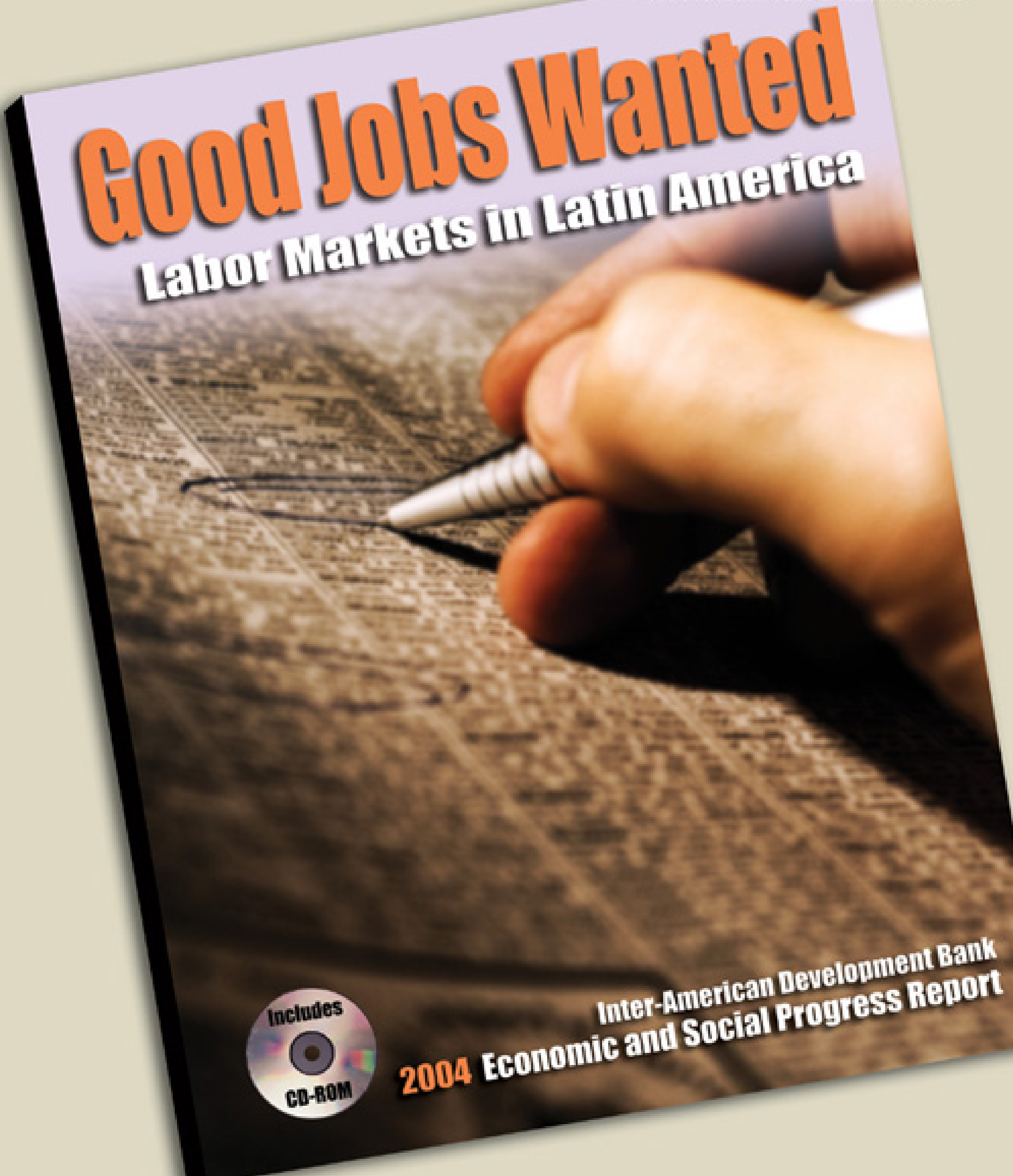
PREVIEW

"This book provides an up to date summary of the best available evidence on the causes and cures of Latin American labor market problems."

—James Heckman, University of Chicago
Nobel Laureate in Economics



Introduction

People and their jobs: What could be more basic to a person's wellbeing? Where people work determines how they live, how their families live, and how economies perform. The quantity and quality of jobs available has implications for individuals and countries alike.

That is why the problems with Latin America's labor markets are so worrisome. Unemployment, underemployment, job instability and low wages are not just personal problems, they are national problems as well—and much of the region is suffering from them. Unemployment is at its highest in years; much of the labor force earns poverty-level wages; wage inequality is one of the highest in the world and is not getting any better; and while the probability of losing a job is high, only a dwindling minority of workers is insured against this risk. Not surprisingly, in public opinion surveys, Latin Americans identify unemployment, low wages and job instability as the most pressing problems in the region, ahead of corruption, crime and other troubling social ills.

Given the importance of this topic, the Inter-American Development Bank made labor the focus of its annual Economic and Social Progress Report in Latin America. The report presents an anatomy of Latin American labor markets, a diagnosis of their ills, and prescriptions for treating these ailments. The in-depth research and analysis within its pages make it an invaluable resource for academics and policymakers alike. This brochure offers but a sampling of the wealth of information available in:

Good Jobs Wanted:
Labor Markets in Latin America

Faces of the Latin

Juan &

Juan was laid off from his job at the electric company after nearly 10 years of service. In the run-up to the company's privatization, thousands of employees were let go in order to clear the decks for the new owners. Fortunately, the government sweetened Juan's severance package, which gave him some breathing room to look for a job. Still, months passed, the benefits were running out and he had few promising leads to follow.

Although thousands became jobless overnight as a result of the privatization, not everyone had a hard time finding employment. A firm that did contract work for the newly privatized electric company, for instance, quickly hired Juan's boss. Juan even knew of people who were rehired by the same company once it was sold. But Juan also had many friends who, like himself, were displaced. Some of his younger coworkers were worse off than he was, since their benefit packages were smaller and they had less experience to offer in the marketplace. With no national social insurance to fill in the gaps, many of these people were forced into menial jobs that paid less than what they were making at the electric company.

At age 38, Juan had quite a few years' experience under his belt, but he never graduated from high school. He realized now what a costly error it had been to drop out of school. The lack of a diploma limited the salary he could command, even compared with what high school graduates would make. He could hardly imagine what a college graduate would earn.

Fortunately, Juan learned some important skills during his years at the electric company. There had to be someplace where he could put his experience to work. The problem was how to locate those potential employers. Juan pounded the pavement, inquired with friends, and combed the want ads. But beyond that he was at a loss as to how to proceed in his job search. Sadly, there were few resources or services in the marketplace available to the jobless.

Juan wanted to find another job in a company that could provide him with some security and benefits. However, as time passed he increasingly entertained the idea of starting his own small business. After all, he had learned a lot about electricity in 10 years on the job. He liked the idea of being his own boss. Still, Juan was realistic—working on your own is risky business. Maybe he would just pack up his bags and leave. He'd heard there were plenty of jobs in the United States. But that too is risky business.

Neither María nor Juan are real people, but their stories illustrate very real aspects of the Latin American labor market. Some of the facts behind these fictional profiles can be summarized as follows:

◎ Latin America has witnessed a huge increase in female labor force participation in recent years. Women of all educational levels are working more than a decade ago, but the largest increases have been among the least educated women.

◎ Unemployment has increased substantially and is higher among urban, female, young and semi-skilled workers.

◎ Job turnover is pervasive in Latin America. About one in every four jobs is created or destroyed in a given year.

◎ Social insurance is a rarity in Latin America, making unemployment a luxury few people can afford. Less than half of all workers enjoy severance benefits, which is the

American Labor Market

María

most prevalent form of social insurance in the region.

◎ After losing their jobs, workers often take substantial wage cuts and work at jobs unsuited to their skills. On average, displaced men tend to suffer larger wage losses than displaced women. Similarly, workers displaced from jobs that did not entitle them to social security and severance benefits have higher wage losses than covered workers.

◎ Most unemployed workers in Mexico and Argentina, the only countries for which job transitions could be studied, find jobs in the uncovered (or informal) sector. In Argentina, 81 percent of the unemployed who find work do so in jobs that do not offer social security. In Mexico, the figure is 62 percent.

◎ Many prime-age workers who become unemployed move into self-employment, small firms, or jobs without benefits. In Mexico, prime-age workers who become

María had to find a job. Her husband's income just wasn't enough to cover all the family's expenses anymore. In the past two years he had been laid off three times, and while he had been lucky enough to find a new job, each time he had settled for a lower salary. After all, with no savings to speak of and no unemployment insurance or other benefits to tide him over, he couldn't afford to remain unemployed. Consequently, he was working more, for less, and María had to join the job market.

But María wasn't the only woman in her neighborhood looking for work. Many of her friends were in the same situation, looking to bring in a second salary to compensate for their husbands' shrinking paychecks. In fact, it seemed that the city was full of women looking for work, although many were being pulled into the workforce by attractive opportunities rather than pushed by the demands of shrinking family budgets. How times had changed, María thought. It used to be that few jobs were open to women, but only a few women were interested in working anyway. Nowadays, women who worked were the norm rather than the exception—but that didn't mean that finding and keeping a decent job was easy. In spite of the changing times, María had discovered first hand that the job market could still be a hostile place for women. Juggling responsibilities at home and work was a daunting task and one that most men simply do not face. It seemed unfair that María had to work harder to meet all her obligations and was actually paid less than the men who worked with her.

