in Brazil cannot be expected to represent the interests of low productivity workers, precisely those for whom the individual labor code is most binding. Therefore while the proposal to allow collective bargaining to supersede the individual labor code may help in reducing the cost of labor to employers, it is unlikely to help increase the productivity and formality, and income security of poorer workers.

Union Bargaining Coverage, 1995[1]	
Country	**%**
Brazil	*"100"*
Argentina	73
Chile	13
Colombia	
Mexico	
Spain	78
Portugal	
Italy	82
Germany	92
Netherlands	81
UK	47
USA	18
Korea	11.2
Thailand	2.9

Source: ILO and OECD (1999)

Figure 23: In Brazil, Union Members are More Educated Than Non-unionized Labor, and are More Likely to be Managers and Professionals than Production Workers



Source: Volume II, Chapter 4.

Reducing the Mandated Minimum Package May be Necessary

97. In the sixty years since the CLT was adopted, three developments deserve mention. First, the composition of labor supply has radically changed. The main changes have been an increase in the share of women in the labor force from less than 15 percent to about 40 percent, and a rapid rise in the share of the services sector from about the same as industry and agriculture each to more than agriculture and industry combined. Second, the structure of labor demand has changed considerably. The demand for more skilled workers has increased. Third, in contrast, Brazil's labor institutions and regulations have not changed much. The two main institutions—collective bargaining rules and organizations and the labor justice system—continue to be based on principles appropriate for the post-Depression era. And the regulations mandating minimum wage and other benefits remain essentially unchanged.

The Minimum Wage Set by Law Is
(1=never enforced, 7=strongly enforced)

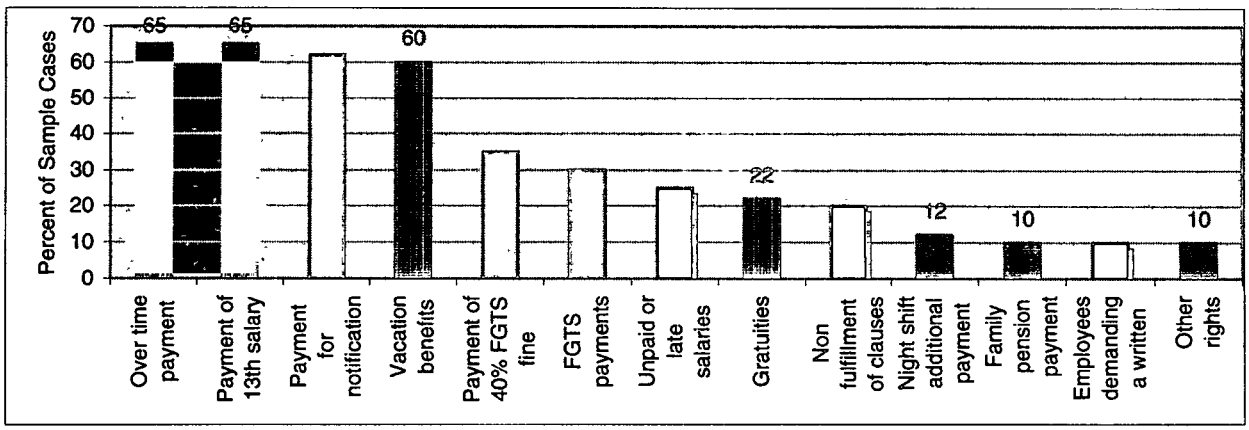
Country	Rating
Brazil	5.1
Argentina	3.1
Chile	5.8
Colombia	5.5
Mexico	5.4
Spain	5.7
Portugal	5.1
Italy	5.0
Germany	5.1
Netherlands	5.7
UK	5.5
USA	6.3
Korea	4.8
Thailand	5.2

Source: Global Competitiveness Report (Employer survey) by Harvard University and WEF (2001)

98. The result is a growing dissonance between labor market forces and the institutions that govern their interaction. While it has not helped richer, educated workers much, it has definitely hurt those workers that all governments vow to help—low-skilled, poorer workers. Since broad-based reforms that frontally address such contradictions are political non-starters, stealth appears to be the principle underlying many of the proposed changes in labor institutions and regulations. One proposal is to give unions more responsibility while making the market for collective representation more contestable by reforming unionization rules. There is some merit in such proposals, but they do not improve the prospects of poorer workers to find jobs which give them the chance to increase their productivity and pay through hard work and secure tenure.

99. The best way for Brazil to help the weakest segments of the population is to gradually reduce these mandates. Minimum wage increases should be restrained, and non-wage benefits required by the law should be scaled back. This may be seem contradictory, but consider this: today, fewer wage and salaried workers get these benefits than are denied these rights—in 2000, the number of informal wage workers in Brazil surpassed employment in the formal sector. It is also illustrative that the most frequent cause for labor disputes is non-wage benefits (about two-thirds of all cases—see red bars in Figure 24), and that the average court judgment results in about 40 percent of the contested amount being paid the worker (**Volume II, Chapter 6**). It may be time for the government to recognize *de jure* what labor courts appear to judge *de facto*: that the minimum mandate is too high. Reducing these mandates would be the surest way to lower informality among the poor, reduce labor litigation, and thus to increase productivity, employment, and earnings security.

Figure 24: Why Workers Litigate: Reasons for Taking Employers to Court



Box 7: There Are Always Negotiations: How Labor Courts Function in Brazil

The Brazilian Labor Court system has three levels: Conciliation and Judgment Boards; Regional Labor Courts; and the Superior Labor Court. Until recently, the Conciliation and Judgment Board was composed by a labor lawyer, and a representative each of employees and of employers (known as class representatives). These last two members were nominated by the president of the Superior Labor Court where the Board is to function. The Regional Labor Court was composed largely by labor lawyers and by a minority of representatives of employees and employers. The class representatives were chosen by the President of Brazil. Regional Labor Courts rule on demands made and pronounce judgment. Employees and employers may appeal these sentences to the Superior Labor Court. The members from the Superior Labor Court are nominated by the President but must be approved by the Federal Senate. It had three representatives each of workers and employers, and eleven labor lawyers who have lifelong tenure. At all three levels, the practice of having class representatives was abolished in 1999. The decisions of the Superior Labor Court are final, except if the dispute is related to a constitutional principle, in which case an appeal to the Federal Supreme Court can be made.

All individual disputes start with an employee or labor union filing a claim at the Conciliation and Judgment Board. The employer is notified and is asked to provide documents proving he/she is not guilty. At this level the process is completely bureaucratic. At the hearing the judge asks if the employer would like to make a counter-proposal to the employee. If one is made, the judge asks the employee if the counteroffer is satisfactory. If so the dispute is over. If not, the judge tries to make the parties reach an agreement. If the employer does not make a counteroffer or if the conciliation has no results, the hearing is closed. The demand is then analyzed by the judge who is in charge of issuing a sentence.

It is worth emphasizing one point here. There are always negotiations! Therefore, clauses in an individual contract protected by law are included. In reality, most of the demands and, therefore, of the rights negotiated, refer to individual rights enshrined in the CLT and/or the Constitution. What the data show is that there is a large fraction (about 80 percent) of disputes that is taken to labor courts for clauses already foreseen in the law. The regular procedure is to come up with an agreement between parties. In other words, this means that the possibility of negotiation of individual clauses foreseen by law is made available to employees and employers. More than 60 percent of the disputes that are not decided at the conciliation stage are decided partly in favor of the workers and partly in favor of the company. A lower and apparently declining percentage is resolved entirely in favor of the worker (10-20 percent), while the percentage of cases resolved entirely in favor of employers is 15-30 percent.

Source: Camargo (2002), Volume II, Chapter 6.

7. ALIGNING INCENTIVES BETTER

100. Chapter 6 dealt with cost implications of mandated wage and non-wage benefits. This chapter examines the labor market implications of the design of labor regulations and institutions in terms of their incentive implications for workers and employers. Chapter 6 suggests that because the minimum mandate is too high, employment will be lower than otherwise, and relatively low productivity workers will be hired only illegally. This chapter proposes that the current design of regulations and the functioning of contract enforcement institutions is such that it leads to a labor market that is adversarial, and the main result is that productivity is compromised. In other words, labor regulations and the manner in which they are enforced create a perverse incentive for workers to negotiate after the contract has ended. Thus while labor turnover may be the sign of flexible labor markets in other countries, in Brazil a significant part of it may be reflecting constraints to in-contract negotiations induced by the law. And while the focus of the last section was on regulations stipulating minimum wage and non-wage mandates and the institutions of collective bargaining, the emphasis in this chapter is on regulations governing severance and the institutions to resolve labor disputes.

