

Labor Market reforms in Latin America: an alternative view
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The challenge and its solutions: The range of solutions proposed all have in common that they seek to maintain income security for workers while reducing inefficiencies in the labor market: this should be stated more explicitly.

Replacing a PAYG system by a fully-funded Social Security system: The proposal assumes half the cost of social security payments is passed from employers to workers after the replacement of a PAYG for a fully funded system. Benefits come from increased employment and higher GDP, while costs are assumed to be zero. Other studies actually show that employees value their contributions more highly than assumed, so the benefits of the reform are probably underestimated by the author. On the other hand, the paper also assumes zero pass-through rate of payroll taxes to workers before reform, which is an extreme case. If, as I think is realistic, we assume a 20% pass-through before reform and a 100% pass-through of workers' contributions to individual accounts, the gains from this reform are halved.

Another factor the author does not take into account is partial substitution of capital by labor after the reform. The reduction in the capital stock would reduce the increase in GDP generated by the reform by about 25%. There are also additional transitional costs needed to pay workers' pensions, but the net effect of these still makes the net benefit highly positive. Finally, it should be borne in mind that the reform provides greater incentives for people to enter the labor market so, although employment would rise, unemployment may not fall at the same time.

Replacing severance payments by individual accounts: This is a clever and relatively novel solution, but the model used to quantify the impact is not the most appropriate. The paper assumes a net increase in employment, but the actual impact is ambiguous. Nevertheless, in the absence of restrictive regulations, turnover is likely to increase and overall efficiency should rise after the reform as labor is reallocated to more efficient production plants. Taking a range of assumptions about remaining costs for employers, there are positive net benefits in all cases, with costs amounting to between 10% and 15% of benefits.

Replacing minimum wages by EITC: Although designed to help the poor, minimum wage schemes introduce rigidities and reduce the demand for labor. The proposed change to an Earned Income Tax Credit targets money where it is needed without providing disincentives to work. The author calculates benefits on the assumption that the minimum wage accounts for half of unemployment, but this does not seem valid for all countries. Using the alternative assumption that the minimum wage is only binding in half the countries, and allowing for capital-employment substitution, the benefits of reducing deadweight loss is halved, while the GDP gain is somewhat lower than for solution one. The costs of introducing EITC are also a lot higher than the transitional costs for a fully-funded Social Security system. Overall, the net gain from replacement of the minimum wage I estimate is 2% of the present discounted value of GDP, compared to 3% for the introduction of a fully funded Social Security system.

Conclusion: All three solutions are sensible and well targeted, but the cost-benefit calculations do not take proper account of all factors. A re-analysis changes the ranking of solutions, making redesign of social security the most attractive option.