

Chapter 6

LABOR POLICIES TO IMPROVE INCOME DISTRIBUTION

Labor policies in Latin America have been greatly influenced by redistributive objectives. Workers have benefited from protection in their relationships with enterprises, and attempts have been made to stabilize their income during both their working and retirement years. These policies as applied have attempted to increase labor's income participation vis-à-vis profits, rather than to distribute income among workers. However, to the extent that these policies have been designed to oversee a labor relationship established in a contract between formal enterprises and permanent workers, they have left out many workers, particularly those with less income generation capacity, thus accentuating differences among workers.

The conflict between protecting employment and income distribution cannot be resolved without considering workers' demands for economic stability and security. The solution could reduce the discriminatory aspects of the present social security and protection systems, extending basic benefits to all workers, and reducing restrictions on job creation in the formal sector. The changes required by labor and social security laws and regulations cannot be made at the expense of workers, and certainly not to their detriment. In many countries, owing to the great deficiencies and low coverage levels in existing social security and protection systems, major workers' groups should step in as the main advocates of reform.

Latin American labor protection laws and regulations have traditionally involved placing restrictions on probationary periods and temporary and fixed-term contracts, and imposing penalties on labor contract terminations. For the workers that they cover, these laws and regulations have increased job stability and protection against loss of income associated with unemployment. In most countries, however, the law provides low and poorly distributed levels of coverage, favoring workers who are more educated, more experienced, and higher-paid. Protection in many countries has aggravated wage differentials between workers covered by the laws and those who are not. In the end, such laws have protected only a few workers and have widened the differences in incomes, benefits and job stability.

Nor has social security protection covered everyone equally. In practice, in order to participate in the system workers must be associated with a formal sector enterprise, and even in these enterprises many workers are also excluded. The workers who remain outside of the system have the lowest income-generating potential, in part because enterprises can easily replace them, and in part because the workers themselves prefer to waive coverage in exchange for higher pay. On the other hand, social security systems have also failed to generate the progressive redistribution among participants that they were theoretically designed to create because of evasion by higher-income workers, special schemes for certain privileged groups of workers, or simply because, in many cases, such systems have operated in deficit, using general tax funds.

The establishment of minimum wages has not been particularly effective in improving the income of the poorest groups, in part because it is not a targeted redistribution mechanism. The minimum wage applies equally to a poor head of household and to a recent university graduate from a high-income family. While reasonable minimum wage levels have been established in many countries and have not interrupted normal operation of the labor market, in other countries they have been ineffective in redistributing income because they have been set too high. In such cases, the minimum wage in fact helps protect higher-income workers rather than poor ones.

The central policy conclusion of this chapter is that the objective of income distribution is only compatible with the aim of protecting workers if it corrects discrimination in laws and regulations against formal contracting for less privileged workers. Action is therefore suggested in four areas: contracting conditions, unemployment protection, pension systems, and minimum wage regulations. During the past decade, a number of countries have made progress in these areas.

Where *contracting conditions* are concerned, greater flexibility should be introduced into the contracts permitted by law. As has occurred in a number of countries, restrictions applied to part-time and temporary contracts

should be removed, and benefits associated with permanent contracts should be extended to part-time and temporary workers. This would give workers and enterprises greater scope to choose the type of contract that best meets their needs, without losing social security benefits. Work days should be more flexible to allow for greater margin for negotiation between workers and enterprises. Biases in labor legislation against employment for women should be eliminated by having the social security system collectively cover maternity costs rather than charging them to enterprises.

In the area of *unemployment protection*, penalties for arbitrary dismissal should be distinguished from income protection in connection with unemployment. The legislation should aim to prevent arbitrary dismissal—that is, dismissals that the enterprise cannot attribute to economic reasons or to the worker's lack of effort or integrity—and to penalize enterprises that unjustly dismiss their workers. Unemployment protection mechanisms should be carefully designed to stabilize income for workers who lose their jobs or who wish to change jobs, while protecting against abuse of the system. Many countries have established individual savings accounts to be used for periods of unemployment, potentially supplemented with low-interest loans or transfers from a mutual interest fund established with workers' contributions. The new protection systems should be designed to cover the maximum possible number of workers from potential loss of income, without impeding employment mobility. Additionally, since it will be difficult for unemployment savings schemes to protect lower-income workers vulnerable to unstable employment, collectively-financed social safety nets must be established to support them.

In the area of *pensions*, the simple pay-as-you-go system still predominant in Latin America should be replaced with a two-pillar system that establishes basic universal protection while narrowing the relationship between individual benefits and contributions for workers. The basic protection pillar should offer a minimum pension to workers who have no other old-age resources, and should be covered with general budget funds. The contribution pillar might consist of a savings system under which individual accounts are administered with the assistance of the private sector under strict government supervision. Such systems already exist in eight countries in the region.

Last, in connection with the *minimum wage*, a level should be set to protect the incomes of the poorest individuals, with a reduced minimum for young workers to ensure that there is no negative stimulus to employment.

JOB PROTECTION REGULATIONS

Labor legislation in most Latin American countries aims to defend workers in their relations with enterprises by specifying conditions for contracting and dismissal and establishing standards on extending the work day and compensation for overtime. To guarantee stable employment, labor legislation emphasizes standard labor contracts and places severe restrictions on contracts for temporary and part-time contracts. This section will show that while the labor situation is better for groups of workers covered by such legislation, income distribution does not improve. The existence of an informal sector, where income levels are different than those in the formal sector, and where stability is less favorable, cannot be exclusively attributed to labor protection regulations. The segmentation between formal and informal sector workers can be largely explained by the preference among many individuals (women in particular) for more flexible work that enables them to make better use of certain skills; different incentives and remuneration mechanisms depending on the activity; and credit market imperfections.¹ But labor regulations exacerbate rather than alleviate the segmentation and inequalities between formal and informal sector occupations.

Regulations to Provide Job Stability

Given the high degree of economic volatility in Latin America, it comes as no surprise that most countries in the region have established protection systems to soften the impact of economic crises on workers. While this objective may be pursued either by ensuring income or job stability, most Latin American countries have traditionally elected the second option. Promoting stable labor relations is the backbone of labor codes throughout the region. To that end, legislation focuses on standard labor contracts, in which a permanent relationship is established between the enterprise and the worker, and severe restrictions placed on their termination.

To protect employment, labor regulations include provisions pertaining to:²

- *Length of the Probationary Period.* During this period, the labor contract between the enterprise and the worker may be unilaterally terminated. In Latin America, the typical probationary period is three months.

¹ See Chapters 2, 3 and 7.

² For a detailed description of the legislation by country, see IDB (1996), Part Two, Chapter 6.

- *Type of Contract and Length of the Work Day.* Typical Latin American legislation limits the work day and rates for overtime hours, night and holiday work, and imposes severe restrictions on temporary contracts. In some countries, such contracts are prohibited from carrying out “typical and ongoing operations of the enterprise,” or are greatly restricted in terms of the duration or number of renewals permitted.