Pay and worker productivity, 2001 (1=not related, 7=strongly related)

Country	Rating
Brazil	3.8
Argentina	3.4
Chile	4.5
Colombia	2.9
Mexico	3.7
Spain	4.0
Portugal	3.4
Italy	4.2
Germany	4.1
Netherlands	4.1
UK	5.4
USA	5.4
Korea	4.2
Thailand	4.1

Source: Global Competitiveness Report (Employer Survey), Harvard University and World Economic Forum (2001)

Mandated Severance Benefits

101. Workers are entitled to receive four main benefits upon severance. First, they are entitled to a month's notification with full pay and some time to look for another job (*aviso prévio*); in practice, most employers just pay a month's salary when dismissing workers. Second, upon dismissal, they can withdraw money from their FGTS accounts, to which employers have contributed about one monthly salary for every year of service, and which earn a government-guaranteed real rate of interest of 3 percent. Third, if the dismissal is *sem justa causa* (or without just cause, e.g., for economic reasons or the employer's whim) the employer must pay the worker a fine of 50 percent of the accumulated FGTS balance. Finally, they are eligible for unemployment insurance payments (*seguro desemprego*). The rules of eligibility and the amounts of benefits are summarized in Table 5.

102. To obtain rough idea of these benefits, consider the case of a person who has worked for five years at a monthly wage of R$250. He would have earned

Table 5: Severance Benefits Can Add Up to a Year's Wages Even for Workers with Short Tenure

Benefit	*Eligibility*	*Benefit Amount*
Unemployment Insurance	Most formal sector workers	1 to 2 minimum wages 3-5 payments depending on contribution history
FGTS	Most formal sector workers (other than household help)	8 percent of wages per month, with guaranteed rate of 3 percent
Fine for Dismissal Without Just Cause	All workers with FGTS accounts	40 percent of balance (Employers pay extra 10 percent to the government)
Aviso Previo, or Advance Notice of Dismissal	All formal sector workers	One month's previous notification of dismissal or one month's wage

R$15,000 in wages and obtained another R$9,000 in benefits (see Chapter 6) not counting the FGTS contributions by the employer. Upon dismissal, the worker gets R$250 as *aviso prévio*, access to an FGTS balance of more than R$1,250, the employer adds another R$500 to the FGTS account if the dismissal is ruled without just cause, and unemployment benefits between R$500 and R$1,000 over the next 3-6 months. These additional payments add up to about R$2,750, or almost a year's pay. Dismissal is not always a tragedy and, in good economic conditions, it seems it can even be a blessing.

Severance Laws and Labor Court Functioning Distort Behavior

103. Workers respond to these incentives as any rational person would: they induce dismissals after accumulating these severance rights. The more patient ones wait longer than those who need the money more urgently, but turnover is higher for all workers than it would be in the absence of these rules. In principle, firms can reduce turnover by increasing the reward for seniority, i.e., tilting the tenure-wage profile upward (see Lazear, 1986). But because this leaves workers vulnerable to reneging by firms when they are older, this is probably a credible strategy only for larger, better-regarded firms. So it appears that while the laws make the Brazilian labor market generally hyperactive, this may be especially true for poorer worker, and for workers in smaller firms.

Value Added per Worker, 2000*

Country	US$
Brazil	13,894
Argentina	24,257
Chile	27,765
Colombia	15,886
Mexico	18,492
Spain	42,796
Portugal	27,890
Italy	42,986
Germany	41,859
Netherlands	42,745
UK	41,054
USA	54,879
Korea	33,855
Thailand	10,670

Source: ILO
* or latest

104. Artificially high turnover is only one of the consequences. While the lower-than-market interest rate on FGTS accounts induces higher job separation, the distinction between dismissal with and without just cause also provides workers with a strong incentive to get themselves fired. The reasons are: first, the distinction between firings with and without just cause; and second, the fact that the additional payment in case the dismissal is ruled without just cause goes to the worker, rather than be treated as a fine (*multa*) and paid to a neutral party such as the government. This tends to make labor relations distrustful and adversarial, with employers refusing to pay the fine until taken to court. Court records (see **Volume II, Chapter 6**) provide supporting evidence for this severance-related benefits—not providing advance notification or *aviso prévio*, not paying the FGTS fine and not contributing to the worker's FGTS account are the second-most frequent reason for litigation, after non-payment of non-wage benefits (see Figure 23 on page 33). So, besides increasing turnover, the laws also increase the frequency of litigation, thus making the labor market not only hyperactive but also "hyper-litigious".

105. It could also be argued that if labor courts functioning were altered, then litigation would be lower even with the same labor regulations. And there may be some validity in this argument. The main rules are the following (**Volume II, Chapter 6**): Workers can file appeals against the employer up to three years after being dismissed. Workers do not have to pay court fees (though even the money costs to employers are low). The burden of proof is on the employer. Labor courts often "split the difference"–workers get about 40 percent of the disputed amount—a practice found to increase litigation in other countries. So workers have the incentive to both litigate more often and to inflate claims, and employers have the incentive to not pay all of the accumulated rights of the

workers upon dismissal and wait until the court orders them to pay. It should be mentioned here, however, that judgments are not always in favor of workers.

106. Again, it is likely that poorer workers litigate more, since they would reasonably be expected to be more impatient to access their FGTS balances. This means that poorer workers are more likely to take their employers to court. Volume II, Chapter 5 provides evidence from court records that workers with less than 2 minimum wages account for 70 percent of court cases, while their share in the workforce is about 45 percent. Workers earning more than 5 times the minimum wage constitute more than 16 percent of the labor force, but only 4 percent of the court cases (see Figure 25). Since employers will be more hesitant to hire workers that they expect to be more likely to litigate against them, the consequence could be lower (formal sector) employment.

107. After the worker is hired, if the objective is to minimize costs, the right strategy for the firm is not to pay the severance benefits and wait until the worker files a complaint when fired. Since it is known that the time until the sentence is very long, the employer hopes that workers will accept the counter-proposal at the first stage of conciliation, even if the worker believes these to be less then the entitled amount. Again, this strategy tends to be more effective when the work contracts are informal since with a formal contract it is easier to solve the dispute favoring the worker. This way, another effect of the functioning of the Brazilian labor justice is to increase the frequency of informal work contracts.

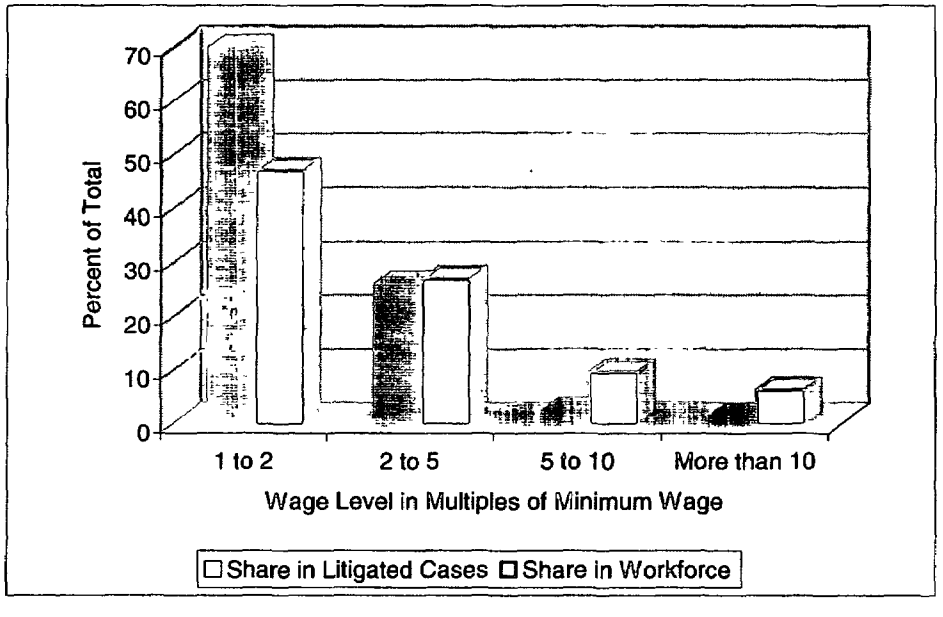
108. In contrast to the high frequency of litigation, the frequency of labor unrest is moderate. Less than 2 percent of the workforce was involved in a strike or lockout in 2000, compared with more than 50 percent in Argentina. But even in this dimension, Brazil is not exceptionally peaceful compared with most other countries.