And then there was the question of labor laws. They were supposed to protect workers, but María had seen that some companies ignored the laws altogether. When the laws *were* followed, they often ended up hurting workers more than helping them. For example, the laws supposedly ensured workers a fair wage, but about a year earlier, María had been hired by a small textile firm that paid her less than the minimum wage. She worked there a few months, but once she paid for transportation every day, the meager wage was hardly worth the trip. And going to work every day meant that she had to leave the children home alone after school.

That was when María made the decision to set up her own day care center. She could provide a service to her neighbors, take care of her own children, and make some money as well. She also did some sewing on the side. Together, these activities allowed her to round out her family's income. In fact, her day care business was so successful that she had too many children to take care of alone. Her oldest daughter had to quit school and help her out. Maybe later she would go back, but for now she had to help out at home.

unemployed experience higher wage losses than younger and older workers. Prime age men are also more likely to find jobs in the above-mentioned categories of employment than prime age women or younger workers.

◎ Labor legislation in the countries of the region tends to be heavy on regulation but often poorly enforced. Worse yet, legislation often operates against the workers it is designed to protect.

◎ Compliance with the minimum wage is not universal and is lowest in countries where the minimum wage is relatively high.

◎ The International Labor Organization estimates that 18 million children in Latin America are involved in economically productive activities that directly or indirectly raise family income.

◎ The increase in skill premia has been significant. A worker with secondary education earns about 50 to 60 percent more than a worker with primary education. This differential is even larger for workers with tertiary education. On average, a college degree increases earnings by another 85 percent.

◎ Unions bargaining on behalf of their members can impact a firm's efficiency.

◎ Payroll padding is common in public sector firms, and layoffs have been inevitable as these companies are slated for sale to private owners. Many workers were displaced by privatization but were re-employed either by the same firm or by subcontractors and suppliers of the privatized firm.

◎ Latin American immigrants to the United States, up from 1.8 to 4.3 million between 1971 and 2000, are more educated and more likely to be economically active than the compatriots they have left behind. However, they are less educated, on average, than Americans.

◎ Few resources or services are available to the unemployed in Latin America to aid them in their job search.

These points highlight some of the most salient characteristics of today's labor market in Latin America. Despite its abbreviated form, the summary gives a good idea of the complexity of the environment in which the people of the region work. The next question to ask is, what determines this environment? How does the functioning of labor markets in Latin America condition the lives of workers like María and Juan?

"The many myths about the workings of Latin America's labor markets hamper our ability to redesign labor policies and institutions in order to improve opportunities and create more and better jobs. Good Jobs Wanted: Labor Markets in Latin America *is a comprehensive and systematic study that marks an important step towards a better understanding of complex labor related issues. It makes clear that there are no easy solutions for Latin America's urgent problems, and that policymakers face complicated challenges and tradeoffs."*

— Jaime Saavedra

How Do National Labor Markets in the Region Fare?

Labor markets determine the lives of millions of people, with each person's story as different, complicated and personal as those of María and Juan. The functioning of labor markets is a monumental task, and one that is carried out with varying degrees of success in different countries. Specifically, labor markets must carry out three major functions: allocate resources, incomes and risks. How well the labor market in each country does these jobs determines how efficient and equitable that market is.

When a labor market allocates resources, it matches workers with jobs. In an efficient job market, all workers willing to work find jobs that match their skills, and no job vacancies are left unfilled. A key point is that not only should workers have jobs, but also that they should have the right jobs given their education, skills, experience and the needs of the marketplace. If Juan the electrician is forced to take a job as a security guard in order to make a living, this may not be an efficient allocation of resources. Other indicators of how efficiently a market allocates resources include how long workers spend trying to find employment, the share of workers that would like to work more hours, and whether certain types of workers—distinguished by gender, age, skill or profession—suffer more than others from unemployment.

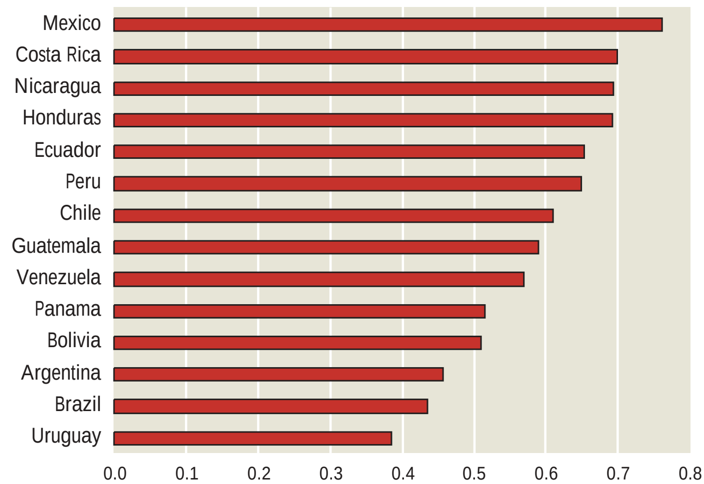
Overall, the performance of labor markets in Latin America in terms of fitting workers to jobs has been mixed during the 1990s. Some countries have persistently high unemployment rates, while others have rates that are perhaps too low for workers to be properly matched to good jobs. Many countries saw their unemployment rates rise towards the end of the decade when economic growth was slow. On the other hand, long-term unemployment is low in the region when compared to Eastern Europe or industrial countries. This rate was largely unchanged during the 1990s, although there were wide variations between countries. People spent longer looking for jobs in half of the countries in Latin America than in the United States. Moreover, where workers found jobs quickly, it may be that the lack of social insurance pushed them to take a less desirable job rather than wait for a good match.

As far as the burden of unemployment on certain types of workers, women and youth suffered far more than men and prime-age workers. However, these unemployment gaps did not change much during the decade. Urban to rural unemployment gaps were also very large, although the relative difference actually fell during the period. Regarding skill levels, unemployment did not seem to be worse among the unskilled. If anything, the opposite seems to be true, with university-educated workers increasingly more likely to be jobless than their less skilled counterparts. All told, labor markets in Mexico, Honduras, Guatemala, Peru and Chile did the best in allocating workers to jobs, while Colombia, Panama, Uruguay and Paraguay did the worst.

The second major task of labor markets is to allocate earnings. Are workers paid a fair wage? That is a basic criterion on which to judge a country's labor performance.

Summary Measure of Overall Efficiency in Labor Market Performance

(Index, 0-1)



Source: IDB calculations based on household survey data; Latinobarometer (1997); World Economic Forum (2001).

In a region where wage inequality goes hand in hand with income inequality, and where nearly half of workers in several countries earn less than $1 per hour, the knee-jerk response to this question would likely be that workers are not paid a fair wage. But it is important to clarify what is meant by "fair." The answer is twofold. First, fair refers to whether a worker is paid what he or she is worth; stated differently, the wage should reflect the worker's productivity. Second, workers of similar productivity should be paid similar wages regardless of gender, firm size or sector of employment.

Wages across the region have remained virtually stagnant over the past decade. However, contrary to popular belief, this is not because employers have chipped away at the workers' share of output. Actually, wages and productivity have remained pretty much in line. The problem is that for Latin America as a whole, labor productivity growth in the 1990s was practically zero. Thus, using this yardstick, wages may be low, but they are "fair" when compared to productivity.

Labor markets would seem to be less fair when wage differentials are considered. Employees of large firms earn 29 percent more on average than employees of small firms. Workers in construction, retail, restaurants and hotels are paid less than those in manufacturing, while those in business and finance tend to earn more. Latin American men earn on average 26 percent more than women of comparable age and education. Interestingly, however, as lamentable as these differentials may be, they are not unlike those in the United States, where inequality is lower than in Latin America but still high by industrial country standards. The "unfairness" of Latin American labor markets in allocating earnings does not seem to come from here either.

Indeed, not all inequality in terms of earning is created in the labor market. Clearly, wage inequality exists, but much of it is simply *reflected* by the labor market, not caused by it. Instead, workers are paid very different wages because they are very different individuals. Variations in education, experience and gender explain an average of 35 percent of the labor income concentration in the region and about half of the concentration in Argentina, Costa Rica, El Salvador, Panama and Honduras. By far, educational differences account for the lion's share of inequality, explaining an average of one-fourth of labor income concentration. Thus, the difficulties of María and Juan in finding a job, and more specifically a well-paying job, are due largely to their own educational characteristics, not the limitations of the labor market.

All told, Latin American labor markets allocate incomes reasonably well, despite widespread wage inequality and low wages throughout the region. The problem is not so much the market. The problems are the snail's pace at which productivity has grown and the disparities in personal endowments, namely education.