- *Advance Notice for Dismissing a Worker.* This period normally depends on the worker’s length of service. The average period is one month, although, for example, regulations in Guatemala, Peru and Uruguay do not provide for any advance notice.

- *Severance Pay.* Labor legislation typically requires enterprises to pay dismissed workers severance pay equivalent to one month’s wages per year of service. These amounts may be higher in some cases, when seniority exceeds 10 to 15 years. In some countries, workers also receive a separation payment that is determined by seniority, although this payment must be made on termination of the labor contract, even when the worker has not been dismissed.

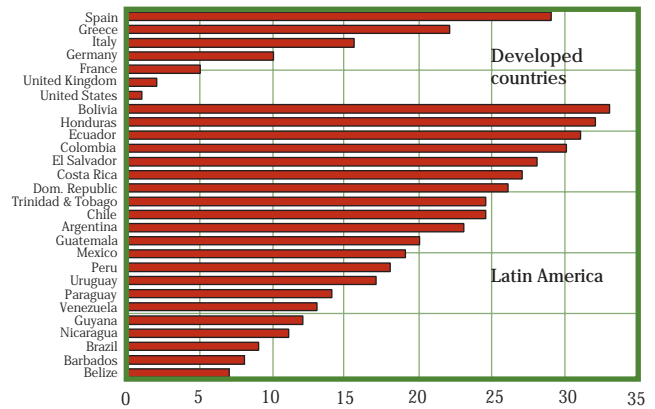
- *Just Cause for Dismissal.* Legislation in most countries determines the causes that justify dismissal. Argentina and Chile, for example, stipulate lower levels of compensation for dismissal arising from economic difficulties experienced by the enterprise. However, in many other countries, such economic difficulties are not considered just cause for dismissal.

- *Rehiring of Workers.* The law stipulates in some cases that enterprises are required to rehire workers who have been dismissed for unjustified causes.

These regulations are much more restrictive in Latin America than in most industrial countries (Figure 6.1). This figure assigns higher values to more restrictive regulations (on an ordinal scale of all countries considered), implying that workers enjoy greater protection from the risk of dismissal. The regulations themselves provide high levels of job protection, even in comparison with Southern European countries, traditionally considered to provide high levels of protection. Within the region, some of the Caribbean countries provide lower levels of protection similar to those in industrial countries with more flexible legislation, such as the United States, the United Kingdom and the Netherlands.

Only a few countries have undertaken labor regulation reform during the 1990s. In 1991, Argentina established a ceiling on involuntary dismissal indemnities, and incorporated cases of economic need as justified cause for dismissal. New formulas were also established for contracting youth and other groups severely affected by

Figure 6.1. Labor Code Rigidity Index (Country ranking)



Source: Márquez and Pagés (1998).

unemployment. In Panama, a 1995 reform changed the computation scale for severance pay, reducing the forced severance pay for some groups of workers and creating new fixed-term and temporary contracting procedures. In Colombia (1990), Peru (1991), and Venezuela (1997), legislation on severance pay was changed, and a requirement was established for enterprises to make periodic deposits of a proportion of each worker’s wages into individual accounts with specialized financial institutions. These funds yield market interest rates and are available to workers in the event of forced dismissal or voluntary termination of the labor relationship. The allowed duration for temporary contracts was also changed (Colombia) and new contracting procedures were created for specific activities and groups (Peru). In Ecuador, new temporary contracting options (virtually nonexistent prior to the reform) were created, although dismissal regulations were not changed.

However, a number of other attempted reforms have been unsuccessful. In 1993, there were discussions in Chile of a draft law on unemployment insurance, but the Congress did not approve it. In 1997, the Argentine government decided not to support a proposed reform that would have converted dismissal indemnities into an individual savings system. Reforms of current worker protection systems normally run into problems, particularly because of insufficient knowledge of alternatives, but also because reform involves redistributing rights and income from those who benefit from the existing system to those marginalized by its coverage.

Regulations Increase Stability for Some....

Typical job protection standards in Latin America might appear to increase worker turnover and decrease workers' average length of service in an enterprise. Although this theory is plausible, there is no evidence that it is true.

International data show that, in general, a worker's length of service in a job is directly related to his or her level of education and the size of the enterprise. These patterns tend to occur in Latin America, although in Peru and Bolivia turnover for more educated workers is as high if not higher than for less educated workers, and in Brazil worker seniority in large enterprises is low and no greater than the levels found in small enterprises (Figure 6.2)

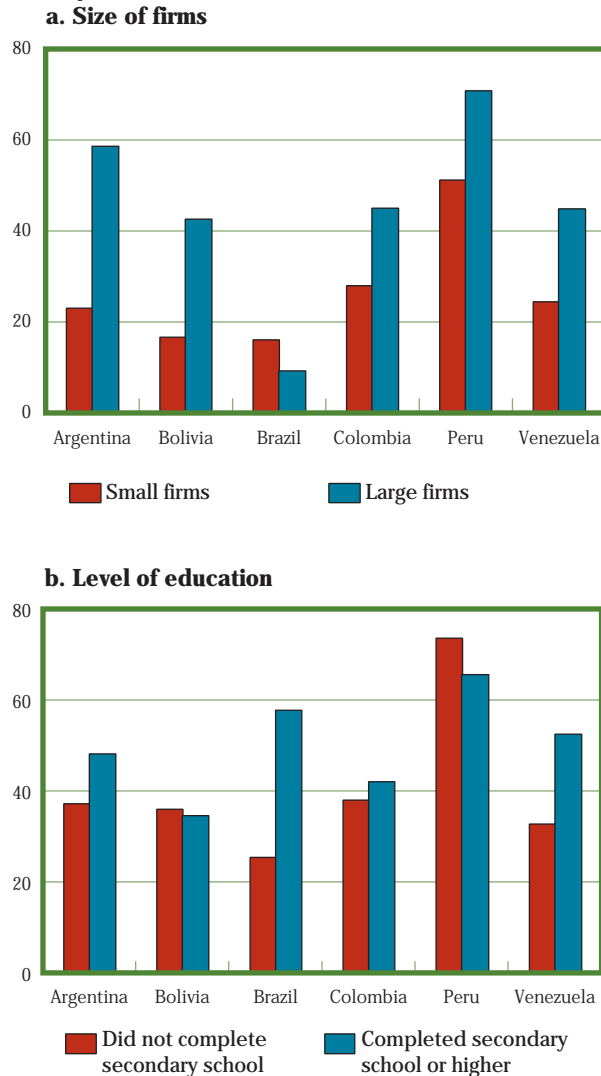
Moreover, international comparisons of length of service also yield surprising results, attributable to labor protection regulations. Although volatility is higher in Latin America than in industrial countries, workers in the region who have permanent affiliations with enterprises,³ as well as workers having similar age and education characteristics and employed in similar sized enterprises, achieve greater seniority in Latin America than in the United States, where job protection does not exist.