Annual Hours Worked per Worker, 2000*

Country	Hours
Brazil	1,689
Argentina	1,820
Chile	1,902
Colombia	1,911
Mexico	1,888
Spain	1,812
Portugal	2,009
Italy	1,682
Germany	1,480
Netherlands	1,365
UK	1,720
USA	1,979
Korea	2,474
Thailand	2,228

Source: ILO
* or latest.

Figure 25: Poorer Workers Take Their Employers to Court More Often



Encouraging In-contract Negotiations May Reduce Litigation

109. The functioning of labor courts generates perverse incentives with relevant implications in the performance of the labor market. In order to minimize these distortions, it is important to keep in mind the behavior of the economic agents involved, i.e., workers and employers. First, despite the large volume of regulations and restrictions, work relations in Brazil are "negotiable" and negotiated. However, the locus of the negotiation is the Labor Court, not the workplace, and the timing of negotiation is after the worker is dismissed, not while the worker is still employed. Second, negotiations do indeed reduce the effective cost of work in relation to what is stipulated by law.

110. The main consequences are a congested Labor Justice system, non-cooperative behavior and a high frequency of informal contracts. A potential solution is to have negotiations removed from the labor court and let it happen within firms while workers still have an interest in the firm's good financial health. In other words, the principle would be to make negotiations more attractive at the firm level than in court, for both the workers and employers. This can be done in two ways: ***changing the legislation prohibiting negotiations*** of many clauses in individual contracts outside the labor justice, and/or ***raising costs of accessing the labor justice system***. **(Volume II, Chapter 6)**

111. With respect to the first point, the best way to implement it would be to allow the negotiation of individual rights through collective contracts at firm level with the participation of the union. From the point of view of the employer this enhances the attractiveness of a formal contract as it avoids the uncertainty of decisions in the labor justice. Making unions participate in the negotiation is to avoid situations where the low bargaining power of workers results in them signing contracts that are excessively unfavorable. What is being proposed is not that the rights now be negotiated since these rights are indeed negotiated at the labor courts. What is being suggested is that the negotiation takes place within the firm through the union while the employee is working. But it also implies a recognition that negotiations between employers and workers are a good way to resolve conflict. But two changes are necessary: a system based less on the idea of "justice" and more on the idea of "dispute" would have to be outlined, and union rules would have to be changed to make them more representative of workers and sensitive to conditions of employers.

112. In relation to the second point, one solution is that all firms involved in processes at the labor justice have their tax responsibilities (e.g., social security, other taxes) verified. This would create an incentive for businesses to avoid the labor courts altogether and pay the benefits negotiated between parties. It would reduce informality by penalizing at least one side of this relation, in this case the employer. While this would raise the bargaining power of the worker, it reduces the role of the labor justice as ***negotiators*** of clauses in individual work contracts and it increases its role as effective ***enforcers*** of these contracts. With respect to collective contracts, conflicts should be effectively resolved by discussions between workers and firms; this result depends on the bargaining power between parties and should not be a matter of justice.

Labor Unions and Productivity
(1=prevent productivity improvements, 7=contribute to productivity improvements)

Country	Rating
Brazil	3.4
Argentina	2.9
Chile	3.6
Colombia	2.8
Mexico	2.9
Spain	3.9
Portugal	3.4
Italy	4.4
Germany	4.1
Netherlands	5.2
UK	4.6
USA	3.6
Korea	3.7
Thailand	4.1

Source: Global Competitiveness Report (Employer survey) by Harvard University and WEF (2001)

Redesigning FGTS Will Reduce Perverse Incentives

113. The effects of the FGTS account are different from those of the penalty for dismissal. So we discuss the two factors separately, first considering the ***impact of FGTS itself***, and then that of the ***FGTS penalty***.

114. The fact that workers have restricted access to their FGTS makes this a low liquidity asset. Together with a financial return that is generally lower than the market rate, this reduces its value to the worker. This under-valuation of the FGTS has two consequences. First, it means that each R$1 deposited by the firm in a worker's FGTS will be valued by the latter at less than R$1, and second, as the benefit to the worker is less than the cost of the firm, the presence of the FGTS becomes a source of inefficiency. Inefficiency leads to informality, since employees and employers both prefer contracts where the latter pays a direct transfer, instead of making deposits to the employee's FGTS account. This generates an incentive to informality. This increase in the cost of labor is not a result of the FGTS contribution *per se* (because it is valued by the worker and hence can be offset by lower wages), but stems from the existence of a wedge between its benefit as seen the worker and the cost as borne by the firm.

Hiring and firing of workers is (1=impeded by regulations, 7=flexibly determined by employers)

Country	Rating
Brazil	4.2
Argentina	4.2
Chile	4.3
Colombia	3.5
Mexico	3.5
Spain	3.2
Portugal	2.7
Italy	2.3
Germany	2.1
Netherlands	2.5
UK	3.9
USA	5
Korea	3.8
Thailand	3.8

Source: Global Competitiveness Report (Employer Survey), Harvard University and World Economic Forum (2001)

115. As the balance held in the FGTS accumulates, the incentive for the worker to trigger a dismissal rises. Volume III Chapter 10 presents evidence of demand among employees to gain control over their FGTS: nearly two-thirds of employees with employment record cards that quit their current job simulated dismissal in order to gain access to their FGTS. As the FGTS creates these incentives for workers to induce dismissal, employees and firms expect contracts to be short-lived, which weakens incentives by either to invest in firm-specific human capital. This may end up raising turnover rates further still. The dismissal penalty has two characteristics that influence worker and firm behavior: the penalty is ***paid by the firm*** only in the event of unfair dismissal, and it is ***received by the worker*** when this happens.

116. The existence of the penalty can also impact hiring. To the extent that firms consider the probationary period insufficient to judge a worker's performance, they will tend to invest more in the recruitment process. This raises hiring costs since firms try to identify worker characteristics that could be more easily observed while they are actually working in the firm. But high dismissal costs may even lead to discriminatory practices because—to avoid the high cost of trying a worker out—firms will use any indicator that might have some correlation with litigation. This may be observable personal characteristics, such as gender and color, or some assessment of the job applicant's wealth status.

117. In theory, the penalty can actually lead to *lower* turnover, longer-lasting employment relations and higher productivity and wages, as a result of firms choosing their workers more carefully and greater investment in specific human capital. Wages could rise as a result of the productivity increase. In practice, it appears that the penalty raises labor costs, thereby reducing the demand for labor and leading to lower wages (Carneiro and Faria, 2001). The penalty also has consequences for workers' behavior, since it is paid directly to the dismissed worker rather than to a collective workers' fund, to be used to finance an unemployment insurance or training program, for example. This generates a

conflict of interest, because workers have incentives to provoke dismissal during an economic upswing, whereas firms would like to avoid it. If workers are capable of provoking their own dismissal, the penalty is likely to shorten the average duration of tenure and increase the turnover rate, and reduce productivity and wages.

118. Actually, the FGTS is based on a sound economic principle—a government scheme to augment self-insurance efforts by workers who face a frequent but relatively moderate loss (see Table 6). It is also an improvement upon the mandate it replaced—many of its detractors forget that until the introduction of the FGTS scheme, workers with more than ten years of tenure had lifetime job security. The proposal to make it a mandatory retirement account (a "second pillar" of old age income security) and rely entirely on *seguro desemprego* for income support does not accord with the principles of insurance (see De Ferranti et. al.) and may not adequately recognize the role played by Brazil's thriving system of voluntary pensions. The FGTS should be continued as an income support program for the unemployed. But rules introduced in the 1988 Constitution and the high market rates of return since 1994 have accentuated flaws in the FGTS's design which need to now be addressed.