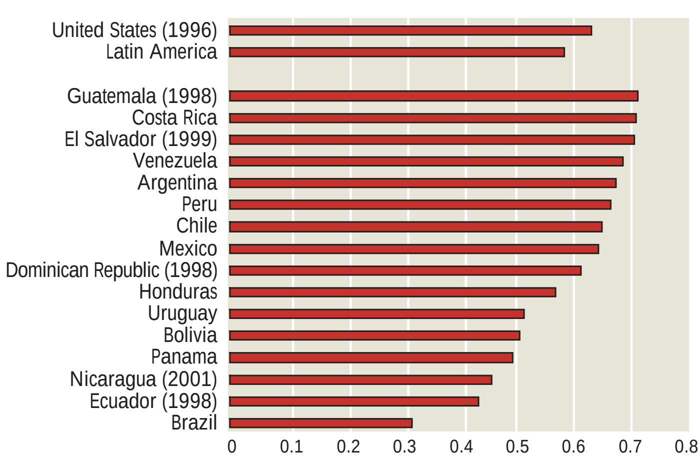
Labor markets also allocate risks. What risks do workers face that could result in income losses? The most obvious risk is of losing their jobs. Workers who are displaced from their jobs not only lose income while they are unemployed but may suffer a further loss if they end up finding a job that pays less than what they were making before.

In a well performing market, workers are protected against the risk of income loss. One way to protect against risks is if the labor market adequately performs its first function to properly allocate resources. If workers find new jobs quickly, their loss of income is kept to a minimum. For those who are left unemployed, unemployment insurance provides a cushion of support. Unfortunately, few countries in the region offer this benefit. Instead, the mechanism of choice in Latin America to insure these risks has been mandatory severance pay and indemnities for dismissal. If a firm fires an employee, that worker is entitled to compensation—and sizable compensation it is in many countries. That's why Juan could take his time looking around for another job and consider such options as opening up a business on his own or migrating, options that require at least some capital to explore. Social security programs that offer old age pensions and health/maternity benefits are also fairly common, but provide far fewer benefits than in industrial countries.

If severance pay is so high and other social security benefits are higher than in much of the developing world, then why do so many Latin Americans work under the threat of unexpected illness, job loss or poverty in old age? The problem is coverage. On average,

Summary Measure of Efficiency in Allocation of Incomes

(Index, 0-1)



Source: IDB calculations based on household surveys.

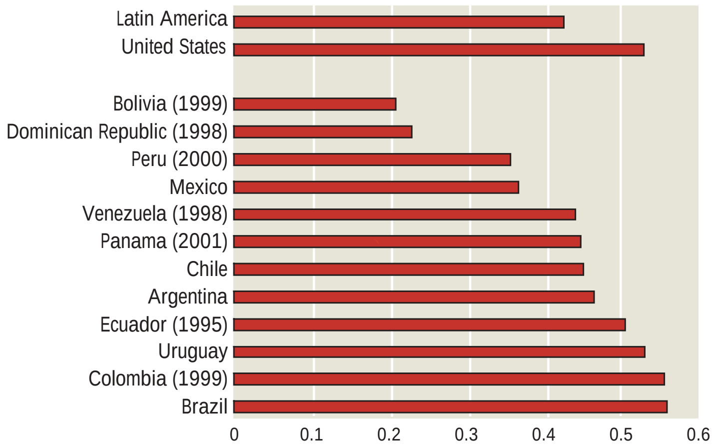
only 44 percent of workers in the region are protected by labor laws. María's husband was not covered and he was forced to take the first job that came his way, even though it meant a wage cut and pushed his wife into the labor market. To make matters worse, enforcement of labor laws in the region is poor. Therefore, the few who are entitled to benefits cannot always cash in on what they are due. Once coverage and enforcement are considered, the levels of insurance around the region turn out to be very low, particularly in Mexico, Peru, the Dominican Republic and Bolivia. Only Brazil and Colombia have insurance levels comparable to the United States, where benefits are low by industrial country standards. For too many workers, the risk of losing their source of income is a very real and catastrophic possibility. It is no wonder that public opinion polls identify poor labor market performance as a main concern for a growing number of people in the region.

How do countries stack up in terms of the efficiency of their labor markets? When the efficiency of markets in allocating resources and incomes is aggregated and the quality of labor market relations is factored in, Mexico, Costa Rica, Honduras and Peru come out in the lead, while Argentina, Brazil, Panama and Uruguay show the greatest room for improvement. But efficiency is not everything. Indeed, equity may be equally important for some governments. The good news for policymakers is that at least in this case they may not have to make a choice. When efficiency is tracked against equity, there does not seem to be a tradeoff. In general, the better the labor market functions, the lower are the wage differentials between comparable workers and the higher is the measure of equity. The rub is with insurance. Those countries that best protect their workers against the risk of losing labor income also tend to be the least efficient in the performance of their labor markets.

Clearly there are important tradeoffs for policymakers to consider, and the consequences can be ponderous in both political and economic terms. Weighing the costs and benefits of policies and making the right decisions can be as crucial to the future of governments as it is to the future of people like María and Juan.

Summary Measure of Insurance

(Index, 0-1)



Source: IDB calculations based on household survey data and data on severance pay, indemnities for dismissal, and advance notice from Heckman and Pagés (forthcoming).

On Second Thought:

Dispelling Myths about the Latin American Labor Market

First impressions of people are often misleading. The same is true of economics. Since Latin American labor markets deal with both people and economics, it is not surprising that closer scrutiny of many commonly held beliefs has turned up some unexpected results. Concepts that may seem straightforward on the surface are in fact far more complicated once they are researched and analyzed. The statements below reflect common perceptions that at first glance seem logical, but on second thought reveal some interesting twists.

Unemployment is the bottom line when it comes to problems in the labor market.

Actually, it's only the tip of the iceberg. Many people who are employed work in low paying jobs, hardly eking a living. Besides, figures on unemployment also ignore the vast majority of activity that occurs in the labor market. In any given year, an enormous number of firms expand their workforces while many others trim their payrolls. And this happens in boom years and recessions alike, in industry and agriculture, in big and small firms, and in seasoned companies and market newcomers. In short, focusing on unemployment risks missing all the action. Total job turnover, measured as the sum of all new jobs created in a given year (job creation) and all old jobs destroyed in a given year (job destruction), gives a good idea of the enormous task accomplished by the labor market. In a sample of 12 Latin American countries, job turnover ranges from 16 to 35 percent. Total job turnover is orders of magnitude higher than the unemployment rate. In the case of Brazil, for instance, a change of 1.1 percent in the unemployment rate hides an impressive amount of activity in the labor market; gross flows indicate that each year one out of three jobs is either created or destroyed, meaning total job turnover is 31 percent.

Interestingly, this high level of job reallocation characterizes both developed and emerging market countries. The Latin American countries for which data are available show turnover rates within the ranges observed in developed countries. This is a surprise, considering that labor market regulations vary widely across countries.

But do all these gyrations in the job market really matter? Shouldn't the focus be on those who lose out in this game of musical chairs? In other words, even recognizing that there is an enormous amount of activity in the job market, isn't unemployment what's really important?

Not entirely. To begin with, focusing exclusively on the unemployed assumes that everyone else who has shifted around in the job market is a winner. This is far from the truth, particularly in Latin America, where most workers are ill prepared for this high level of mobility because social insurance covers only a small number of workers. Most workers cannot afford to remain without income while they search for jobs.

These workers are forced to grab the first job that comes their way, even though waiting for a job that better fits the workers' abilities would result in higher productivity and, therefore, higher wages. The fact that wage losses tend to be higher for workers who change sectors or have higher tenure suggests that specific skills are lost in the process of displacement. Employers and employees alike may lose out as workers accept jobs below their ability or in areas not suited to their skills. Add to this the likelihood that re-employed workers will have to accept a wage cut and it is no wonder that in 1996, public opinion surveys revealed that more than 85 percent of Latin Americans were either unemployed or worried about losing their jobs. By 2001, this concern had increased in 11 of the 17 countries covered by the survey. The policy implication is that it is important for workers to have flexible skills and some kind of social insurance to reduce the cost of job instability.

Looking beyond unemployment to the massive movements in the job market also has important implications for growth and productivity. The lion's share of job reallocation is associated with firm-specific shocks that reflect changes in the demand for firms' products, the cost of inputs, or the technology used by individual firms. In other words, job turnover reflects the wide variation in firms' performance.

The fact that much job reallocation derives from plants that start up or shut down each year indicates that the owners or managers of young firms continuously adjust their production and labor force based on their changing perceptions of market conditions and production costs. This process of trial and error is important for growth. In countries with low entry and exit costs, entrepreneurs will launch many projects and follow through with the most promising ones. In countries with high entry and exit costs, entrepreneurs will have limited incentives to experiment and many good projects will never be tried. This also indicates that perennial churning is both a cause and a consequence of productivity growth. In fact, research has shown that the fact that less productive plants exit the market and new ones enter accounts for between 20 and 40 percent of total productivity growth. These results highlight the importance of having low entry and exit costs for firms.

Market economies are extremely fluid and require a constant reallocation of resources (employment) to their most efficient use. Losing sight of all this activity or obsessing on rates of joblessness risks turning a blind eye to key factors in promoting productivity, growth and welfare among workers, firms and economies as a whole. In fact, the main challenge of public policies in this area is how to keep the growth engine running while providing adequate insurance for workers.

Latin America's macroeconomic volatility has had a profound impact on employment.