Labor protection laws therefore do achieve the objective of increasing employment stability for workers covered by the law. However, coverage of the laws is often incomplete and poorly distributed: workers with low education levels, who are younger or less experienced and have lower incomes and heavier family burdens, are very unlikely to have access to job protection.

...But Increase Levels of Informal Activity and Wage Gaps

Job protection regulations have come under frequent criticism for having a paradoxically negative impact on employment. In industrial countries, broad literature exists regarding the impact of wage-earning employment regulation on employment and unemployment, with inconclusive results. While some studies have found more severe job protection regulations to be associated with a higher unemployment rate or a lower employment rate, others show no significant relationship between protection and unemployment in the labor market. Insufficient evidence for developing countries still prevents precise conclusions from being drawn in this connection. One recent study that examined the subject found no clear correlation between protection and employment or unemployment.⁴ While there may be a negative correlation between levels of protection and employment rates in

Figure 6.2. Employees with Ten or More Years of Service
(In percent)



Source: Márquez and Pagés (1998).

some countries, this seems to be attributable to the fact that both issues are related to level of development and not to the existence of true causality between them. The conclusions are quite similar when analyzing events in the long term in countries that have undergone changes in labor protection standards. Chile is a good example, as its protection regulations have been changed since the 1960s on a number of occasions in either direction. Employment and unemployment levels there have under-

³ In countries of the region, this is tantamount to being affiliated with social security, making it possible to identify them.

⁴ See Márquez and Pagés (1998).

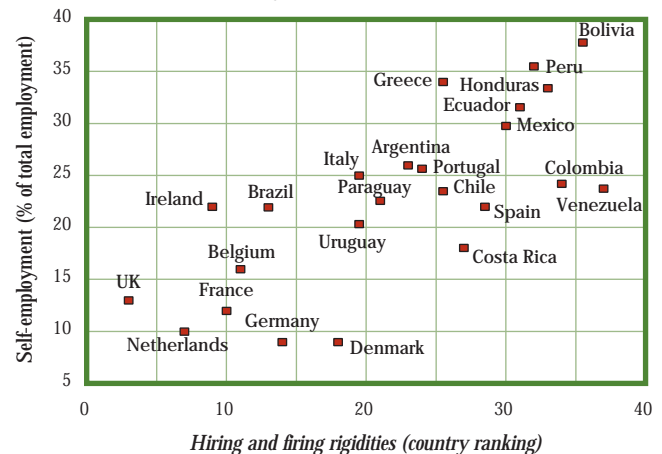
gone pronounced changes, but they do not seem to have been influenced significantly by changes in labor protection regulations.⁵

However, while labor protection standards might not have a significant effect on total employment or on unemployment rates, they appear to affect the composition of employment in ways that are unfavorable to equity. In countries where labor protection is more severe, the proportion of self-employed workers is significantly higher than might be explained by the level of development or per capita income. In countries such as Venezuela, Nicaragua, Bolivia, Colombia and Honduras, which have more severe labor protection laws, the percentage of workers employed in independent activities might be 5 to 10 points lower than its present level had there been more flexible labor legislation (Appendix 6.1 and Figure 6.3). Labor protection standards also seem to affect youth employment. Data from Chile, for example, shows that periods of greater employment protection have been accompanied by a significantly reduced level of youth employment, offset by an increase in employment for more experienced workers with more job seniority (Appendix 6.2).

Labor legislation also affects the composition of employment, as it makes it less attractive to contract wage earners, especially women. Contrary to the objective of the legislation, the proportion of wage earners in Latin America holding permanent contracts is very low. In Chile (1996) and Venezuela (1995), only 38 percent of wage earners were employed using this option. In Mexico (1994), this percentage was even lower, accounting for only 19 percent of wage earners. The differences between men and women are considerable. In Chile, Venezuela and Mexico, 55, 56 and 27 percent, respectively, of male wage earners held permanent contracts; for women, the figures were 25, 26 and 12 percent.

A more detailed study of the determinant factors that affect the probability of being employed under a permanent contract in the three countries mentioned above indicates that, regardless of the size of the enterprise in which the worker is employed, persons who are more educated, in the 35-55 year age bracket, live in urban areas, and have fewer children are more likely to be covered by labor legislation (Appendix 6.3A). Being a woman reduces this probability in Chile, regardless of marital status, and in Venezuela and Mexico, this applies to married women. This might reflect a bias against contracting women with family obligations; alternatively, women who have such obligations might prefer more flexible employment arrangements. In any event, legislation does not help solve the problem, as it leads to more rigid hours and working conditions than would be acceptable to enterprises and potential workers.

Figure 6.3. Labor Rigidity and Self-Employment



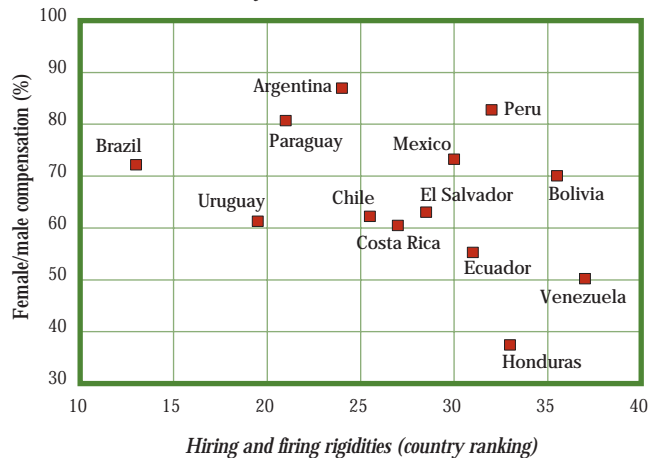
Source: Márquez and Pagés (1998).

The foregoing discussion highlights considerable inequalities in labor legislation coverage. Regardless of whether they work in large or small enterprises, the weaker and less educated workers are the ones excluded from the benefits of permanent contracts. It is not surprising, then, that different levels of coverage are reflected in income differences. In Chile (1996), a worker employed under a permanent contract was paid approximately 13 percent more than a worker not covered by the law, although both had the same age, education and gender characteristics, were employed in the informal sector and in enterprises of the same size, and performed the same activity (Appendix 6.3B). In Mexico (1994), this differential was 26 percent, and in Venezuela (1995), 17 percent. Accordingly, the benefits guaranteed by law lead to income differences that magnify existing gaps between workers employed in large and small enterprises. These differentials are normally greater for women and youth than for men and older workers.

As labor regulations provide particularly negative stimulus for female employment, income differences between men working in the formal sector and women in the informal sector are greater in countries having more rigid labor relations (Figure 6.4). These differences are less pronounced in Brazil, where the labor market is relatively flexible, than in Honduras or Venezuela, where labor legislation is more rigid. Although this is only one of the possible income differentials, it was found that the magnitude of many other differentials (for example, between men in the formal and informal sector, or between

⁵ See Pagés and Montenegro (1998).