Adult Participation in Continued Education and Training, 2000

Country	%
Brazil	
Argentina	
Chile	
Colombia	
Mexico	
Spain	-
Portugal	14.2
Italy	-
Germany	-
Netherlands	37.4
UK	43.9
USA	39.7
Korea	-
Thailand	-

Source: OECD(2001b)

119. There are several reform alternatives. First, increasing competition in the management of FGTS accounts so that they earn market rates of return would reduce the tax component, and lead to lower turnover and greater efficiency. A second option is to cap contributions to FGTS, so that the perverse incentive to trigger a fire does not grow too large. A third option would be to eliminate the *multa*, in effect making the FGTS a "no-fault" insurance scheme. This would reduce turnover and litigation, and lead to greater investments in firm-specific skills and higher productivity. A fourth option—that recognizes many of the political economy constraints—is to divert the penalty to a fund used to increase the interest rate paid on FGTS accounts. Thus while worker (as a group) would still receive the *multa* paid by employers for dismissal of workers, the perverse incentive (for individual workers) would be largely eliminated. The final option is that the 40 percent penalty that currently is paid to workers by employers could be maintained, but the funds be put into a fund to assist unemployed workers. Since 2001, there is precedence for the diversion of FGTS revenues and fines for collective purposes—the fine has been raised to 50 percent of FGTS balance with the additional 10 percent being diverted to a common fund to pay FGTS interest arrears (see Box 8). Along with reform of *seguro desemprego* (mainly, its redirection to the informal sector—see Chapter 8), this could increase income security and, by reducing litigation, also increase productivity and employment.

Box 8: Supreme Court Decision Forces Increase in FGTS Contribution and Fine

FGTS accounts are managed by the state housing and loan bank, the *Caixa Economica Federal*. Since the accounts earn a guaranteed real rate of 3 percent, the government has to calculate what the nominal rate should be (essentially the rate of inflation plus three). In 2001, the Supreme Court ruled that during a period of sharply falling inflation rates, the government had underpaid FGTS account holders. The underpayment amounted to about R$40 billion, and the government was ordered to pay this to the account holders, based on their account balances during the period of miscalculation.

The federal government—already in the midst of a painful fiscal adjustment—clearly did not have the resources to pay this amount all at once. A period of protracted negotiations between the unions and the government resulted in a compromise solution. The account holders would be compensated gradually, and the total sum of compensation was less than R$40 billion. The compensation is to be financed by an increase in the employer's FGTS contribution from 8.0 percent to 8.5 percent, and by an increase in the fine for dismissal without just cause from 40 to 50 percent. That is, the additional 10 percentage points are to go to the government instead of the fired worker.

Table 6: Income Support For the Unemployed—Summary and Policy Implications

Program	Nature	Advantages and Disadvantages	Policy Implication
Individual saving accounts	Self-insurance—no pooling of risk	Low labor market efficiency costs, but welfare reduction especially for poorer workers	Should be considered by countries that have high unemployment, especially where labor reforms are only a distant possibility
Severance pay	Pooling over small group—globalization makes group even smaller	Almost no advantage. Little pooling of risk, entails labor market inefficiency, makes labor relations contentious, and is administratively challenging	Possibly the worst form of unemployment support in a globalized economy
Public work programs	Market-type insurance elements—implicit pooling of risk	Can reach informal sector workers and poor; but can entail high leakages in the form of non-labor costs when investment element is made a priority	Should be considered for a part of work force, but not a universal scheme. Permanent schemes allow for better balance between consumption smoothing and investment over the economic cycle
Unemployment insurance	Market-type insurance—explicit pooling of risks	Most pooling of risk, can be used both to address idiosyncratic and aggregate risk and hence serve as a "automatic fiscal stabilizer", generally politically popular	Should be considered by governments that have carried out comprehensive economic reforms; labor market disincentive effects can be reduced by keeping benefits frugal and "mimicking the market" as much as possible in design

Source: Securing Our Future in a Global Economy, De Ferranti, Perry, Gill and Servén (2000).

8. Improving Income Security

120. FGTS reforms can result in better or less distortionary income security for the unemployed manner, and even increase the size of the formal sector. But informality will be a fact of life in Brazil for many years to come, and interventions should be designed keeping this in mind. Unlike the uniqueness of labor market functioning in Brazil due to the interaction of its institutions and regulations, in the mater of interventions Brazil's experience has been the same as what evaluations in other countries appear to show. Accordingly, Brazil's priorities are to improve the effectiveness of its training, job search and micro-credit programs, and to extend the coverage of passive income support programs to cover more of the unemployed.

Poverty, 1998* (% of population living below US $ 2 per day)	
Country	%
Brazil	25.4
Argentina	-
Chile	18.4
Colombia	28.7
Mexico	34.8
Spain	-
Portugal	-
Italy	-
Germany	-
Netherlands	-
UK	-
USA	-
Korea	2.0
Thailand	28.2

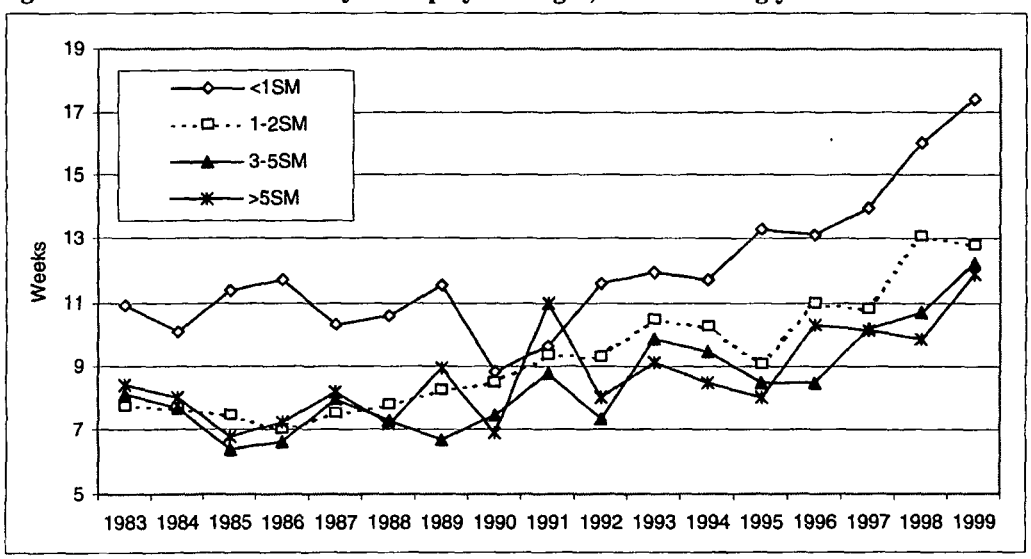
Source: ILO
* or latest.

Unemployment or Poverty? What We Should Care More About

121. An important issue in the design of interventions is whether one should care less about unemployment and more about poverty in Brazil, given the general belief that in developing countries unemployment is a luxury that only the relatively wealthy can afford. Brazilian data indicate the following:

- PME and nationwide surveys reveal that between 70 and 80 percent of the unemployed are from poor households. So concerns about unemployment in Brazil are not inconsistent with being concerned about the poor.
- But the magnitude of poverty in Brazil dwarfs the problem of unemployment. In 2000, there were between 40 and 60 million poor in the country (depending on the poverty line used), and 6 to 10 million are unemployed (depending on the definition of unemployment).
- In fact, about 75 percent of Brazil's poor have jobs, and about 20 percent are inactive. In the large metropolitan regions, however, these ratios are about 55 percent and 40 percent respectively. Labor-related policies to reduce poverty would, therefore, need to emphasize measures to increase labor force participation in large metro regions, but earnings of the working poor in smaller cities and rural areas.

Figure 26: Poorer Workers Stay Unemployed Longer, and Increasingly More



Source: Volume II, Chapter 9.

