

Labor Market Reforms in Latin America: Consequences and Costs **Alejandra Cox Edwards; California State University, Long Beach**

Introduction

Latin America has reluctantly begun to integrate its markets into the global economy, despite some concerns about loss of jobs. In fact, globalization can potentially benefit all workers by changing the division of labor across countries, but this requires a degree of adaptability. The challenge for the region is to seize the benefits of globalization while instituting policies which improve the functional role of the labor market and encourage the development of skills and employment opportunities.

Current labor laws undoubtedly have a negative effect on job creation, formal employment (by encouragement of the informal sector) and productivity. But they were originally enacted to improve the welfare of workers, and their reform is not popular. Nevertheless, labor market reform is needed to respond to the challenges of employment creation and social security.

Labor Market Regulation: a Conceptual Framework

Labor markets in Latin America and other emerging economies differ from those in industrialized countries in two primary ways. First, they have large “informal” segments, not directly affected by regulations. Second, labor market regulations include payroll taxes, earmarked for worker benefits but with rather weak links between individual contributions and benefits.

It is possible to build a model of the labor market in a typical economy which is open to international trade and characterized by the coexistence of “formal” and “informal” sectors. Use of this model shows that the key consequence of labor market reform is to redistribute income across different economic participants.

The “modern” (formal) sector is subject to minimum wage and social security coverage. All other things being equal, workers would prefer to be employed in this protected sector, but there are too few jobs available for all. Many therefore get work in the informal or unprotected sector, where we assume that the wage rate is equal to the expected take-home pay in the formal sector (that is the net wage times the probability of employment in the formal sector). Formal sector workers face the risk of unemployment (as a result of wage rigidities) and are, of course, subject to a payroll tax (to fund social security), which I assume is “pay as you go”, with no connection between contributions and individual benefits.

Social security payments of this sort are normally regarded by workers as simply a tax. However, replacing this by an individual accounts-based system can change the perception. The reform itself may lead to a reduction in contributions (as was the case with pension reform in Chile) and there is an increased link between contributions and benefits, so they may be seen as a sort of deferred compensation.

Building a model of the unreformed labor market gives quantitative relationships between the various labor market factors. The net effect of existing costly labor market regulations is to reduce employment in the modern sector, depress wages in the informal sector, and create unemployment.

Labor Market Regulations and Distortions in Latin America

There are two types of distortion in labor markets in the region: payroll taxes and high minimum wage, and high adjustment costs (restrictions on short-term contracts, high dismissal costs etc). These adjustment costs cause particular difficulties at times of change. Also, while payroll taxes are generally higher in OECD countries than Latin America, the reverse is true for costs of adjustment.

Average social security taxes in the region are estimated as 20% of wages. Additional costs associated with job security regulations adds a further 5% to this. This does not include the indirect costs of regulation on the dynamics of the labor market.

Minimum wages are binding in Latin American countries and have substantial effects on employment and wage distribution. Since wages in the informal sector are related to the take-home pay in the formal sector, the level of the minimum wage affects essentially all employees. Although the minimum wage raises pay for many workers, it also significantly increases the chances of unemployment for those earning around the minimum. Overall, it seems that the region is paying a high price in reduced flexibility for a possible small effect on poverty alleviation.

Re-regulating Labor Markets: Benefits

Research shows that mandated benefits reduce employment and job security regulations have a substantial impact on the distribution of employment and turnover rates. Although protecting those in employment, job security regulations overall promote inequality, disadvantaging young people, women and unskilled workers.

The overall challenge of reform is to increase labor market efficiency. One of the major contradictions in Latin American labor market regulation is that it fails to help the poor. Because benefits are currently decoupled from contributions, it seems reasonable to find ways for beneficiaries to pay their costs and remove the tax burden from those who are unlikely to benefit. The aim should be to have an actuarially fair system giving benefits which are valued by the majority of the population.

Alternative regulations to address Old-Age Pensions

A system which mandates for people to save towards old age in a defined contributions (DC) program has already been introduced in some countries in the region, and this improves workers' incentives to participate in a formal pension scheme.

The reformed system in Chile satisfies the criteria for actuarial fairness. The expected present value of payments on retirement equals the total contributions with a compound market rate of return, each increment of contribution gives an equivalent expected incremental benefit and delaying the start of a pension gives benefits equal to those forgone.

However, actuarial fairness will not mean that some contributors will not continue to see their payments as at least in part a tax. The element of choice is taken away, with workers having to contribute at a particular minimum rate if they want to participate, and the benefit rules may not be ideal for all individual circumstances. Although, under the new Chilean scheme, contributions could be seen as a form of deferred compensation, in practice workers still consider about half of their contribution to be a tax.

Alternative regulations on job security

The level of job flow – the sum of jobs both created and lost as a percentage of total employment – seems remarkably similar at between 20 and 30% for a range of countries. When workers leave a job, for whatever reason, there is a case for a severance pay. If this severance was paid from a fund built with monthly contributions, and this was part of the contract of employment, the severance payment would be fully internalized.

However, this is not generally the case in Latin America. Severance payments are based on final salary and length of service and are not applicable for voluntary resignation. Although mandated, workers may in practice often receive less than the minimum requirement. Bolivia, Brazil and Colombia have all undertaken reforms which provide severance pay in all cases where an employee leaves a job. The evidence is that such policies reduce labor market distortions, reduce costs for employers and benefit workers on lower wages in particular.