Figure 6.4. Labor Protection and Compensation of Women in the Informal Sector (Relative to the salary of men in the formal sector)



Source: IDB calculations based on recent household surveys.

urban and rural areas) tends to be greater in countries that have more rigid legislation.⁶ Therefore, while rigid labor relations are not the only explanation for the existence of considerable wage differences between workers having similar personal characteristics, it does help enhance these differences.

WHAT COULD JOB PROTECTION REGULATIONS ACCOMPLISH?

The analysis above has shown that labor protection systems generate inequalities between workers in three dimensions: income levels, opportunities for protection under the laws and regulations, and job stability. This is indicative of the need to undertake reforms in current protection schemes, extend the benefits of protection to more workers, reduce biases in the present system against less advantaged groups, and reduce income inequalities among workers.

Undertaking labor protection system reforms is a complex task that requires its share of political initiative and consensus among representatives of workers, enterprises and the government. As this consensus can be achieved more easily in some areas than in others, reforms are more likely to succeed when they are comprehensive in scope and combined with other institutional changes that can benefit all groups of workers. The solution to the problems found in labor schemes is not to dismantle the protection that some groups of workers now enjoy, but to replace this protection with more comprehensive schemes that meet the basic needs for protection and stability of larger groups. The solution, then, is

to find a balance between protection, equity and competitiveness in the changing world in which workers and enterprises now must operate. Some countries have already undertaken reforms with these aims. The four areas for reform presented in this chapter reflect this experience to some extent. They are summarized as follows:

- Reform in contractual relations to facilitate part-time contracts and alternative solutions, without associating them with a loss of basic benefits.
- Review of legislation governing maternity to avoid biases against contracting for women.
- In the area of unemployment protection, separation between the system of penalties for arbitrary dismissal and the unemployment income protection system. Penalties should be applied to employers for arbitrary dismissal and collected by the Ministry of Labor. In the area of worker income protection, severance pay mechanisms should be replaced with individual savings-based systems, and supplemented with transfer or credit schemes for unemployed workers.
- Improvement of social safety net systems in order to protect the poorer workers who do not participate in contribution-based systems.

Reform in Contractual Procedures

Current contractual procedures severely restrict part-time and temporary contracts. This bias is the result of the economic situation at the time when many of the Latin American codes were drafted. At that time, men were much more predominantly responsible for supporting the family, a role that they assumed at an early age. However, in recent decades, women's participation in the labor market has increased substantially. Between 1970 and 1994, the proportion of women in the total work force in Latin America rose from 23 to 35 percent. In addition, as a result of higher education levels, men and women now enter the labor market later. These two factors imply that more workers would now prefer jobs that offer flexible schedules to enable them to combine productive activities with family or educational ones. Labor laws and regulations need to be adapted to these changes to reduce segmentation and provide more equal opportunities, benefits and income in the labor market.

⁶ Appendix 6.4 shows that all correlations between income differentials and legislation rigidities have the same sign. The same 15 differentials were analyzed in Chapter 2 (see Figure 2.7). Wage-earning men in the urban formal sector were used as a basis for comparison in all cases.

In many areas, the establishment of new contractual procedures is associated with a relative loss of workers' rights and benefits. This can occur if basic benefits enjoyed by permanent workers are not extended to new contracts, and if the latter bear the full brunt of job and wage instability. This has in fact occurred in a number of countries where labor legislation has become flexible "at the margin," excluding temporary workers and those employed in sectors considered apart from coverage, such as free trade or *maquila* areas. This could be resolved by finding the best possible balance between the benefits and contributions associated with new contractual procedures and those applicable to permanent contracts. In addition, to the extent that the employment protection system is reformed based on severance pay, it will not be necessary to use temporary contracts as a mechanism to achieve more flexible conditions for hiring and dismissal.

Revision of Labor Legislation Applicable to Women

Chapters 2 and 3 of this report show that there are major wage differences between men and women. A factor that clearly helps to explain these differences is the real or perceived costs of contracting a woman as opposed to a man. Laws and regulations governing paid maternity leave, child care facilities in enterprises and other benefits may have an adverse effect if they encourage enterprises to hire men. Such regulations require careful review so that the costs of protecting women, which are now borne by enterprises, can be socialized. Depending on the type of cost involved, this might be achieved through the social security system, or in connection with health and education programs covered by general budgets.

New Unemployment Protection Mechanisms

The previous section showed how the protection system, which is based on guaranteeing employment stability, generates biases in contracting and dismissing certain groups of workers and contributes to wage inequalities. However, the system exists in response to the need to protect workers from the risks of losing their jobs, a need inherent in any economic activity. New unemployment protection systems should avoid the biases and coverage gaps that are found in the present system, while preserving the objective of protecting workers.

First, the distinction should be made between penalizing for unjustified dismissal and protecting workers

who lose or decide to change their jobs. The current system uses worker indemnification as an instrument to achieve these objectives, resulting in a less transparent system, and confusing the issues of protection and penalties. In the future, the economic requirements of an enterprise should be considered a justified cause for dismissal, while arbitrary dismissal should constitute grounds for an enterprise to be levied a penalty, payable to the Ministry of Labor, rather than to the worker, as is now true in many countries. The amount of the penalty should be determined by the authorities of each country, taking into account that an excessively high penalty may increase incentives to initiate legal proceedings regardless of the reason for dismissal.

Where income protection for the unemployed is concerned, it might be argued that the best defense against the economic risk of unemployment is voluntary personal saving and a sufficiently flexible labor market that enables workers to find new jobs with relative speed. However, for a number of reasons, a system based on these principles would be insufficient. First, workers may not save enough money to cover a period of unemployment, attributable to inadequate assessment of their unemployment risks, or their perception that the government would help them should they become unemployed. Second, although a flexible and efficient labor market is synonymous with finding a job easily, there are times when labor market fluidity is disrupted. During economic recessions, dismissals exceed new hires. Also, some workers may require time to readapt their skills, should their specific skills fall into disuse.

Unemployment insurance is the main protection mechanism used in industrial countries. The principal advantage of unemployment insurance, as compared with voluntary or mandatory saving mechanisms, is that, like fire insurance, it diversifies risk and does not require each individual to save enough money to cover himself fully against this contingency. However, such programs do entail problems, hence the principle known as "moral hazard," whereby individuals behave more recklessly precisely because they are insured. In the case of fire insurance, for example, an individual may be more careless with his property, and in an extreme case, may burn it down in order to collect insurance benefits. In the case of unemployment insurance, the problem is to make the distinction between the possibility of unemployment and potential voluntary inactivity. In addition, as insurance transfer payments are associated with being unemployed, insurance may reduce a worker's incentive to find a job, or encourage him to find one and not declare it.

In practice, most unemployment subsidy schemes pose restrictions aimed at reducing moral hazard and

abuse. In many countries, job search activities must be documented, waiting periods are required, and the amount and duration of transfers are limited. However, the more conditions and complexities are built into the system, the higher its administrative costs. In addition, the existence of a large informal sector in many countries makes it impossible to determine whether or not a worker finds a job. Accordingly, in countries where there is no institutional capacity to administer relatively complex programs, or where there is a large informal sector, unemployment insurance is not a viable alternative to current programs that focus on job stability.