Actually, no. Intuitively, it makes sense that when economic conditions are good, employment increases and unemployment declines. Similarly, when the economy slumps, it should drag down employment and boost unemployment. But in Latin America, this is generally not the way it works—or at least, not

Average Annual Gross Job Flows in Manufacturing

(Percentage of employment)

Source: IDB calculations; Davis, Haltiwanger and Schuh (1996); Barnes and Haskel (2002); Gronau and Regev (1997); Kaplan, Robertson, and Martínez (2003); Medina, Meléndez, and Seim (2003).

as much as in other parts of the world—and that may be good for the region.

There's no arguing that labor markets in Latin America operate in an unfavorable macroeconomic environment. Over the last 30 years, average growth of per capita income in the region has been just above 1 percent. Only sub-Saharan Africa and the Middle East did worse than Latin America. Not only has Latin America's growth been slow, but, because of its high degree of economic volatility, it could also be described as "unsafe at all speeds." Again, only Africa and the Middle East have been more volatile than Latin America.

How does economic volatility affect labor? A negative shock to aggregate demand can play itself out in the job market in one of two ways: either employment levels can drop, or part of the shock can be absorbed through an adjustment in wages.

Is it better to adjust to crises through lower wages or through higher unemployment? Despite the difficulty of making a value judgment on which adjustment mechanism is better, the truth is that wage adjustment helps spread out the cost of a crisis, while unemployment has a much more unequal effect. In fact, besides being inefficient by leading to a waste of resources, wage rigidities create winners and losers and may increase inequality. Workers who keep their jobs at wages above the level likely in the absence of rigidities are clearly better off, while workers who are involuntarily unemployed are worse off. In theory, losers could be compensated with unemployment benefits and the like. In reality, compensation is common in wealthy industrialized countries and rare in Latin America.

To make matters worse, all social classes do not suffer equally from the increase in unemployment. Workers with low skills and low income are often the first to be either laid off or to move to low-quality jobs. From this point of view, recessions have negative distributional consequences and play an important role in expanding poverty.

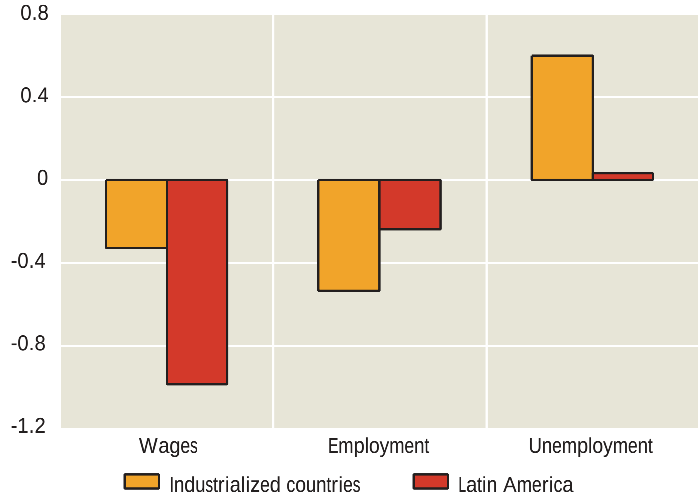
When wage, employment and unemployment volatility in Latin America and industrial countries are compared, the contrast is striking. Although Latin America's GDP is much more volatile than that of the industrialized world, the volatility of Latin American employment and unemployment is not very different from that of industrialized countries. However, this relative stability in terms of employment is more than offset by very volatile real wages. Latin American real wages are five times more volatile than real wages in industrialized countries.

But times are changing, which may explain why unemployment rates have reacted so virulently to the economic shocks of recent years. In Latin America, high wage flexibility seems to be the result of two ills: high inflation and low enforcement of labor laws. As inflation drops and enforcement of labor laws improves, countries are likely to adjust to macroeconomic shocks less via wages and more via employment and unemployment.

Since GDP volatility varies so much between Latin American and industrialized economies, comparing the wage and employment responses of each provides a somewhat distorted picture. But when the income shock is the same—say, 1 percent—the picture comes into clear focus. In industrial countries, when GDP declines by 1 percent, unemployment increases by 0.6 percent, employment drops by 0.5 percent and real wages dip by 0.3 percent. In Latin America, on the other hand, if GDP shrinks by 1 percent, employment and unemployment have a smaller response (0.24 and 0.28 percent, respectively while wages adjust far more dramatically (1 percent).

Clearly, when compared with industrialized countries that can provide better safety nets for unemployed workers, Latin America adjusts to an income shock more through wages than through employment. This helps spread the cost of an economic crisis more evenly, which is no minor point for a region that already suffers from the greatest inequality in the world. One can only imagine how high unemployment would be in the absence of this wage volatility.

Effect of a One Percent Decrease in Output on Wages, Unemployment and Employment



Notes: The coefficients were obtained by running a set of fixed effects regressions where the dependent variable is real wage, employment or unemployment growth, and the explanatory variable is real GDP growth.

Liberalization and privatization have destroyed many jobs.

False. The dire predictions by critics of reform never came to pass. The truth is that liberalization affected the level and composition of employment minimally, and while privatization eliminated many redundant jobs, it had little effect on total unemployment. But free marketers should hold their applause. Liberalization has in fact reduced salaries, particularly those of unskilled workers, and many employees who stayed on in privatized firms have seen their working conditions deteriorate. In short, critics and reformers alike have had to eat their words and rethink their positions vis-à-vis the effect of reforms on labor.

Latin America's experience with reform is full of surprises. To begin with, liberalization did not produce the massive shifts of resources to potentially more efficient sectors that economists predicted. Nor did the increase in imports displace employment in the tradable goods sectors. All told, changes in the composition of employment were modest, as was the effect on unemployment. This too was a surprise, even for economists who were bracing for at least an initial surge in unemployment as workers moved from sector to sector.

That's the good news. On the down side, economists were also surprised to see real wages fall with liberalization, especially in industrial sectors. According to neoclassical instincts, workers' wages follow their marginal productivity and liberalization should lead to a more productive use of all resources, including labor. Moreover, liberalization should reduce the rents that favor capitalists on the one hand and reduce the prices of goods for workers on the other. However, things did not turn out as expected. The hitch is that apparently workers shared in these rents and were forced to give them up and watch their living standards decline in order to keep their jobs. Industrial wages may also have suffered when the doors flew open to goods from countries with low production costs that competed with domestic products.

Another unpleasant surprise for economists concerned the wage gap between skilled and unskilled workers. Instead of shrinking as many had expected, the gap actually grew. While the debate rages on over the magnitude and causes of this effect, the fact remains that the gulf between skilled and unskilled wages has widened in the wake of free trade reforms.

Open markets produced two more surprises, both related to the quality of jobs. Happily, the new jobs that have sprung up in the export sector have been comparable, and often better in quality and remuneration, than other jobs. Unfortunately, however, as trade barriers have come down and imports have flooded in, some countries—particularly those with restrictive labor legislation—have reported an increase in the share of jobs without benefits and in firms with less than five employees.

Privatization was another big area of reform in the 1990s, and as with liberalization, the vision of its effect on employment has at times been distorted. Public opinion has decried privatization for the loss of jobs it engendered, while economists have pointed to the improved efficiency of privatized firms as a gain for government and consumers alike. But as with liberalization, both are right—and both are wrong.

Clearly, many jobs were lost when firms were privatized.

After all, bloated payrolls in many state enterprises were a political tool that could not be sustained when these firms shifted into private hands. However, even in countries where layoffs in privatized firms were massive, the effect on overall unemployment was small. In the most extreme case, Argentina, close to 150,000 people lost their jobs due to privatization between 1987 and 1997. Yet, even if all these workers remained unemployed (which they did not), privatization would still account for only 13 percent of the increase in unemployment during the same period. In other countries, there was even less of an effect. In Bolivia, for example, jobs lost when the electricity and telecommunications industries were privatized (by far the largest privatizations of the 1990s) explained just 3 percent of the rise in unemployment from 1995 to 2000. In Mexico, state enterprises employed about 4 percent of the urban workforce in 1983 when privatization took off. Ten years later, this proportion had slipped to 2 percent.

Even getting the numbers right, comparisons of employment before and after privatization can be deceiving. New hiring by the same firm or by its suppliers and contractors offset many jobs lost when firms were initially privatized. In Argentina, an estimated 80 to 90 percent of the personnel cuts in privatized firms were offset by new jobs in the same sectors over the following four years. In Mexico, the re-employment rate in the affected sectors is estimated at 45 to 50 percent in the year following privatization.

In Peru, nearly 20 percent of the people fired during the privatization process became subcontractors of the same firms by forming their own small companies in the transportation, water, mining, port and electricity sectors.

Improved productivity in many privatized firms also resulted in better wages and benefits for those who kept their jobs. In Mexico, for example, salaries in a wide range of companies privatized in the late 1980s and early 1990s soared an average 76 percent in the years that followed (through 1993), well above the average for the rest of the economy. Surprisingly, wage hikes were higher among blue-collar than white-collar workers.

But not all criticism of the effect of privatization on labor can be explained away. Working conditions often deteriorated during and after the privatization process. Organizational adjustments within newly privatized firms have usually gone hand-in-hand with changes in working conditions that translated into welfare losses for workers. Union influence and activity has often been restricted and longer work days have been blamed for a rise in accidents and health problems.