122. An important question for the design of interventions is the issue of target group, i.e., some groups such as women, youth and the (less) educated have higher unemployment rates than others. Brazilian data show that:

- Unemployment rates of women are almost a third higher than for men, and those for young job-seekers (aged 15-17 years) are more than twice as high as for prime aged (25-29 years) workers.
- Between 1991 and 1997, unemployment rates were highest for job-seekers with 5-8 years of education, but since mid-1998, unemployment rates of people with 9-11 years have been the highest. Unemployment rates have remained the lowest for people with more than 12 years of schooling.
- Between 1991 and 2000, unemployment rates rose for all groups, suggesting a structural element, which has to be addressed not by temporary, targeted interventions but by sustained economic recovery and (permanent) changes in labor legislation. At the same time, the poor need help the most. Figure 26 shows that the duration of unemployment is highest for low wage earners.
- Unemployment rates among informal sector workers are high and increasing, despite the common belief that informality is itself a safety net (Figure 27). This has been observed for other countries as well (Volume II Chapter 3).

Youth Unemployment Rate, 2000

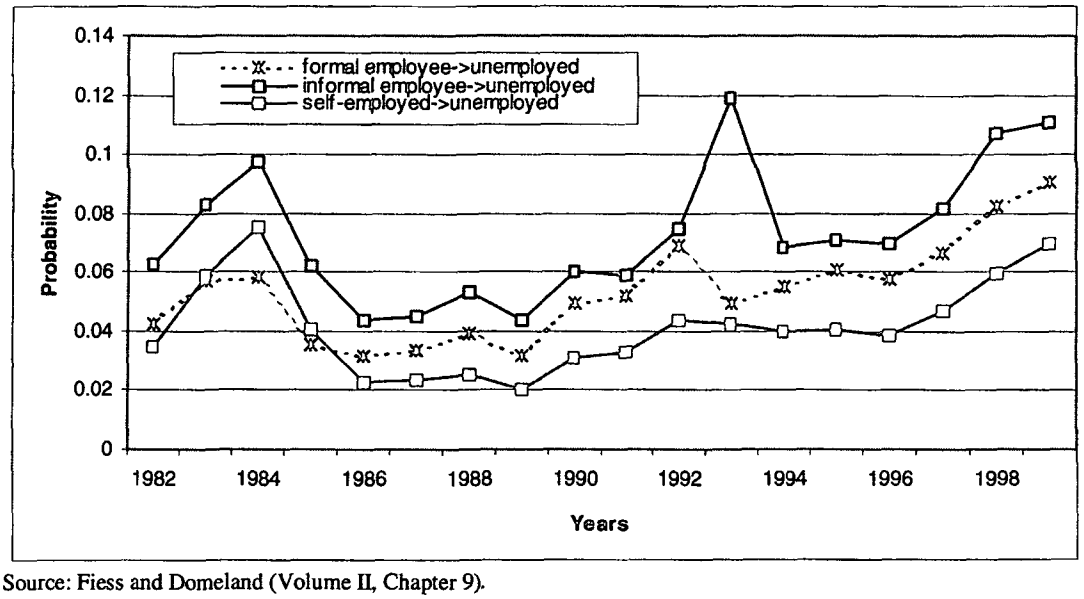
Country	%
Brazil	21.2
Argentina	18.3
Chile	-
Colombia	7.7
Mexico	7.4
Spain	-
Portugal	28.5
Italy	14.2
Germany	32.9
Netherlands	8.7
UK	9.9
USA	-
Korea	3.4
Thailand	12.3

Source: ILO

Improving Effectiveness of Active Labor Programs May Help

123. The main interventions used to increase income security are ***micro-credit programs, professional training,*** and ***labor market intermediation***. Some government intervention in these areas may be necessary, as they are important for income generation among the poorest families, for whom markets tend to be imperfect. But the fact that credit, professional skills and labor intermediation are important for reducing unemployment and increasing productivity—and consequently for tackling poverty—does not mean such services have to be *provided* publicly or even subsidized; and even less so that they should actually be *produced* by the state. This section briefly considers why and how the state should intervene. It then surveys the experience in Brazil and suggests remedies.

Figure 27: Informal Workers are Most Likely to Become Unemployed, and Increasingly So



Source: Fiess and Domeland (Volume II, Chapter 9).

124. If it were possible to provide access to these services without subsidies for their consumption and direct state involvement in their production, would there still be a need for subsidies and intervention? While direct state intervention in production is hard to justify, there are at least three arguments justifying the existence of subsidies. First, given the importance of these services to the incomes of poor families, they may be "merit goods" that justify a compensatory policy of subsidized provision to low-income population segments. Second, as these services can help in helping workers displaced by structural changes to rejoin the labor market, their subsidized provision can be seen as a social contract to compensate those made worse off by such changes. Last, there may be positive externalities in both professional training and labor intermediation. A worker who is trained may pass on at least part of the training to his colleagues, at no cost. The more intensively workers search, the lower are firms' recruitment costs. In the presence of positive externalities, the private demand for such services will be below what is socially desirable. The only justification for direct state intervention in the production of these services arises from technical or logistic reasons involved in ensuring access to the poor, though it is not clear what these might be.

125. On the whole, the evaluations of the real impact of such policies on unemployment and productivity in Brazil are far below the theoretical expectations outlined in Box 9 (see Box 10). But they are line with international experience (see Table 8). These limited impacts may partly reflect intrinsic shortcomings in the policies as instruments for combating unemployment, low labor productivity and poverty, but they may also be a result of shortcomings and imperfections in their implementation.

126. Although there is a wide range of factors that could explain why the impact of the government training program, PLANFOR, on unemployment and productivity is below its potential, the most important one seems to concern the selection of courses and clientele. Course selection is made on the basis of assessments of demand in local labor markets made by municipal and State employment commissions. These are consolidated by the State Employment Commission and the State Labor Secretariat into a State Skill Training Plan (PEQ). The selected courses are then contracted out to a set of executing agencies. Once supply has been defined, trainees are then sought to fill the available vacancies. As widespread publicity for the courses on offer and their requirements is seldom

Time Required to Register a Business, 2001*

Country	Days
Brazil	63
Argentina	48
Chile	28
Colombia	48
Mexico	67
Spain	82
Portugal	76
Italy	62
Germany	42
Netherlands	31
UK	4
USA	4
Korea	27
Thailand	35

Source: Djankov (2001)
* or latest.

Box 9: Objectives and Effects of Active Labor Programs: The Theory

Microcredit programs aim to reduce unemployment and raise labor productivity. Microcredit acts as a weapon against structural unemployment, since it leads to an expansion of output and hence greater demand for labor. As it has no impact on workers' skills or on available information, microcredit cannot address frictional or mismatch unemployment. Microcredit is a useful tool for improving the quality of jobs, since it leads to investment in physical capital and encourages incorporation of new technologies. But it is of little relevance in raising productivity if this is limited either by workers' skills or by the quality of matching.

Job training also aims to combat both unemployment and labor-force productivity. It reduces mismatch unemployment, to the extent that expanding the capacity of some workers gives them access to a set of jobs that would not be available to them without additional training. Training cannot combat frictional unemployment and, as it does not generate jobs directly, its impact on structural employment is small and indirect. Training impacts productivity mostly through increases in workers' skills, whereas its impacts on the quality of jobs or worker-firm matches are minor and indirect.

Job search assistance or labor intermediation services aim to reduce information imperfections in the labor market. Consequently, they can reduce unemployment if it is frictional, and also increase productivity insofar as poor matching reduces productivity. Labor intermediation does not have a direct impact on workers' skills or on the quantity and quality of jobs available; nor is it effective for tackling structural unemployment. Labor intermediation will not be effective in raising productivity when this is limited either by workers' skills or by low quality of the jobs.

Source: Paes de Barros and others (2002); Volume II Chapter 10.

made, it is generally left to the executing agency to fill class vacancies from its own clientele.

127. This procedure appears to suffer from two problems. First, the failure to use the workers' own preferences as a basic input in the course selection process may result in errors, since labor market conditions are difficult to predict. Second, the current system does not ensure equal opportunity in terms of access to the program. One way to avoid these problems involves setting up a four-step procedure: (a) construct a catalog of courses that could be offered, and evaluate the quality of courses and executing agencies; (b) select the program's clientele; (c) ask each client to choose a course and provider, and the time when they would like the course to be held; and (d) direct executing agencies towards the existing demand for skill training to allow them to program their supply. On the basis of this system it could be possible simultaneously to guarantee equal opportunity to the program and to incorporate workers' preferences in the selection of courses.