Perhaps a more appropriate system in moderately developed countries would be a mandatory savings-based scheme, such as separation funds in Colombia, Ecuador and Peru, where enterprises deposit a percentage of wages into individual accounts in the worker's name. These accounts are managed commercially by private administrators, who invest the funds and guarantee a market return. The government supervises the administrators and guarantees a minimum return should market returns fall short of a preestablished limit. Experience has shown that it is important to define a ceiling beyond which workers would be permitted to withdraw funds, in order to avoid oversaving.

Such schemes provide the major advantage of being relatively simple to manage, as they do not involve the moral hazard problems inherent with insurance. Another important advantage is that the benefits are portable, and therefore workers can easily change jobs as they wish without fear of losing seniority rights under the traditional protection schemes. The major disadvantage is that workers may not deposit sufficient funds in their accounts to cover a period of unemployment. One way to solve this problem is to introduce provisions to give workers who have deposited a certain level of funds into their accounts the option to receive additional amounts in the form of loans or transfers. This would ensure that workers receive the amount deemed appropriate to cover a period of unemployment. To ensure the solvency and equity of the system, these provisions should be financed entirely with contributions from workers deposited periodically in a mutual interest fund.

Of course, there will be difficulties involved in converting from the present scheme to a new protection scheme. Workers who are older and more experienced—who in fact are the ones who benefit from the current system—will press against the implementation of such reforms. If overall system reforms do not prove to be politically viable, a transitional system would be the next best alternative. New contracts would be included in a savings-credit or savings-transfer scheme, while entitle-

ments acquired by workers employed prior to the reform could be kept in their current form, or exchanged for deposits in individual accounts.

Coverage under current employment protection schemes is quite low. Any new protection scheme should aim to expand coverage to workers not participating in the existing systems. As we have observed, workers who are less educated, women, those living outside of major cities, and those with greater family burdens tend to be marginalized by the employment protection system, even if they work in large enterprises. These coverage gaps may be corrected at least partially with an individual savings program managed by private financial concerns aiming to extend their customer portfolio. However, incorporating workers at higher risk of unemployment into the system may increase the costs of savings-credit or savings-transfer systems and therefore raise the contributions that each participant must make to the mutual interest fund. This dilemma could be solved by requiring higher-risk individuals to pay larger contributions, or by partially subsidizing higher-risk workers through the government budget.

New unemployed workers' protection systems will be increasingly effective if supplemented with policies to assist workers in reentering the labor market. For example, job exchanges and other job search assistance mechanisms are effective when coordinated with unemployment benefits. In addition, adequately targeted training programs supplemented with apprenticeships have been effective in increasing employability among young workers in Chile, Argentina and Mexico (see Box 6.1).

Improving Social Safety Net Systems

It is not feasible to try to extend unemployment protection systems to workers in the informal sector or to the poorest workers. Lack of employment records makes it difficult to determine how long an informal sector worker has been unemployed. Thus, the participation of these workers should be limited to individual savings accounts without access to credit or transfer systems in the event of unemployment. Participation should also be voluntary, owing to the lack of records.

It is quite probable that the poorest workers will not participate in the contribution-based programs described above, even if their contributions are partially subsidized. Poor workers do not have the economic means to forgo present consumption for the sake of stabilizing future consumption. A reasonable alternative would be to extend social safety net systems so that they respond—in the form of income transfer programs, food or work—

Box 6.1. Training and Employability Programs

Traditionally, training in Latin America has been dependent on centralized government agencies financed through payroll taxes. It is difficult for such programs to meet the present needs of employment and qualified labor because they were designed to support the early stages of import substitution in a context of slow technological change.

As a result of their monopolistic and government nature, these training programs often operate at high cost, with little administrative and occupational flexibility. And their connection to demand for skills in the productive sectors prevents them from keeping up with changing technological requirements of enterprises.

Some countries in the region have already taken steps to remedy this situation. Youth programs provide a much-used model for such intervention. Chile was a pioneer in these efforts in 1994, followed soon thereafter by Argentina and by pilot programs now being developed in six other countries.

Under these programs, the Ministry of Labor allocates funds to train unemployed youth, in connection with competitive bidding procedures involving various training providers, which constitutes a departure from the monopolistic nature of supply. To participate in the competitive process, training providers must hold contracts with enterprises that assure that a certain number of trainees will be hired, thus ensuring that these services are linked to demand.

Another successful activity has been a comprehensive training and modernization program (CIMO—*Capacitación Integral y Modernización*) implemented by Mexico's Secretariat of Labor. This program targets workers employed in small and me-

dium-scale enterprises. The Secretariat creates local units to promote and organize training demand, and define training programs. Competitive bidding procedures are used to contract independent suppliers to provide the training courses. The costs of the program are partially subsidized for a limited period of time. This methodology has proven useful where local production lines provide a natural forum for the organization of training activities.

Though these systems have been successful to the extent that they have adapted workers' skills to enterprise demand, they cannot contribute substantially to job creation, let alone to the reduction of income inequality. First, no training system can create jobs when this is prevented by adverse growth trends or regulatory rigidities. An effective training system can only improve worker employability by providing workers with varied and timely skills necessary to enter the labor market. Second, training programs have often been presented as part of a social safety net system, based on the assumption that a better-trained worker will be more likely to obtain employment and support his or her family. The alternative would be direct transfers to households, which may be more decisive in the critical situations of the poorest sectors of the population. Experts are divided as to which option is preferable, and under what circumstances, and there are a limited number of studies on existing programs (Ravallion, 1998). In summary, while government intervention is justified to provide training to help protect workers and address changing demands for skills, it is not viable for purposes of generating jobs or as an income transfer mechanism.

to the needs of the poorest workers who lose their jobs and are temporarily without another source of income (see Box 5.1 in the preceding chapter). To prevent these initiatives from reducing incentives to contribute to the above-mentioned protection systems, assistance must target the poorest individuals, and must be carefully designed to prevent people from becoming dependent on protection systems.