In sum, the impact of reforms on the labor market has been anything but clear. People on all sides of the debate have been hit by the unexpected. The advice for reform pundits and plaintiffs alike: Speak based on facts, not dogma.

Education is the silver bullet to solve labor market problems.

Not necessarily. If education were the answer, why are there so many well-educated Latin Americans who are unemployed or poor? True, education is a critical factor in developing a productive and competitive workforce. But without an adequate institutional and macroeconomic environment to back it up, education alone cannot put people to work or assure them a decent wage.

It is hard to argue with the fact that education outcomes in Latin America have been dismal. The region suffers from low levels of schooling, high dropout rates, poor quality schools and profound inequalities. The deficiencies of the education system are so acute that it is tempting to blame them for unemployment, low wages and other ills of the labor market. But as logical as this may seem, it masks a different reality. If education were the only problem, all well-educated people would have great jobs. That is simply not the case. Interestingly, the rates of unemployment are usually lower among less educated than among more educated people, and increases in unemployment, where they have occurred, have affected both low-skilled and high-skilled workers.

Undoubtedly, lack of education contributes to low labor productivity and poverty. However, it is not the only problem and may not even be the main cause. Workers' productivity depends to a large extent on factors beyond their control. If the economic and institutional environment discourages investment and innovation, or if financing and basic infrastructure are absent, labor productivity will be impaired and efforts to raise educational levels will do little to improve labor outcomes.

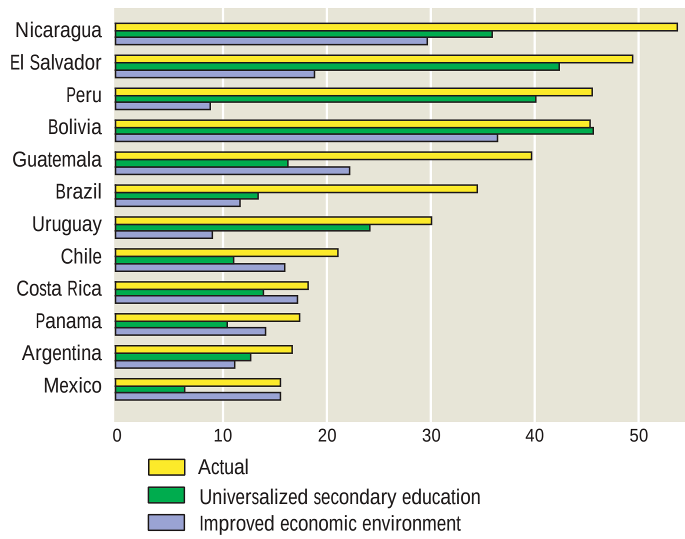
It is telling that many relatively well-educated workers in some countries are unable to scratch out a living. Their productivity is so low that they earn less than $1 per hour, which is not enough to provide even the bare necessities for their families. In Bolivia, 46 percent of workers with secondary education and 18 percent of workers with four years of university education earn less than $1 per hour. These percentages are similarly high in Nicaragua and Peru.

What can education do for the problem of low wages? Unfortunately, not much. A simulation of making secondary school universal shows that the effect would be disappointing. Even making the optimistic assumption that the increased supply of skills would not depress the return to education, over 30 percent of the workers in Bolivia, Peru, El Salvador and Nicaragua would still earn below the threshold even if everyone graduated from secondary school. Taking the average across countries, the percentage of low-paid workers would fall by only about one quarter, that is, from 36 to 27 percent of all workers—an impressive drop, but a Herculean task to achieve. In some countries such as Argentina, Chile, Costa Rica, Panama and Peru, this educational leap could be achieved in two decades at current rates of progress, or in one decade if educational progress zoomed to the levels achieved in Southeast Asia. In other countries, however, the mission is daunting. In Brazil, for example, average years of education would have to increase by at least four years, which at historical rates of progress would take another 40 or 50 years.

Clearly, more education by itself is not a ticket out of poverty. For expansions in education to really boost individual incomes, the effect of every additional year of education on wages (the so-called returns to education) has to be large. Interestingly, despite the sad state of educational systems in Latin America, the returns to education are in fact quite high. The problem is that a worker without education or skills in Latin America earns so little that even if additional schooling were to dramatically boost his or her wage in percentage terms, the worker would still be earning a pittance.

Scenarios for Reducing Low Productivity Jobs

(Percentage of workers earning less than $1 an hour)



Source: Duryea and Pagés (2002).

If education alone cannot boost wages, what can? The answer lies in the "quality" of the institutional and economic setting—the physical, service, regulatory and policy infrastructure—where workers live and produce. Just how important is the environment? Imagine the effect of a hypothetical simulation in which countries could instantaneously achieve the economic and institutional conditions of Mexico—the country with the best "underlying" conditions in the sample—as measured by the earnings of a person without education or labor market experience. The projected results are eye-opening: Peru's share of low-paid jobs would plummet from 46 to 9 percent, while El Salvador's share would shrink from 49 to 20 percent.

Certainly, increasing the level and quality of education is desirable, but it is not the silver bullet against unemployment and low productivity. If nothing else changes, more education will probably lead to more rather than less unemployment, and will do little to boost the productivity and wages of millions of workers in countries with weak economies and crumbling institutions. The message here is not to disregard education as a source of productivity, economic growth or social development. Rather, the warning is not to expect miracles from education if the economic and institutional milieu remains unchanged.

Technological change is a threat to workers.

Not at all. Technology and workers are not competing factors. Technological progress does not necessarily lead to less demand for workers. Actually, technology can help grow the economy, which means more jobs and better pay for workers. Indeed, Latin America should be far more concerned about the limited impact of technology on its economies than the potential harm caused by technological change.

The much-heard argument is that new technologies in Latin America have reduced the demand for labor, causing employment to decline and wages to stagnate. In fact, this could not be further from the truth. True, unemployment has risen in many countries. But technology is not to blame. The idea that technological progress reduces the need for workers is a phantom threat. History has proven this theory wrong time and again. Rapid technological progress and a significant increase in employment are not incompatible, as witnessed by Great Britain following the Industrial Revolution and the United States during the entire 20th century. The reason for this, of course, is that output is not fixed. Simply put, technological change leads to rising output instead of rising unemployment. For much of Latin America, the question is not whether technology has increased unemployment, but why the region has not been able to benefit more from foreign technology to increase domestic output.

In terms of wages, the concern is similarly misdirected. In principle, wages can stagnate either because workers are getting a smaller share of GDP, or because GDP fails to grow. Interestingly, labor shares of output have been very stable over time and across countries, ranging from the United States to East Asia. Is the experience of Latin America in recent years one of the few exceptions to this rule?

If labor's share were shrinking, the increase in wages should lag that of output per worker, or labor productivity. That is simply not the case in Latin America. Research shows that wages move proportionally with labor productivity. This means that the failure of wages to grow rapidly is not due to a falling share of income going to workers, but to slow growth in labor productivity. In other words, it is not that workers are getting a smaller slice of the GDP pie, but that the pie is not growing.

Sadly, labor productivity merely limped along over 1985-2000 in Latin America. In nine of 18 countries, the growth rate was negative, and overall it averaged -0.03 percent. Only four countries boasted growth rates in labor productivity above 1 percent per year.

How does technology figure into this picture? Since technological change cannot be measured directly, an indirect measure is to look at the growth of output that cannot be explained by increases in inputs. In this way, growth in labor productivity can be traced to two contributing factors: technological change and capital deepening. According to this measure, from 1985 to 2000, technological progress contributed nothing to labor productivity in the region. This is a sad statement indeed in this era of rapid technological change.

Unions are sand in the wheels of the labor market.

Not necessarily. Unions have played a key role in securing major welfare benefits for workers, often taking on repressive governments and exploitative firms. Of course, the priority of unions is not always economic efficiency, but worker-management relations in a union environment need not be the winner-takes-all game it is often portrayed to be.

With all the noise about union activity in Latin America, it may come as a surprise that only 18.3 percent of the workforce is unionized, below the world average of 23.8 percent. Interestingly, these low unionization rates are not necessarily a consequence of political repression and legal barriers. Rather, such regional characteristics as a young labor force and employment in small agricultural enterprises would make it difficult to unionize in almost any institutional environment. Surprisingly, unlike the pattern in developed countries, workers with less than a secondary school education are less unionized than more educated workers in the region, which may explain the perception that unions are a club for the elite that reinforces wage inequality.

Actually, unions have done just the opposite in many countries in Latin America, helping to reduce the wage gap, particularly between skilled and unskilled workers. Research shows that the greater the union affiliation, the better is the distribution of income. More specifically, a 10 percentage point increase in union affiliation is associated with a 6 to 10 percent decline in salary inequality. Wage gaps between men and women are also lower among unionized workers. Little wonder that wage inequality grew as union membership slipped during the 1980s and 1990s.

This effect on wage gaps is just one of the benefits unions have attained for their members. Overall they have secured better salaries, although the average 5 to 10 percent increase in earnings they have achieved is far less than the boost workers would receive from more education and is hardly a release from poverty for most members. Unions have also won better working conditions: working hours are lower, while severance pay, vacations, pensions and other benefits are generally better. Moreover, unionized workers tend to receive more training than their non-unionized peers.