Can companies cut back workers' hours or get overtime labor without too much extra cost in your country? (1=No, 7=Yes)

Country	Rating
Brazil	2.8
Argentina	3.8
Chile	3.3
Colombia	3.1
Mexico	3.0
Spain	3.3
Portugal	3.0
Italy	2.3
Germany	2.9
Netherlands	3.5
UK	4.5
USA	4.9
Korea	4.1
Thailand	4.4

Source. Global Competitiveness Report (Employer Survey), Harvard University and World Economic Forum (2001)

128. In the case of job search assistance, the main operational constraint seems to be direct intervention by the state in production. Intermediation services are also produced in four phases: (a) registration of vacancies; (b) registration of unemployed workers; (c) matching of vacancies and unemployed workers; and (d) sending workers to the selected jobs. The key problem in public provision arises in stage (d). As a vacancy is a "perishable good", once a potential vacancy has been found, it is essential for the worker to be sent there as quickly as possible. If the vacancy is registered after registration of the worker, he or she has to be notified or required to check regularly to the agency providing the intermediation service. In either case the costs are high, and there is no guarantee or expectation that the process will ever be quick enough.

129. A way of resolving this problem, with less public intervention, would be to limit the government's role to registering unemployed workers and developing a computer program to match them to the available jobs. All registered firms could use the computer program in searching for workers, with the possibility of developing their own selection criteria. In this case, workers would be called directly by the firm, although part of the costs of calling them may be borne by the state. As the firm itself would be selecting workers, it would also be financing part of the costs. The cost would be less and a larger proportion of the candidates called would actually be hired.

Box 10: Effects of Active Labor Programs in Brazil: The Evidence

Impact assessments in Brazil only exist for training and labor intermediation. In the case of ***training***, there have been numerous evaluations of PLANFOR, including a series that track the subsequent development of course graduates. Some of these, apart from tracking course graduates, also include information on performance of a comparison group. The results of all the analyses with a comparison group, except one program in Pernambuco, suggest the impact on unemployment and income is quite small. An evaluation in Rio de Janeiro and Fortaleza showed that training programs had a positive and statistically significant impact on unemployment, but not on incomes of those already employed: those with access to training were 3-4 percent more likely to be employed six to 12 months afterwards, but there was no impact on wages of those employed already. As the program costs about R$170 per person, the new jobs for participants need to last more than 17 months for the program to have a net positive benefit.

Evaluations of ***labor intermediation*** services are less common. A recent assessment by IPEA and FIPE based on PME longitudinal data tracked the labor market performance of two groups of previously unemployed workers for two months: unemployed workers who sought labor intermediation in the week of the interview and those who did not. Those who sought these performed better than those who did not in just two of the six Metropolitan regions investigated (Belo Horizonte and Salvador). Even in these regions, the impact was such that those who sought work ended with a employment rate 2-3 percentage points higher, and a rate of formality 3-6 percentage points higher than those that did not use intermediation services. These results suggest that labor intermediation is important in terms of greater access to the formal sector, but not in reducing unemployment.

Better Targeting of Income Support Will Help Poorer Workers

130. The main difference between consumption smoothing and safety-net oriented unemployment insurance (UI) systems lies in replacement ratio and depth of coverage. UI systems which primarily focus on consumption smoothing generally aim at a high replacement ratio of the previous income. Such systems are often restricted to workers who were employed during a substantial period of time before becoming unemployed. UI programs that emphasize a social net objective generally provide low levels of benefits, but cover a large fraction of the population.

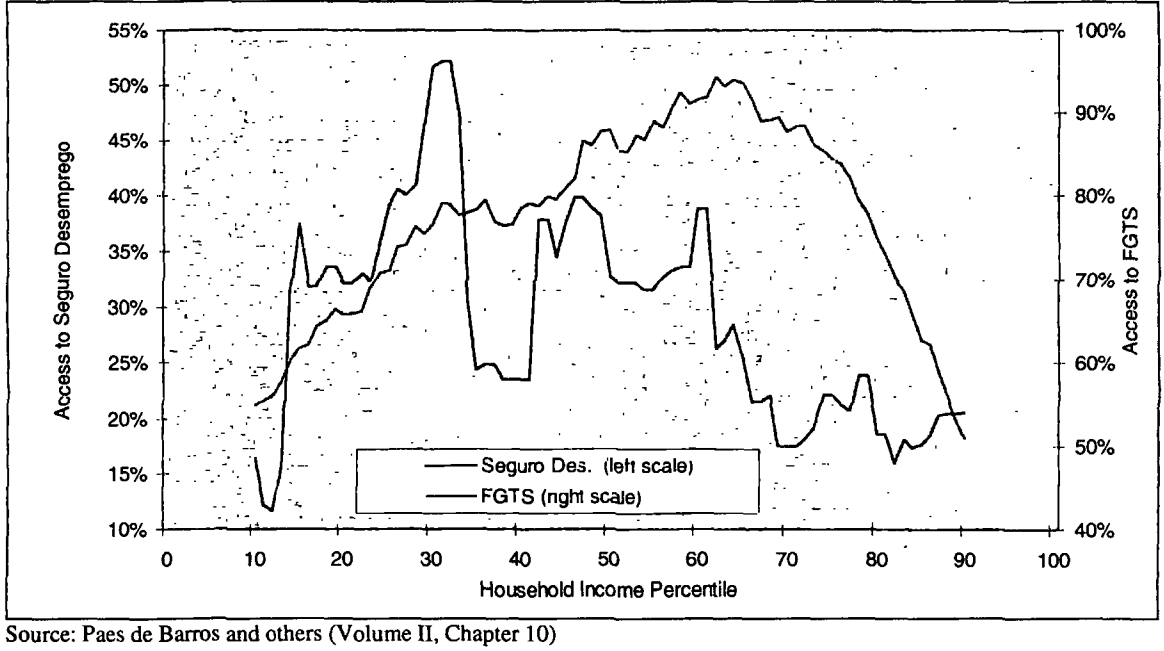
131. The Brazilian UI system is the largest in Latin America, serving an average of 300,000 to 400,000 beneficiaries each month. It is characterized by a low replacement ratio, short benefit duration and the fact that it is restricted to formal sector workers, which implies that UI is not accessible to over 50 percent of the workforce (see also Figure 28). The program's design does not seem to fit its objectives. A further inconsistency with the social safety net objective arrives from the fact that receiving UI is conditional on having access to the *Fundo de Garantía do Tempo de Serviço* (FGTS). For a long time the FGTS was the only program that provided income to the workers when they were laid off. Even nowadays, this aspect of the FGTS is important. UI benefits in Brazil are low and do not exceed two minimum wages. As a consequence, the amount worker receives from their FGTS is likely to exceed unemployment benefits by far. At the other extreme are those that are not covered by the FGTS. These workers are not covered by UI either. If these workers were less likely to become employed this would be less of a concern. But **Volume II, Chapter 9** provides evidence that the likelihood of becoming unemployed is highest for those earning less than the minimum wage, who are (almost by definition) informal sector workers without access to income support programs.

Share of Work Force Contributing to Social Security, 1999

Country	%
Brazil	32.6
Argentina	31.6
Chile	56.5
Colombia	35.4
Mexico	31.2
Spain	-
Portugal	-
Italy	-
Germany	-
Netherlands	-
UK	-
USA	-
Korea	-
Thailand	-

Source: Packard (2001)

Figure 28: Access to Income Support Programs



Source: Paes de Barros and others (Volume II, Chapter 10)

132. Under these circumstances, it would be sensible to expand access of informal sector workers to some form of income support during unemployment. It may be argued that it would be difficult to provide *insurance* against unemployment to the informal because they are mostly self-employed, and it would be impossible to verify that they are indeed without work during the period in which they are claiming eligibility. And unemployment benefits are usually funded by a tax on payroll, which—almost by definition—is impossible to collect from informal sector enterprises. But these arguments do not pass muster in Brazil. First, the informal wage and salaried workforce is larger than the number of self-employed in Brazil. Second, there is considerable evidence from household surveys that a high ratio of the current (formal sector) claimants of UI benefits is in fact employed while receiving these benefits. Third, unlike most other countries, unemployment insurance in Brazil is financed not by a tax on payroll but by a 0.65 percent tax on revenues of private firms, 1 percent tax on revenues of public enterprises, and a 1 percent tax on costs of nonprofit organizations.