SOCIAL SECURITY SYSTEMS

Labor protection mechanisms in Latin America focus on the typical relationship between the enterprise and the worker, as do the region's traditional social security systems. Workers join the system through enterprises that make contributions, part of which are deducted by arrangement from the worker's wages. The social security system is typically administered by a government agency, which is responsible for providing health services and

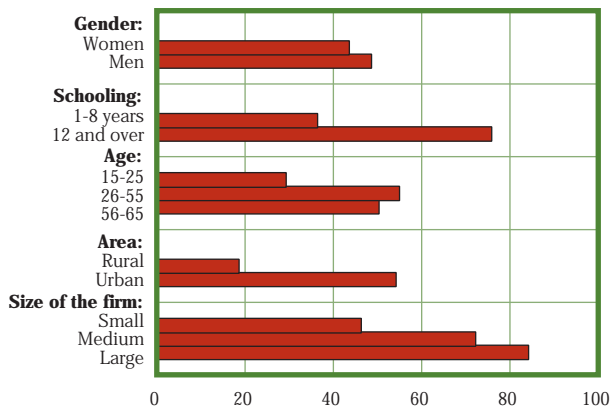
payment of old-age pensions and disability or death indemnities. While this social security system is inherently redistributive, the redistributive aims are often a double-edged sword that can favor those in a privileged position to begin with. Such is the case with the traditional pay-as-you-go system, the model still in effect in most countries. In many cases, the individuals most vulnerable to instability and uncertainty have been excluded, as have workers who are less educated, women, and rural workers. In addition, the principles of redistribution among members of the system have often become distorted.

Whom Does Social Security Protect?

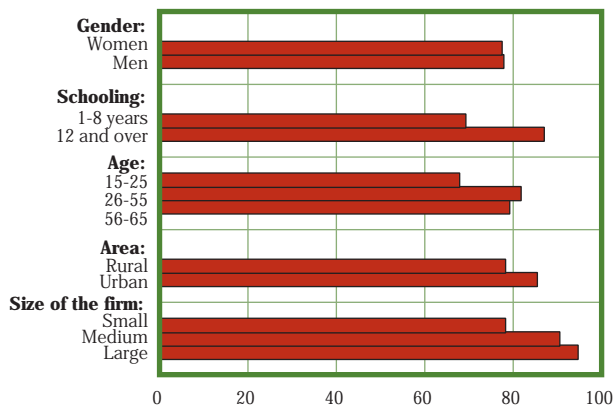
Social security protection does not provide equal coverage for all, due in part to the fact that to be affiliated with the system, a worker must be associated with a formal sector enterprise. However, this is not the full explanation, as many workers in these enterprises are also ex-

Figure 6.5. Whom Does the Social Security System Protect?
(In percent)

a. Less equitable systems: Brazil (1995), Peru (1985) and Venezuela (1995)



b. More equitable systems: Argentina (1996), Chile (1994) and Costa Rica (1995)



Source: Márquez and Pagés (1998).

cluded. Workers who remain outside the system are those with the lowest income-generating potential, since they are easier for enterprises to replace and they prefer to waive protection in exchange for higher pay.

These are the conclusions of a comparative analysis of social security system coverage in six Latin American countries. Persons under 25 and older than 55 receive less protection than persons in the more productive moderate age categories. Women have less access than men, and rural workers have less access than those who live in the cities. A worker with five or six years of education, that is, a typical worker according to Latin American standards, is as likely to be affiliated with social security as not, while a university graduate can almost take affiliation for granted. However, these inequities in protection are not inevitable. They are much lower in Argentina, Chile and Costa Rica than in Brazil, Peru and Venezuela (Figure 6.5).

A detailed econometric analysis shows that these inequalities are even observed within medium- and large-scale enterprises.⁷ Data for Argentina and Venezuela show that the probability of being affiliated with social security, regardless of the size of the enterprise and economic sector, is significantly greater for a person with 15 years of education than for someone with only five, and is much greater for an employee who earns the equivalent of four or five times the wages of a rank-and-file worker.

We might expect some enterprises to evade the rules and deceive workers. It is also possible, however, that these low-income workers themselves prefer to waive social security voluntarily in exchange for higher pay, which may make the difference between covering or not covering their basic needs. (This explanation is also corroborated with data indicating that most social security contributions paid by enterprises correspond to affiliated workers, and hence the actual cost to the enterprise is virtually unchanged.⁸) And in a number of countries that have introduced more flexible contracting conditions, affiliation is not a legal requirement, as workers with temporary or part-time arrangements do not receive the same social security benefits as those who have permanent contracts.⁹

Systems Are Designed for Redistributive Purposes...

Pay-as-you-go pension schemes are inherently redistributive, since contributions from active workers are earmarked to pay the pensions of persons who are already retired. Under this "inter-generational arrangement," some current income of present generations is transferred to cover the pensions of earlier generations; in exchange, it is expected that pensions for the present generations will be covered in the future by new generations. Theoretically, this system of redistribution between generations could work indefinitely, with provisions to adjust the combination of benefits and contributions to growth trends in terms of the number of pensioners, on the one hand, and the active population of workers, on the other. In practice, however, this balance is difficult to maintain. Initially, the relationship between contributors and retirees tends to be quite favorable, and leaves scope to pro-

⁷ Calculated based on results from Márquez and Pagés (1998).

⁸ Based on the case of Chile and analyzed by Gruber (1997).

⁹ In the United States as well, unskilled workers have less social security coverage and receive fewer benefits than skilled workers employed by the same enterprises. Further, protection inequalities have worsened since the early 1980s. See Hamermesh (1998).

vide the first generations with substantial pensions, which are subsequently difficult to sustain. Under present demographic conditions, paying out large pensions is a great temptation for most Latin American countries, but one that would result in a severe burden for future generations. In fact, the number of working-age persons per individual over 60 years of age exceeds nine in most countries (Figure 6.6). Only Argentina, Barbados and Uruguay now have six or less persons of working age for each person older than 60. However, in three decades, the demographic situation in most countries will be similar to the present situation in these three countries. And in five decades, there will be an average of only four working-age persons for each person over 60. Further, in more demographically mature countries, there will be only about three economically active persons for each retirement age person. This will involve a proportionally greater burden that will increase as coverage, which is still very limited in many countries, is expanded.

In addition to this redistribution among generations, pension systems also redistribute benefits among individuals in the same generation, since some beneficiaries receive more substantial pension benefits than others in absolute terms as well as in relation to the contributions that they have made during their economically active lives. In principle, substantial progressive and equity elements are incorporated into defined-benefit pension systems, the traditional characteristic of all systems in Latin America until the recent reforms that incorporated individually funded mechanisms into systems in Argentina, Bolivia, Chile, Colombia, El Salvador, Mexico, Peru and Uruguay.

Defined benefit systems include the following main progressive factors:

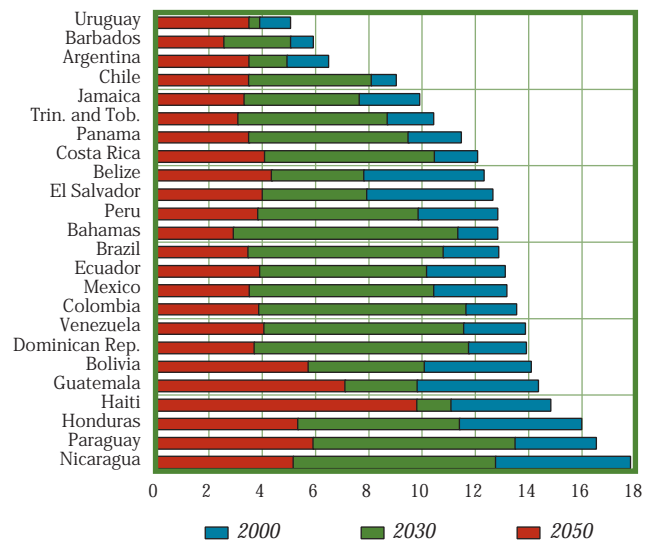
- Establishment of minimum pensions for persons with lower incomes, and whose contributions are therefore lower;
- More career interruptions with periods of unemployment and informal activity for the poor;
- Shorter working lives and longer retirement periods for women.