Unions do, however, affect productivity, although not always in the same way. Whether their effect is positive or negative varies by industry, country and time period. A blanket case for or against unions cannot be made on productivity grounds. Careful attention to industry conditions, the structure of bargaining, industrial relations, and production methods is needed to assess the effects of unions on business productivity. Unions also raise wages, which may cut into profits. This raises concern over whether unions may affect firms' incentives to make new investments in plants, R&D and equipment.

Unions also raise employment levels, which may seem paradoxical, since unions increase the price of labor to firms. Actually, though, it is logical because unions are concerned with employment as well as wages. This is particularly relevant in troubled industries where unions have a special interest in preserving the jobs of their members. Greater coordination between firms and unions in the collective bargaining process may be what is called for to limit adverse effects. On the other hand, though, it is de-unionization, not unionization, that is associated with employment cutbacks. While such cuts may eliminate inefficiencies, the short-term costs of weakening union power appear to include job losses at the affected firms.

Nowhere is the reputation of unions worse than in the region's public sector. The high level of unionization is often blamed for the poor performance of many public services, most notably education. However, a closer look in some countries uncovers some surprises when student performance on standardized tests is used as a measure of educational success. Contrary to popular belief, studies in Peru find that unions do not have a significant influence on either teachers' effort or students' test scores. In Argentina, the results tell an even more interesting story of unions that influence class size and teacher satisfaction in ways that favor higher achievement test scores. Argentina's decentralized educational system highlights another important point. Provinces with a higher frequency of strikes are those with the greatest competition between unions and the most adversarial relations with government. In other words, neither competition between unions nor adversarial managerial relations—both supposedly disciplining forces for public sector unions—work well, at least in this case.

Economy-wide, it is difficult to reach conclusions regarding the impact of unions. On the one hand, unions appear to have played a role in delaying and diluting the reform process in Latin America over the past two decades. On the other, union density appears to have no correlation with economic performance indicators such as inflation, the unemployment rate, real compensation growth and labor productivity. Bargaining coverage, however, may be associated with higher real wage growth, lower employment rates and higher inflation. Using both measures, unions appear to have helped reduce wage inequality.

Perhaps the best answer as to whether unions are good or bad for Latin America is that it depends. It depends on who is talking; it depends on the country, industry and institutional context; and it depends on the degree of coordination between unions and firms in collective bargaining. The surest conclusion is that the story of unions and management need not be one of winners and losers. It can be a win-win situation.

The informal economy is the dark side of the Latin American labor market.

Not always. Self-employment sometimes offers a step up for people and a chance to increase their income. Thus, the informal economy is not always "dark." Nor is it a clearly defined "side" of the market. People constantly move in and out of so-called informal jobs. Focusing on the informal economy as the source of all labor ills risks turning a blind eye to other serious maladies.

What is the informal economy? It depends on whom you ask. For some it describes jobs that provide low incomes, low benefits, and little possibility of advancement. For others, informality is a measure of non-compliance with the state, or a means to get around labor laws or taxes. Still others, including the International Labor Organization (ILO), offer a more specific definition of informality as the sum of nonprofessional self-employed workers, domestic workers, unpaid workers and workers employed in firms with five employees or less. Each of these definitions describes a different set of workers. Yes, there is overlap, but there are also people who enter into one definition and not into another. The common thread is an underlying implication that jobs in this sector are "bad" and somehow inferior to jobs in the so-called formal sector.

Are all people who are self-employed or who work in small firms toiling away at miserable jobs? And are all miserable jobs in small firms? The answer to both questions is no. Many small firms may be low paying and have poor productivity, but they may also be thriving new enterprises. Many people may be pushed into self-employment because they have exhausted their employment options. However, people also voluntarily leave their jobs in large firms to strike out on their own, and some do very well. If self-employment is such a losing option, why do four out of five self-employed Brazilians prefer this status to a "formal" job? The answer may lie in the fact that many workers in large firms are paid below the minimum wage and receive no benefits in what are essentially dead-end jobs. In short, the distinction based on quality is very ambiguous.

Perhaps even more flawed is the dualistic view of the labor market. According to this view, the formal and informal economies operate in segmented labor markets and there is limited mobility between the two. Nothing could be further from the truth. On the contrary, there is high mobility across the informal and formal sectors, regardless of how these sectors are defined. Using the definition of an informal worker as one who does not receive the benefits mandated by labor laws, the average probability of an informal worker transiting to a job with these benefits is 16 percent in Mexico and about 12 percent in Argentina. The probability of a worker making the shift in the opposite direction is about the same. The magnitude of these movements is enormous: in a given six-month period, about 16 percent of workers in Mexico and 11 percent of workers in Argentina move either in or out of an informal job. If self-employment or firm size is used as the defining characteristic of informality, the same degree of movement is apparent. In a given six-month period, about 23 percent of workers leave self-employment to become wage employees in Mexico and Argentina. The reverse is less common. Only about 5 to 6 percent of salaried employees in these countries move to self-employment. About 16 to 17 percent of the workers employed in firms with fewer than five employees move to large firms while an even larger percentage of workers in medium-sized and large firms transit to small firms. The message is clear: at least in Mexico and Argentina, mobility between sectors is high.

Undoubtedly there are millions of street vendors, handymen and domestic workers who barely eke out a living throughout Latin America. But there are millions of workers in big-name companies who fare just as badly. At the same time, there are many self-employed painters, carpenters or workers in any number of other types of such jobs who lead productive, economically rewarding lives. There is no clear-cut line. In fact, there may be no line at all.

Treatments for Ailing Labor Markets

Latin American labor markets are hurting, and so are millions of dissatisfied and discouraged workers. Jobs are hard to find, pay is low and stagnant, working conditions are often dangerous, and there is no authority to turn to if workers are abused or neglected. What can governments do to relieve their pain and to help workers lead better and more productive lives?

To begin with, governments can help by adopting policies to reduce macroeconomic volatility and create stable and growth-friendly macroeconomic conditions. This would go a long way towards reversing the two-decade-long stagnation in productivity and, therefore, real wages. But this quest for a better macroeconomic environment and all that it promises should not blind policymakers to the very real risks that workers face every day in the labor market. Every year, a quarter of the total number of jobs are either created or destroyed and many workers will be displaced. The lucky ones will move from one job to another, but most will go through an unemployment episode, some will get stuck in unemployment, and still others will accept a lower paying job for lack of a better alternative.

There is no one-size-fits-all recommendation to help workers cope with this. In some countries with excessive regulation and a large number of legally mandated benefits, this job churning may spawn a large unprotected sector and long periods of unemployment. In other countries, lax enforcement may manifest itself in deteriorated working conditions and exploitative and confrontational worker-management relations. The mix and orientation of policies in each country should reflect the widely different contexts and the underlying endowment and distribution of assets, particularly human capital.

For this reason, before looking at policies it is important to look at the regulatory framework. Labor market regulations are often as much a part of the problem as they are of the solution. First and foremost, lack of enforcement of regulations damages the rule of law, a critical social asset. Regulations should be enforced and adequate resources should be dedicated to this task. Governments need to reverse the institutional and financial decay of the labor authority (normally the Ministry of Labor) that has resulted in de facto non-enforcement of core labor standards. Building and maintaining the administrative records that regulations mandate is essential for any labor policy to be effective. Without them, it is impossible to enforce the social contract as expressed in the laws and regulations that govern transactions in the labor market. Treating regulations either as untouchable sacred objects or as removable obstacles to efficiency does a disservice to workers and firms. The level of mandatory benefits, job security and minimum wages are legitimate policy variables. However, as with any remedy, there are side effects that need to be considered. Generous increases in the minimum wage may be a

Pyrrhic victory for workers who lose their jobs because firms simply use fewer workers to offset having to pay higher wages. Increasing mandatory benefits may end up hurting workers if firms reduce employment or offer employees substandard, unregistered contracts to compensate for the increased cost. To avoid that, current or desired levels of mandatory benefits need to be assessed in light of workers' willingness to pay for them. If workers value such benefits, and they are willing to pay for them in the form of lower wages, mandatory benefits do not affect demand by firms for workers. Thus, regulatory reform should be treated as a medicine: choose the right one for the symptoms, and exercise caution with side effects and counter-indications.

Rx Prescription 1 for Regulatory Reform

Mandatory benefit regulations provide valuable services to workers such as paid vacation, maternity leave, health benefits, pensions and accident and unemployment insurance. Mandating these benefits can help workers and firms achieve results that are unattainable in private negotiations. If workers value the benefits, they will be willing to pay for them in the form of lower wages.

Side effects: Too high a dose may cause rejection of the treatment. If the benefits are too costly for workers and firms, both will try to evade the law. Side effects may also include reduced employment for young, female and unskilled workers in countries where enforcement of the regulations is adequate. A more common side effect is an inflammation of the informal sector, also described as a movement of workers into uncovered sectors without any protection.