133. Given these facts and the duplication of benefits (or even triplication, if *abono salarial* benefits are considered), redirecting the current unemployment insurance system to serve the poor may be a low cost way to help Brazil's poorest and most unemployment-prone workers while maintaining income support for the bulk of the workforce through a sensible reform of the FGTS that eliminates its design flaws.

Table 7: International Experience with Active Labor Market Programs

Program	Appears to Help	Comments
1. Public Works Programs (17 evaluations)	Severely disadvantaged groups in providing temporary employment and a safety net.	Long-term employment prospects not helped: program participants are less likely to be employed in a normal job and earn less than do individuals in the control group. Not cost-effective if objective is to get people into gainful employment.
2. Job-search assistance/ employment services (19 evaluations)	Adult unemployed when economy is improving; women may benefit more.	Relatively more cost-effective than other labor market interventions (e.g. training) – mainly due to the lower cost, youth do not benefit usually. Difficulty lies in deciding who needs help in order to minimize deadweight loss.
3. Training of long-term unemployed, those laid-off *en masse*, and youth (47 evaluations)	Women and other disadvantaged groups generally when economy is improving. However, little positive impact on youth.	No more effective than job-search assistance in increasing re-employment probabilities and post-intervention earnings and are 2-4 times more costly. For youth, employment/earnings prospects not improved as a result of going through the training. Taking costs into account - the real rate of return of these programs is negative for youth.
4. Employment/ Wage subsidies (22 evaluations)	Long-term unemployed in providing an entry into the labor force.	High deadweight and substitution effects. Impact analysis shows treatment group does not do well as compared to control. Sometimes used by firms as permanent subsidy.
5. Micro-enterprise Development Programs (15 evaluations)	Relatively older groups, the more educated.	Low take-up rate among unemployed. High failure rate of small businesses. High deadweight and displacement effects. Cost-benefit analysis rarely conducted but sometime show costs to UI budget higher than for control group.

Source: Dar, 2001 (Volume II, Chapter 11)

9. Summary and Policy Priorities

134. This concluding chapter may also be viewed as the executive summary of the report. It recapitulates the approach used and highlights the innovative features of the report, summarizes the main findings, and discusses the principal policy implications.

What's New About this Report

135. Brazil's labor market has received a lot of attention from researchers, and it is fair to ask what this report adds to the large stock of knowledge on the subject. There are five features that distinguish this report from earlier attempts:

- **A new approach**. First, it is structured to systematically address all the aspects of Brazil's labor market that are central to the public debate in the country—labor market governance, labor market functioning, and labor market outcomes. It traces the link from outcomes—employment growth, productivity levels, and income security—to the labor market's functioning—litigation, turnover and informality—to arrive at policy options to improve its governance, viz., its institutions, regulations and interventions.
- **Macro-labor linkages**. Second, in doing so, it also breaks new ground in identifying links between macroeconomic policies, its effects on labor market functioning and outcomes, and labor policy priorities corresponding to different macroeconomic stages. The priority during trade liberalization is to facilitate reallocation of labor—strengthening income support programs while lowering severance costs. During stabilization the priorities are to increase wage flexibility—collective bargaining reform and reassessing wage-related mandates such as minimum wages. In periods of fiscal adjustment, the policy focus is on non-wage costs—streamlining payroll taxes, social security reform and improving enforcement of labor laws.
- **Attention to institutions.** Third, along with analysis of demand and supply of labor, the analysis of labor market institutions—especially the labor justice system and trade unions—has a prominent place in the report. The report thus blends the economic and institutional strands of labor policy analysis.
- **Concern for feasibility of reform**. Fourth, because labor reform is politically difficult and always undertaken in a piecemeal fashion, the report presents policy options that range from the modest to the radical. The recommendations include institutional reform but, recognizing that this will be difficult and time-consuming, other options are also suggested. To guide policymakers, the report also attempts to determine priorities and sequencing.
- **Strong focus on the poor.** Finally, and perhaps most importantly, the report explicitly examines the implications of labor market functioning for poor workers. In particular, it illustrates how Brazil's poor are the most disadvantaged by labor regulations and institutions that are designed to help them, resulting in their exclusion from income security programs and other formal safety nets.

Novel aspects of this report include treatment of the "third side" of the labor market —institutions— along with labor demand and supply; a special emphasis on implications for the poor; and a graduated set of policy options that are sensitive to political feasibility considerations

Summary of Main Findings

136. **Functioning.** Brazil's labor market functions differently when viewed in the aggregate than from the viewpoint of firms and individuals, and from the viewpoint of the non-poor than of poor workers. It is:

Brazil's labor market is characterized by macroeconomic flexibility that masks microeconomic rigidities, reflected in high turnover, frequent litigation, and rising informality

- **Increasingly female and service oriented.** The nature of employment has changed radically. While in 1970, four out of ten women of working age were in the labor force, this ratio is now six out of ten. In 1970, the shares of services, agriculture, and industry were roughly equal; today service sector employment is more than that in agriculture and industry combined.
- **Flexible in macroeconomic terms.** At the aggregate level, changes in real wages have absorbed most of the impact of macro fluctuations during the last decade, with employment growth taking place in both good and bad times. But since stabilization in 1995, this "macro flexibility" has declined.
- **Increasingly hyperactive.** Labor turnover has increased by about 50 percent during the last decade, making an already hyperactive labor market even more so. Labor turnover is high even when compared with active labor markets such as that of the US.
- **Adversarial, especially for the poor.** Labor litigation is an order of magnitude higher than benchmark countries. More than two million lawsuits are filed every year, implying that more than 6 percent of all workers go to court every year, and four out of five lawsuits faced by firms are labor-related. Poorer workers—those earning less than two minimum wages—are about three-quarters of litigants, but less than half of the workforce.
- **Less unionized.** Unionization rates are down to 17 percent from about 22 percent in 1986, a trend that is common around the world. Unlike most other countries, however, union members are more educated than non-unionized labor, and are more likely to be managers and professionals than production workers in Brazil. Unions are not representative of formal sector workers, and even less so of the poor among them.
- **Increasingly informal.** More than half of employment in Brazil is unregulated. While the share of the self-employed has increased since 1990—it is currently 23 percent of the labor force—it remains below benchmark countries. However, the share of informal wage and salaried workers has increased even faster and is now 28 percent of the workforce, much higher than comparable countries. Unlike the self-employed, most of these workers appear to in the informal sector involuntarily. And almost half of these workers earn less than the minimum wage.

137. **Outcomes.** The report finds signs of deterioration of labor market outcomes, or underperformance relative to benchmark countries, both of which signal the need for labor reforms. The main outcomes are:

- **Sluggish employment growth.** Job creation is increasingly insufficient—while the working age population increased by 25 percent between 1991 and 2001, employment grew by about 12.5 percent. The unemployment rate now hovers around 8 percent, as compared with 6 percent in the early 1990s.

- **Falling participation rates.** Labor force participation has fallen in urban areas from 61 to 56 percent. Had it fallen by only half the amount it did, unemployment rates would be in double digits.
- **Low productivity.** Value added per worker in Brazil was lower in 2000 than it was in 1980; in contrast, Chile's labor productivity rose by almost 50 percent and Thailand's more than doubled during this period. Compared with countries at the same income level such as Mexico and Malaysia, Brazil faces a productivity shortfall of about 50 percent.
- **Low income security.** In 2000, for the first time, the number of workers without access to social security and compensatory programs became larger than the number of those who enjoy some income security during unemployment, disability, or old age.

138. **Policies.** Based on the analysis, this report arrives at the conclusion that labor reforms are needed. The three policy objectives are (i) to price labor correctly to increase employment growth, (ii) align the incentives that workers face to raise labor productivity and wages, and (iii) improve income security programs so that workers and their families are better protected from both systemic and idiosyncratic shocks. The instruments for achieving better outcomes are to ***eliminate subsidies for labor turnover, move negotiations from labor courts to the workplace, reduce non-wage benefits while maintaining a moderate minimum wage***, and ***eliminate overlaps in income security programs and expand their coverage***.