...But Implemented Inequitably

However, a number of factors lead to perverse redistribution—that is, from the poor to the rich—in the same generation:

- Higher pension levels for the rich, since retirement benefits are determined by wage level;

Figure 6.6. Working Age Population per Person Older than 60



Source: IDB calculations based on UN Population Statistics (1996).

- Longer life expectancies for wealthier persons;
- Shorter careers for the wealthy, as they spend more time in the education system;
- Exclusion from the system of those who do not have permanent contracts, typically the poorest members of society.

While it is impossible to determine a priori whether the progressive factors are dominant, some studies based on individual characteristics and behavior patterns among persons with different income levels suggest that progressive factors may be important in an “ideal” system with total coverage and totally faithful contributions.¹⁰ In addition, regulations on contributions and pension computation may theoretically aim to reinforce redistributive objectives. For example, contribution rates may be higher for higher incomes. In Brazil, wage-earners contribute 8, 9 or 10 percent, depending on the wage level (in addition to the 20 percent paid by the enterprises); in Colombia, persons earning more than four times the minimum wage are required to make a mutual interest contribution of 1 percent of wages; and in Ecuador and Uruguay, employees in some sectors make higher contributions. Redistribution objectives may also be supported by establishing a ceiling on pension value, as is true in Brazil, Costa Rica, Guatemala, Peru and Uruguay (Table 6.1).

However, the actual situation in any pension system may change the distributive results to the point that

¹⁰ See Falkingham and Johnson (1993).

Table 6.1. Redistributive Features of Pay-As-You-Go Social Security Systems in 1996

	Special systems	Different contribution rates by income level or sector	Ceiling wage for contributions (as proportion of income per capita)	Minimum pension (as proportion of per capita income)	Relevant wage for the benefits calculation
Argentina	Military	No	na ¹	na ¹	10 years
Bahamas		1.7% if weekly insurance wage is under BS60, 3.4% for others	1.17	0.16	
Barbados		No	2.7	0.34	Best 3 years of the last 15
Belize		Between BS0.12 and \$B1.30 according to four wage classes (\$B40 - \$B110)		12.5	Best 3 years of the last 15
Bolivia	Bank employees, military personnel, drivers, miners, railroad employees, petroleum workers	No			12 months
Brazil	Public employees and military, aircraft crew, journalists, veterans and teachers	8%, 9% and 10%	8.54 times minimum wage	100% minimum wage	3 years
Colombia	Public petroleum enterprise employees, teachers and military	1% extra for employees with more than 4 minimum wages		100% minimum wage	10 years
Costa Rica		Between 4.5% and 7% for independent workers		0.61	48 months of the last 5 years
Dominican Republic	Public employees	No		0.49	2 years
Ecuador	Congressmen	6% in industry, 8% by bank employees and teachers, 6% in agriculture		0.74	5 years
El Salvador	Public employees	No	21.7	0.82	10 years
Guatemala	Some public employees	No	9.4	0.39	5 years
Guyana		No		50% of the minimum wage	5 years
Haiti	Public employees	Between 2% and 6% according to wage level (200-1,000 gourdes)			10 years
Honduras	Public employees, doctors, teachers and the military	No	0.92		
Jamaica	Armed forces	No			
Mexico	Petroleum employees, public employees and military	No	25 times the federal minimum wage	100% federal minimum wage	
Nicaragua	Teachers	No		66% of the minimum wage	Last 5, 4 or 3 years
Panama	Rural employees	No		0.86	7 years
Paraguay	Public, railroad, bank employees	No			3 years
Peru		No		Between 0.24 and 0.48	12 months
Trin. and Tob.		No	0.47	0.062	
Uruguay	Bank employees, notaries, university graduates, armed forces, police	15% in industry and commerce and public employees, 16% rural employees		100% minimum wage	10 years
Venezuela	Public employees and armed forces	No			5 years during the last 10 years

¹ 60 AMPOs. AMPO is determined dividing the total employee contribution to the system by the total number of contributors.

Source: *Social Security Programs Throughout the World, 1997*, U.S. Social Security Administration, Office of Research, Evaluation and Statistics.

they become regressive. An important factor in regressiveness is attributable to the fact that pensions in many countries are calculated based on declared wages from the past few years, rather than from an individual's entire working life. In many countries, only the highest pay in the past four to five years is considered; in some countries, the reference period is as long as 10 years. This tends to benefit the higher income groups, which may substantially underreport their wages during most of their careers and make substantial contributions only at the end. To avoid these tactics, some countries impose maximum declarable wage limits, which is not a proper solution to the problem as it reduces the contribution base and redistribution potential of the overall system. It is also a common practice for social security contributions to be exempt from other taxes, which implies more favorable treatment for higher-income individuals, who should pay higher direct taxes.

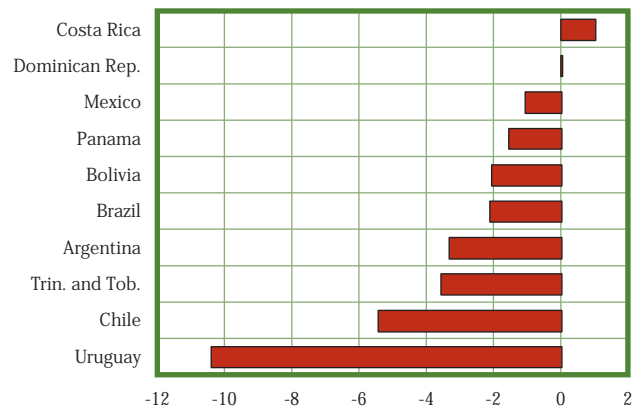
Progressive potential in pension systems is also changed by the creation of special schemes for certain groups of workers. This has been a common practice in Latin America, primarily benefiting government employees, teachers and military personnel, who enjoy special conditions such as early retirement or higher replacement rates, which often correspond only to their lobbying and organizing capacity. In some countries, certain associations for professionals such as bank staff, physicians, notaries and university professors have created pension funds that receive budgetary support through taxes, surcharges and other specifically-earmarked funds.

These are extreme cases of the use of budgetary funds for clearly regressive purposes; however, they are not the only ones. Many pay-as-you-go pension systems are operating in deficit and are financed with general budget resources (Figure 6.7), which implies that persons who are excluded from the system make indirect contributions.