Alternative regulations to meet the objective of the Minimum Wage

While the goal of minimum wage legislation is to raise the income of the working poor, the reality is that it ultimately leaves the unskilled without jobs. Other policy instruments are more effective in helping the poor, for example the US federal Earned Income Tax Credit (EITC) and similar systems in Canada, New Zealand and a number of European countries. In the USA, almost 21 million families received more than \$36 billion through the scheme in 2004.

The EITC transfers funds to the working poor in proportion to their labor earnings. The proportion varies in three phases: first increasing with earnings, then reaching a plateau where the maximum is payable and then finally phasing out as earnings increase above a certain level. The EITC is particularly effective at targeting low-income families, whereas most minimum wage earners are teenagers, young adults, students or spouses supplementing family income.

Although Latin America has a large informal employment sector, incentives can be put in place to encourage people to work in the formal sector, where tax credit payments can be made.

Costs and Benefits of labor market reform

We have already seen that reform of social security to a defined contribution system reduces the tax component for workers. Extending the principle to other programs and making them optional, the tax component is further decreased. This could open up both higher demand for labor in the formal sector and improvements for workers in the informal sector.

Social security reform

Reducing the payroll tax will reduce labor costs and increase both employment and demand for labor in the formal sector. Wages in the informal sector will increase in consequence. I assume that the net take-home wage in the formal sector will be unchanged, but that part of this will now go into a saving account.

Assume that 10% of the current total social security costs of 25% is directed to individual savings accounts as the basis of a direct contribution system. If workers see this contribution to individual accounts as deferred compensation, the total cost of labor in the formal sector would fall. Assuming that workers only value half of the 10% contribution as deferred payment, that reduces social security costs from 25 to 20%.

Because this reduces the burden of taxation, employment in the formal sector will rise. This will reduce the numbers employed in the informal sector, and raise the wages of those who remain. Formal sector employment is estimated to rise by 1%, which is consistent with findings in Chile. This in turn increases output and GDP growth.

The primary cost for the government is to fund the retirement benefits of the transitional generation, who are entitled to defined benefits which will not be funded by taxation as employees begin to contribute to their individual savings accounts under the new direct contribution scheme. However, transition costs are more of a financial challenge for the government than a true additional cost. In a system which is already in significant deficit, the cost will be lower. Because the cost will vary with the ability of government to fund its existing liabilities, I do not try to estimate it here. There will also be a cost – estimated as 10% of contributions – to administer the individual accounts.

Reform to job security regulation and its effect on the labor market

Introduction of Unemployment Insurance Accounts could be funded by a 5% contribution from wages, equivalent to the current estimate of the costs of dismissals. If workers regard 80% of this as deferred compensation (since they will receive benefits when they leave a job, for whatever reason), we can expect labor costs to fall and pro rata benefits to accrue as for the previous reform proposal. The only cost would be for management of the accounts: in Chile this is financed by 0.6% commission on deposits.

Reform to Minimum Wage Policy and its effect on the labor market

Elimination of a compulsory minimum wage, together with a transfer to low-income workers, would lead to a decline in the formal sector net wage, an increase in employment in the formal sector – so eliminating unemployment caused by the minimum wage – and an equalization of net pay in the formal and informal sectors.

We can assume that half the unemployment in the region is caused by wage rigidities associated with the minimum wage. This reform would increase employment, output and GDP growth.

The cost of this measure is difficult to quantify. The cost of direct tax transfers can be high, but has to be set against new taxes generated by additional labor force participation, reductions in other benefits made possible by lifting families out of poverty and taxes generated by additional spending by families in receipt of EITC. Indirect effects may also be found in terms of reduction of crime and other social ills. If we assume that the net annual transfer to each poor worker is \$600 and that 10% of workers qualify, the total annual transfer across the region is \$25.6 billion.

Results

Each of the reforms would increase employment by 1-2% per year relative to current levels: 2.4 to 5 million jobs in total. This additional employment would increase output by ½ to 1%. The net present value of the benefits, after subtracting costs, is around \$400 billion for the tax reduction reforms and nearly \$900 billion for wage reform. Annual gross net income for the region in 2006 was around \$2 trillion.

Summary and conclusions

One of the great contradictions of labor market interventions in Latin America is that they fail to help the poor. The key challenge for policymakers is to implement reforms which allow labor markets to generate additional employment and improve workers' compensation.

The reforms proposed in this paper are designed so that beneficiaries of programs pay for their costs and those unlikely to receive any benefits are not taxed. These can yield high benefits and healthy benefit-cost ratios, and these are summarized below.

- *Option 1: Redesign of pension programs to make them actuarially fair (effective payroll tax falls from 25 to 20%).* Present value of benefits is \$647.5 billion; PV of costs is \$266.7bn. Cost-benefit ratio is 2.4.
- *Option 2: Redesign of job security legislation into unemployment insurance account (effective payroll tax falls from 25 to 21%).* PV of benefits is \$515.8bn; PV of costs is \$80bn. Cost-benefit ratio is 6.4.
- *Combine options 2 and 3 (effective payroll tax falls from 25 to 16%).* PV of benefits is \$1,185bn; PV of costs is \$346.7bn. Cost-benefit ratio is 3.4.
- *Reduction of the minimum wage to make it not binding and introduction of EITC type transfers to the working poor.* PV of benefits is \$1,221bn; PV of costs is \$312bn. Benefit-cost ratio is 3.9.

All these proposals have benefits much greater than the costs. Redesigning social security legislation comes last in quantitative terms, but would also bring other economic benefits, particularly bringing solvency to the pensions system.