The outcome associated with Brazil's labor market institutions, regulations and interventions is that a growing share of jobs offers neither the prospect of productivity and wage growth, nor of adequate income security

Eliminate Subsidies for Labor Turnover

139. While frequent job changes do not imply poorly functioning labor markets, the government should not ***subsidize*** turnover, even inadvertently. It appears that the current regulations and institutions do exactly this. One of the main reasons for the unusually high turnover is the design of severance regulations, especially the FGTS scheme. The first reason is that FGTS accounts usually pay less than market rates of interest; the second is that the 40 percent penalty for unjust dismissal is paid to the worker.

140. The "first best" solution is to pay market rates on FGTS accounts, and to eliminate the 40 percent penalty for unjust dismissal. But this may be politically difficult—those who currently benefit from access to these low-cost funds would likely resist any reform to pay market rates, and workers may see abolition of the fine as reduction of their legitimate benefits. A compromise—for which there is some precedence since 2001—is for the government to collect the fine, and use it to increase the rate of return on FGTS accounts above the currently guaranteed amounts. This would reduce the perverse incentives under the current scheme, and may even serve as a cyclical stabilizer. The report discusses several other intermediate alternatives.

141. The main effect of these reforms would be to lower turnover to more normal levels, and hence increase productivity as firm-specific investments increase. These changes will also make labor relations less adversarial, and hence promote employment growth.

Move Negotiations from Labor Courts to the Workplace

142. The current design of labor regulations, the functioning of labor courts, and the manner in which unions operate all result in most worker-firm negotiations taking place after the contract is dissolved and not—as is the practice in better functioning labor markets—before the contract is signed, or after some time on the job. Encouraging negotiations while on the job and not in courts will reduce litigation and lead to higher employment and productivity.

Brazil's labor policy priorities are to eliminate subsidies for labor turnover, change the locus of negotiations from labor courts to the workplace, lower the minimum mandate down from the middle, and widen the safety net for workers

143. A proposal in Brazil is to increase the role of unions to offset the reach of labor courts. While a shift in negotiations from courts to unions will help, it is not a universal panacea. Collective bargaining laws in Brazil do not encourage unions to be representative of workers' interests. The law that requires all workers to pay dues to unions whether or not they belong to one and the stipulation that there should be only one legally recognized union for each occupation and city implies little or no competition in the market for collective representation of workers. So these laws would have to be changed—no easy task because this would require changes in the federal constitution.

144. But even if these laws were changed, labor outcomes will not improve at once and for everyone. This report has documented that while the main clientele of labor courts are poorer workers, unions in Brazil traditionally represents better paid, more skilled workers. While there is a law that extends union-negotiated terms of employment to all workers, large union-nonunion earnings differentials are evidence that this law is ignored. Therefore, more reliance on unions may still leave poorer workers with no choice but to revert to the current system of bargaining—in labor courts. These changes may reduce litigation among wealthier workers, but not among the poor; inequality in access to formal sector employment may thus increase.

145. And inequality concerns in a country as unequal as Brazil are not peripheral but central. If collective bargaining laws were changed, union membership would rise and litigation would decrease. And if the manner in which labor courts function were reformed there would again be fewer lawsuits. Reduced litigation will reduce the uncertainty regarding costs associated with employing workers, and hence increase formal sector employment. To the extent that this would lower turnover, it would also increase productivity.

Lower the "Minimum" Mandate Down From the Middle

146. The standard neoclassical solution proposed by many labor economists also appears to fit Brazil—lower ***mandated*** non-wage benefits. This is the one change that would help on all fronts—employment growth, productivity, income security—and would especially help low wage workers. This may seem somewhat paradoxical: after all, is it not the poor who most need protection under the law? The analysis in this report shows that the laws and institutions are ***hurting*** those whom they were originally designed to protect.

147. Changes in the demand and supply of labor have resulted in the "standard contract" as stipulated under the CLT and the Constitution becoming more and more unsuitable for workers and firms. Labor institutions and rules designed to regulate employment of heads of households working in large industrial enterprises are now being used to regulate a world of workers employed in small

and medium sized service-oriented enterprises with a growing share of women. The standard contract is suited for a smaller and smaller share of workers, and the most obvious sign of its rejection is the growing share of workers without a signed working card (*sem carteira assinada*).

148. Another important concern in Brazil is the large disparity between the poorer northeast and the richer, more industrialized south and southeast. The report shows that mandating a high federal minimum wage and non-wage benefits unintentionally exacerbates inter-regional differences in the quality of jobs instead of making labor market outcomes more uniform across the country.

149. While minimum wage setting is now regionalized, the federal minimum has risen rapidly since 1995. All signs are that this has led to reduced income security in the poorer northeast, while not helping workers in the richer parts of the country. Allowing workers and employers to customize contracts will increase formality and extend the safety net to poorer workers. This can best be accomplished by reducing the minimum mandate regarding non-wage benefits such as vacations, overtime restrictions, and severance payments, and by regionalizing minimum wage setting and keeping the federal minimum wage moderate so that poorer, less productive, workers are not pushed into informality.

Widen the Safety Net for Workers

150. Brazil's income support programs have two major shortcomings. The first is that there is duplication of benefits for formal sector workers. Thus, while benefit levels are not always generous, formal sector workers who lose their jobs can access FGTS savings accounts to which their employers have contributed, they usually receive 40 percent of the account balance, and generally also receive unemployment benefits. Low wage formal sector workers also get a Christmas bonus from the government (*abono salarial*) and their employer.

151. The second shortcoming is that—in sharp contrast—informal sector workers get nothing. While it can be argued that informality is a deliberate choice for some, it is difficult to support the claim that *everyone* in unregulated employment has chosen this over a job in the regulated sector. In general, many wage and salaried workers are believed to be in the informal sector because these are the only jobs on offer for them, as compared with many of the self-employed who may be there by choice.

152. The changes proposed above will increase the share of the workforce that is formal. But even so, informality will be a fact of life for some years, and the safety net should be extended to increase income security for the informal wage and salaried. This report offers options for doing so, one of which addresses both the problem of duplication and of insufficient coverage. This is the proposal to redirect the current unemployment insurance program—under which benefits are funded by a tax on sales and occasionally paid to those who have found work—to the informal wage and salaried. The table below summarizes the main recommendations, effects on functioning, and the principal effects on outcomes.

The optimal sequencing of reforms is difficult to determine, but Brazil should probably start by reforming severance schemes—especially the FGTS—and expanding the coverage of income security programs; improving collective bargaining and reducing the level of mandated benefits will be more difficult

Policy Recommendations, Effects on Functioning, and Impact on Outcomes

Recommended Policy	Impact on Labor Market Functioning	Impact on Labor Market Outcomes
Reform Severance Payment System (a) Pay market rates on FGTS accounts (b) Make the fine go to workers' fund to increase interest rate on FGTS accounts (c) Make FGTS fine payable to the Government and not the workers (d) Eliminate the fine for unjust dismissal	Primary: **Lower turnover** Secondary: Lower litigation	Primary: **Higher productivity** Secondary: Higher employment
Lower Minimum Package (a) Make use of regional minimum wage setting (b) Reduce mandated non-wage benefits	Primary: **Lower informality** Secondary: Lower litigation	Primary: **Better social protection** Secondary: Higher employment
Encourage Negotiations in Workplace (a) Greater freedom in creating unions—eliminate *unicidade sindical* clause (b) Greater competition for unions—eliminate mandatory union contributions	Primary: **Lower litigation** Secondary: Lower turnover	Primary: **Higher employment** Secondary: Higher productivity
Make Contracts More Flexible (a) Allow wages to be adjustable downward (b) Allow collective contracts to be lower than previously negotiated contracts	Primary: **Lower turnover** Secondary: Lower litigation	Primary: **Higher employment** Secondary: Higher productivity
Improve Functioning of Labor Courts (a) Eliminate inconsistencies between CLT and Constitution (b) Assess the usefulness of *poder normativo* (c) Assess arbitration rules and fairness of court decisions	Primary: **Lower litigation**	Primary: **Higher employment**
Widen Safety Net for Workers (FAT) (a) *Seguro Desemprego* redirected to informal wage and salaried (b) Micro-credit directed to self-employed and micro-enterprises (c) Training and job search assistance directed to formal sector job seekers	Little impact on labor market functioning	Primary: **Better social protection** Secondary: Higher employment
Improve In-service Training (S system)	Little impact on labor market functioning—works through quality of labor supply	Primary: **Higher productivity**

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