Counter-indications: If increasing mandatory benefits or contributions to pay for benefits, carefully monitor employment and unemployment rates (particularly for female, young and unskilled workers), wage levels, and coverage of benefits. Suspend treatment if employment or coverage shrinks, as it may be a sign that benefit levels are set too high relative to the willingness of workers to pay for them.

Regulatory reform is an important first step towards a better functioning labor market, but it is not a cure-all. The institutions that implement policies need to transform the protective philosophy that inspired the original policy design into one that, first, facilitates the labor market task of allocating resources and earnings across workers and firms, and, second, fosters the growth of labor productivity.

There is an inherent policy dilemma involved in this transformation, but the dilemma is not between efficiency and equity. The more efficient the labor market, the lower will be the wage differentials between workers of similar productivity. If productivity is low and stagnant, so will be wages. If education is unequally distributed, this inequality will be reflected in the distribution of earnings. In both cases, an efficient labor market reflects the underlying productivity trends and inequality of endowments. Aggressive education (and particularly adult education) policies will be vastly more effective in attacking this underlying inequality than will be attempts to change market

Prescription 2 for Regulatory Reform

Job security regulations provide a private, small-pool form of insurance against the risk of income losses in case of unemployment. This form of insurance is particularly suitable when more socialized forms of insurance cannot be provided. This insurance is no small matter in economies where one-fourth of all jobs change hands in any given year. If workers value these benefits, they will be willing to pay for them in the form of lower wages.

Side effects: Setting high levels of job security alters the incentives of firms to hire and fire workers. It may also cramp the ability of firms to react to changing economic conditions, slowing down a powerful engine of growth, which is the reallocation of workers to more productive jobs. It also creates strong incentives to hire workers under temporary or fixed-term contracts to evade the law.

Counter-indications: If adopting measures that increase job security, monitor carefully the duration of unemployment and the distribution of employment rates along age, gender and skill groups. High doses increase the duration of unemployment, as firms shy away from hiring for fear of expensive dismissal costs in the future. While prime age males may benefit from more stability in their jobs, young, female and unskilled workers will have a harder time finding a job. At the extreme, workers who lose their jobs may find it very difficult to land a new one unless they accept unregulated and low-benefit work, thus establishing a two-tiered labor market. By international standards, job security regulations are considerable in most Latin American countries. Given the possible side effects and counter-indications, an increase in the number of such regulations beyond current levels is not advisable.

prices in favor of certain groups, which will likely produce unemployment and other labor market illnesses.

The dilemma that policymakers do face results from the fact that policies that provide insurance seem to conspire against both efficiency and equity. Indeed, the quandary is how to avoid stifling the reallocation of labor, a powerful engine of growth, while at the same time furnishing workers with economic security.

A complex network of public and private institutions is needed to implement these new policies, which must fulfill four specific functions:
(1) increase the efficiency of matching, (2) adequately insure workers against the risks of job-churning,
(3) enhance the opportunities of workers by increasing their skills, and (4) enforce regulations.

Increasing the Efficiency of Matching

The labor market has persistent gaps and lags between the demand for workers and the supply of job seekers. Limited information about vacancies, skill mismatches, and discrimination are just a few of the factors that explain these gaps and lags. There are significant economic and social costs from these gaps and lags in a world where one-fourth of workers change jobs every year. Labor intermediation services provide useful information for linking supply and demand, thus increasing productivity and welfare. However, they do not create jobs.
If a country is facing a true

Prescription 3 for Regulatory Reform

Minimum wages provide legal support to low-wage earners in their bargaining with employers and facilitates the hiring of workers by small and medium-sized enterprises. Moderate, well-designed increases in the minimum wage may reduce inequality, at least in the short run. The medium- and long-term effects of increases in the minimum wage are largely unknown.

Side effects: Increases in the minimum wage reduce employment rates and raise unemployment among low-wage and young unskilled workers.

Counter-indications: After increasing the minimum wage, carefully monitor its coverage. Declining coverage or increased evasion may signal that the increase was too high given underlying bargaining and enforcement conditions.

employment crisis with high structural unemployment, it is generally more productive to resolve wage rigidities that impede employment generation.

A particular challenge for Latin America's labor intermediation services is the prevalence of unregulated forms of employment contracts, including self-employment. Services should be adapted to the needs of these clients and include, referral to microenterprise programs. In much of the region, self-employment programs are provided by a variety of governmental and nongovernmental institutions with no central clearinghouse for referral. Labor intermediation should assume that function.

Another challenge is to ensure that the neediest groups are serviced. Low skills, poor education, poverty and discrimination are often roadblocks to entry in the labor market. Intermediation services must include these disadvantaged groups among their clients. As it stands, labor intermediation services in Latin America are few and far between. Thus, reforms should start by fostering an adequate regulatory environment for private and nonprofit providers that facilitates the development of new public-private partnerships in the provision of labor intermediation services.

Insuring Workers against the Risks of Job Churning

The high level of macroeconomic volatility of Latin American economies has raised a clamor for ways to protect the working population from the risk of unemployment and income loss. Traditionally, high severance payments or firing freezes have been the response to this demand. However, these benefits only cover workers with regulated contracts, which represent a minority in the region. More than half of the workforce is either self-employed or involved in unregulated, precarious employment. These are the people who need more widespread forms of social insurance.

Social insurance should aim to provide a minimum income guarantee to the largest number of workers possible. To be feasible in financial and economic terms, social insurance programs must:

- Minimize labor market distortions and, in particular, avoid creating incentives that result in reduced employment or output.

◎ Have as wide a coverage as possible, given that the risk of unemployment affects all workers, including those in unregulated and precarious employment contracts.

◎ Have their financing adjusted counter-cyclically, expanding in economic downturns when unemployment increases, and contracting in expansions when it decreases.

The tools for building a social insurance system originated in the safety net program that Latin American governments adopted to cope with the crises of the 1990s. However, social insurance mechanisms and safety nets offer different treatments for different patients. While the rationale of safety nets is to protect the human capital of the poor during economic downturns, social insurance mechanisms should help all workers (not just the poor) cope with the normal process of job creation and destruction that are characteristic of modern economies. The implication is that labor market policies may require a higher dose of social insurance vis-à-vis poverty alleviation programs than what governments adopted and international financial institutions recommended during the 1990s.

There is no unique mix of policy instruments to build a social insurance system. Countries have to select and adapt the prescription that best fits their circumstances. The only common element is the need to establish administrative and regulatory records of labor contracts. Any insurance "promise" is meaningless

Rx Prescriptions for Social Insurance 1

Unemployment insurance provides workers with supplemental income during their job search. Eligibility for benefits is limited to contributing workers in regulated and registered labor contracts. The system should be connected to the labor intermediation system, both to effectively enforce a job search requirement and to help workers tap into the network of intermediation services. If workers value the benefits, they will be willing to pay for them in the form of lower wages.

Side effects: Unemployment insurance creates incentives to extend the job search, thus increasing both the duration and incidence of unemployment. This effect is amplified if total labor costs increase in line with the insurance premium. Therefore, an offsetting reduction in severance payments is recommended to avoid negative employment effects when establishing unemployment insurance benefits.

Attempts to extend coverage to workers in non-regulated contracts that have not contributed to the system create incentives for evasion and may result in financial strains. In contrast, well-defined eligibility conditions and reasonable costs may encourage workers and employers to register contracts that otherwise would have gone unreported.

Counter-indications: Avoid using unemployment insurance in the absence of well-kept administrative and regulatory records. Countries that do not have viable labor market enforcement and registration systems should give priority to establishing them over and above any discussion of unemployment insurance.

if workers cannot enforce it later when conditions change. Again, caution is needed, since policies, like medicines, can have surprising, and even dangerous, side effects and counter-indications. Policymakers can reduce such costs by continuously evaluating the effects of policies and regulations while discontinuing those that do not work.

The medicine of choice in this social insurance system is unemployment insurance. However, to the extent that workers are not willing to pay for this benefit in the form of lower wages, and that it duplicates the function played by job security, unemployment insurance boosts labor costs and, therefore, dampens labor demand. Moreover, it is suitable only for workers who have regulated and registered labor contracts. For workers beyond the reach of unemployment insurance, the prescriptions available to policymakers are varied but not always recommended. Short-term training courses can bring low-skilled entrants to the job market up to speed with training, labor market experience and job search assistance. For displaced low-skilled workers, labor-intensive public works are the best choice to provide jobs at the local level. Wage subsidies should be used sparingly, if at all. The distortions caused by meddling with the relative wages of different types of workers are reason enough to counsel caution in this area. Finally, cash transfers to poor families are the mechanism of last resort to assist those families that fall through the cracks in the support system. This is where labor and poverty policies intersect in a strong way.

Perhaps the most important ingredient of a social insurance system is its financing. By its very nature, social insurance demands a counter-cyclical fiscal policy, because income must be transferred from booms to recessions. Ideally, unemployment insurance would automatically increase government expendi-

Prescription 2 for Social Insurance

Labor-intensive public works provide income support in exchange for work for unemployed workers. Programs are self-targeted because they pay wages that are below the alternative market wage. The government finances the programs, and the works are executed by a variety of public institutions and nongovernmental organizations. Local organizations normally select beneficiaries. To avoid discriminatory selection biases, community participation, sampling-based monitoring and evaluation are crucial.

Side effects: Beneficiaries may be stigmatized if the program is perceived as social assistance that has no productive or training content. This effect can be reduced by cross-referrals to the labor market intermediation and training systems. Participation in these programs may hinder the search effort of beneficiaries. This risk can be reduced if job search time and requirements are built into the program.

Counter-indications: Expenditure on these programs should be strongly counter-cyclical, increasing in downturns and cut back when the economy recovers. Deep fiscal cuts may make it difficult to maintain an adequate level of expenditure in recessions, and political pressures may make it difficult to cut the program when the economy picks up.

ture as unemployment rises during a recession, and automatically reduce expenditure when employment recovers. Unfortunately, fiscal policy is particularly pro-cyclical in Latin America. At the very least, financing the social insurance system will require reducing this pro-cyclicality.

In the long run, Latin American countries would likely benefit from a more developed welfare state, both through greater macroeconomic stability and less risk for the population from aggregate shocks. In the words of Nancy Birdsall of the Carnegie Endowment for International Peace, developing such a system will demand "brilliant fiscal management," more trust by citizens in government, and more transparency and accountability. Automatic stabilizers, such as unemployment insurance, can be risky in a context of low transparency and limited state capacity. It might well be impossible in such a context to cut spending during booms, particularly if the government cannot determine much less control employment in the sector not covered by the benefits of unemployment insurance.

Enhancing Worker Skills

The third broad group of labor policies aims to enhance workers' opportunities by increasing their skills. Education and training policies, however, cannot operate in a vacuum. Their effectiveness depends on a number of policies that structure the incentives for firms and workers to demand and supply skills.

At the top of the list is education policy. Universalizing basic education up to ninth grade is necessary but far from sufficient to support a process of skill development. School systems must be flexible and attractive enough to motivate students to stay in school beyond basic education. Easing the transition between school and the labor market and vice-versa is crucial to giving undereducated workers the opportunity to acquire the basic skills that are a prerequisite to learning the more specialized skills that firms may need. Adult education must be expanded, given the low edu-

Rx Prescription 3 for Social Insurance

Wage subsidies have been used to speed up the placement of unemployed workers in private sectors jobs. Such subsidies are implemented by reducing payroll taxes or severance payments for particular groups of workers. Employers that expand employment beyond the baseline receive this subsidy. It requires sophisticated record keeping.

Side effects: Without adequate control of baseline employment, firms will substitute subsidized with non-subsidized workers, without impacting total employment. Because of this problem, evaluation of these subsidies in OECD countries has been quite negative.

Counter-indications: After implementing wage subsidies, carefully monitor employment rates of different age, gender and skill groups in order to detect substitution effects. Avoid using wage subsidies in the absence of well-maintained administrative and regulatory records of labor contracts that allow for the measurement of baselines for individual employers.

Rx Prescription 4 for Social Insurance

Short-term training programs have been widely used to transfer income to target groups, normally unemployed youth. The combination of some classroom time and an internship in a firm under Chile's Joven program has resulted in high placement rates in real jobs. The program's operation requires significant investments in monitoring and evaluation in order to enforce high quality and relevance standards among the multiple providers of training. Scholarships should be set at a level low enough so as not to discourage the job search in the local labor market, and targeting should focus exclusively on people out of the school system in order to deter school desertion.

Side effects: These programs ease the entrance of young workers into the labor market and create experience in operating labor market intermediation mechanisms (such as job search assistance).
Counter-indications: As is true for any training program, these should not be expected to create new jobs, but rather to provide new entrants with some labor market experience. Because youth unemployment is an ongoing labor problem, these programs should be a permanent feature of a well-functioning labor market intermediation system, which could be expanded and contracted, following demand in a counter-cyclical way.

cational attainment of the population at large and active workers in particular. Alternative models of delivery that are suitable for adults who are either working or looking for a job will be needed, probably implying a more intensive use of existing educational facilities and the design of accelerated, examination-based accreditation programs. Subsidies to firms that facilitate and encourage their workers to attend adult education could also encourage unskilled workers to go back to school. Policymakers should resist the temptation, however, to use adult education as an income support program. If the quality of the education delivered is deficient, program participants will be stigmatized and the program will lose its effect on the future earnings of trainees. Tax rebates that subsidize a variety of training programs also can be useful.

Labor market regulations also need to be attuned to this process because productivity is a function of contractual relations and working conditions within the firm. Contractual innovations (including apprenticeship contracts) that allow workers and firms to share the cost of training through a reduction in wages, and that eliminate the legal presumption of an indefinite labor contract for trainees, serve to increase the supply and demand for skills. However, opportunistic behavior could result in the use of trainees as cheap labor in the absence of strong and effective enforcement of quality and relevance standards for the training programs

Training programs also have a place in collective bargaining, giving firms and unions the opportunity and means to bargain over the level of investment in skill development. In a number of Latin American countries, unions and employers operate training facilities, some of them of very high quality.
Mechanisms to protect the income of unemployed work-

ers—including severance pay and unemployment insurance—should include subsidies for training, preferably in the form of voucher-like instruments that workers could negotiate as part of their job search strategy.

There is no clear "best" model for the institutional layout of training systems, but there are a number of do's and don'ts that should orient policies in this area. A strong public regulator of the training system is needed to set and enforce quality and relevance standards for training programs. Because of the central nature of this institution in labor market policies, it should logically be based in the labor rather than the education ministry. The regulator should be separate and independent of any other public entity that operates training programs in order to avoid conflicts of interest that could arise from bureaucratic encroachment.

As in any market, regulation operates best when it is separated from provision. Of course, this is not an endorsement of an enlightened but isolated public bureaucracy: the regulator needs to earn the trust of the private sector, and for that needs to interact with the institutional representatives of workers and firms, not just with training providers.

Skill certification also is an important tool in the training process. It solves an informational problem by providing potential employers with a log of the quality and quantity of workers' skills. However, for certification to work, firms, workers and unions must participate in the design of content standards and the mechanisms for accreditation.

To date, training systems have been charged with remedial training and education, and they will likely continue to be involved in this area given the deficits in basic skills of the labor force. The problem is that these programs tend to have little impact on beneficiaries and therefore low social returns. These programs should not be financed without stringent and continuous evaluation that allows for flexible redesign of program content, method of delivery, and clientele. Authorities should not forget that the ultimate mission of the training system is to provide the population at large with the level and mix of skills needed for workers and

Rx Prescription 5 for Social Insurance

Cash transfers only recently have been made unconditional, de-targeted, and used to contain the consequences of massive unemployment during a crisis. The beneficiaries of the Jefas y Jefes de Hogar program in Argentina were unemployed heads of household. The work counterpart requirement was nominal.

Side effects: Cash transfers induce serious labor market distortions by increasing reservation wages and creating incentives against work. They also tend to create strong entitlements, making it difficult to adjust the number of beneficiaries or the level of benefits.

Counter-indications: Use with extreme caution and carefully monitor wage levels and employment and unemployment rates in target areas and groups. Define in advance the readily observable indicators that will trigger activation and suspension of the program.

firms to create the more productive jobs associated with a more competitive economy. This implies that every action in the training system, from basic remedial training to the more sophisticated skill certification process, should be evaluated in terms of its effectiveness and cost efficiency in the attainment of that objective, rather than in terms of its effectiveness in containing the adverse social consequences of unemployment.

Enforcing Regulations and Promoting Harmonious Labor Relations

In order to effectively enforce the social contract, countries will need to invest in the development of institutions for labor policies—both those that collect, analyze and process information, and those that implement policies and enforce regulations. On the one hand, significant investments need to be made in labor market data collection and analysis. On the other, assessing the benefits and evaluating the costs of labor policies requires skills that most labor administration authorities (normally the Ministry of Labor) do not have. While researchers at universities and specialized firms can perform such monitoring, labor officials ought to be the ones that contract the analysis, weigh the costs and benefits, and then decide on the treatments to follow. This means that investments are needed to rebuild the capacity of the labor administration authority and staff it to perform these new roles.

Massive noncompliance with regulations on benefits and working conditions makes the task of enforcement even more arduous. New approaches are needed to expand the coverage of inspections and other mechanisms to increase compliance. Labor ministries have an enormous regulatory task, ranging from occupational safety and health regulations to issues of basic labor rights, such as freedom of association and bargaining. The ministries also are expected to organize a wide range of services, from intermediation to training. Given their wide charter of action and shallow pool of resources, it is not surprising that ministries have often failed to fulfill their mission.

Renewed efforts are needed to enhance the regulatory and enforcement capabilities of the labor authority, and to create new forms of fulfilling both old and new functions. The evolution of training and labor intermediation systems is an inspiring example of the complex network of relationships between public and private (often for-profit) providers of intermediation, placement and training services. These innovative models of collaboration between the public and private sectors should be expanded.

Labor relations in Latin America are mired by conflict between employers and employees. This lack of trust hinders the development of labor policies, as many of these policies require cooperation between unions and employers to be successful. The labor authority should pay close attention to the state of labor relations, as measured, for instance, by the frequency of strikes and the number of workdays lost, and dedicate efforts to promote better relations between workers, firms and unions. More transparent wage and collective bargaining rules would go a long way towards improving those relations.

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