Reforms in the Proper Direction

More and more Latin American countries have reformed their pay-as-you-go pension systems, replacing them partially with individually funded systems. Since Chile established a private pension system in 1981, seven more countries have moved in this direction: Peru (1993), Colombia (1993), Argentina (1994), Uruguay (1996), Bolivia (1997), El Salvador (1997), and Mexico (1997). In principle, funded systems do not involve any income redistribution mechanism, as pensions inherently depend exclusively on individual contributions (and market yields). However, all countries have introduced mutual interest and redistribution components into their new systems.

Figure 6.7. Operational Balance of Public Social Security Systems, 1995 (Percent of GDP)



Source: International Monetary Fund, *Government Financial Statistics* (1997).

In Chile, although the defined benefits scheme has only remained in effect for those who were already retired and those who decided to remain in the system at the beginning, the government guarantees everyone a minimum pension under the new system after 10 years of contributions. In Mexico, where the old system will also be eliminated, there is a government-sponsored minimum guaranteed pension. The final consolidation of the new systems in these two countries will for all intents and purposes eliminate the regressive mechanisms of pension benefits in the prior system.

The situation is more complex in other countries where many components of the earlier systems are still in place. In Colombia, workers may select between the old and new system, but in either case are guaranteed a minimum pension. In addition, under the pay-as-you-go system, retirement conditions are quite favorable to women, individuals over 40 years of age at the time of the reform, and those who have less potential to accumulate contributions during their overall working life. Regardless of which system they select, higher-income employees must also contribute 1 percent of their wages to the pay-as-you-go system. This approach has preserved a number of mutual interest components, which may be progressive. However, it has also retained more regressive factors such as very generous retirement conditions for civil servants and options for private fund participants to claim pensions from the pay-as-you-go system in the event that the yields in private funds are unsatisfactory. In addition, as all of these guarantees will lead to financial imbalance in the pay-as-you-go system, eventual dependence on tax revenue will accentuate its regressive features.

The two systems are complementary in Argentina and Uruguay: the basic component, to which all workers contribute, provides basic pensions up to a maximum amount, which has a progressive feature. The individual funding component, which is mandatory in Uruguay and optional in Argentina, theoretically has no significant distributive impact. While this component should have resulted in an enhanced distributive effect for the entire pension system in the two countries, it is not clear that it is in fact progressive. In Uruguay, the schemes were maintained for special groups (military personnel, police and other groups of employees affiliated with parastatal social security funds). In Argentina, an additional benefit was established for remaining in the old pay-as-you-go system, in the form of ample guarantees on returns for the state bank pension fund, and guaranteed retirement benefits from the old system up to an amount specified in the national budget for persons choosing the funded system.

In summary, Latin American pension systems have not served as progressive income redistribution mechanisms. Countries that have introduced purer forms of individually funded systems, such as Chile or Mexico, will in the long term eliminate the most significant regressive components, which will disappear with the pay-as-you-go system (although there will be a considerable temporary operating deficit to be covered with tax revenue). Progress will be less evident in countries that have opted for a combination of the pay-as-you-go and funded systems, maintaining acquired privileges for various groups and offering government guarantees, with unclear progressive features. However, a pure individually funded scheme is inherently neutral in distributive terms, and hence in and of itself would be an incomplete solution to social security problems and should be supplemented with a purely redistributive component.

WHAT THE PENSION SYSTEM CAN DO

A social security system with two or more pillars may achieve objectives in terms of redistribution, savings and insurance that traditional pay-as-you-go systems in Latin America cannot:

- The payment of minimum pensions to persons not earning subsistence incomes—a basic component financed with general budget resources—may address the objective of reducing poverty and providing the elderly with insurance.

- A mandatory, individually funded component based on defined contributions should address the old-age saving function for persons with regular labor income. This component should be operated under competitive conditions by the private sector, although it should be publicly regulated to avoid systemic risks and protect participants' rights.
- The two components could optionally be supplemented with voluntary long-term savings plans offered by financial institutions or other private organizations to those who wish to have additional old-age coverage.

One of the main problems with the design of any social security system in Latin America is the incorporation of informal sector workers. As it is impossible to monitor, participation of these workers must be voluntary, although they would seem to have little incentive to participate because their incomes are lower and more unstable than formal sector workers, and because the opportunity cost of saving is high due to limited access to credit for informal activities.¹¹ An incentive that might favor poorer informal sector workers would be a periodic direct subsidy in a fixed per capita amount, strictly targeted and subject to continued participation in the system. Another option is to provide seed capital for membership in the form of paper with a future maturity (possibly related to the worker's age). A variation of this option is to allow workers to share in ownership of public enterprises that have been "capitalized" or privatized.

It is a good time for Latin American countries to make the necessary reforms in their social security systems. The state of demographic transition in most countries in the region indicates that the proportion of the population of productive age will peak in the next few decades. The number of children each active worker must support has declined, and the proportion of persons of retirement age has still not increased. As a result, present workers are able to generate savings to cover their future retirement without having to transfer the burden to future generations. Pension system reform can therefore not only improve income distribution among present generations, but also between present and future generations.

¹¹ See Chapter 7.

WHAT THE MINIMUM WAGE ACCOMPLISHES

The minimum wage in Latin America has traditionally been considered a redistributive instrument and an income protection mechanism for the poorest workers. However, as with other labor protection instruments, when goals are excessively ambitious they become irrelevant, if not counterproductive, in terms of helping the poor.

What Is Needed for the Minimum Wage to Protect the Poor?

There is intense debate both in industrial and developing countries as to whether minimum wages constitute an effective mechanism for distributing income and protecting the income of the poorest workers (see Box 6.2). Evidence for Latin America suggests that changes in the minimum wage have a discernable effect on income distribution, although the magnitude is low (see Box 6.3).

For the minimum wage to raise real incomes for the poorest workers, it must meet three difficult conditions. First, it should not adversely affect aggregate employment demand. Income of the poor cannot be protected if income increases for some workers result in a significant rise in unemployment. Second, levels of compliance with regulations must be high. Ambitious wage increase regulations are of little help if they cannot be enforced owing to informal labor contracting practices or to the government's insufficient means to prevent evasion, especially by organized enterprises operating in the formal sector. However, these two conditions are not sufficient. After all, if the minimum wage were established at an extremely low level, it would not reduce employment or generate evasion problems—nor would it improve anyone's income. The third condition, therefore, is that the minimum wage be situated at a level that covers a substantial group of low-income workers.

These three conditions can easily conflict with one another, depending greatly on the minimum wage level. It is widely agreed that, at relatively low levels, the minimum wage does not appreciably change aggregate employment demand, while at high levels its effects can be quite negative. A number of different studies on developing countries have found that low minimum wage levels affect the composition more than the level of employment: although youth employment tends to be reduced, this effect is typically offset with higher adult employment levels.¹² However, when the minimum wage is set at a high level, job destruction effects predominate, as demonstrated by Puerto Rico's experience when it

adopted the U.S. minimum wage during the 1970s. Experience in Puerto Rico and other developing countries indicates that, at high levels, a 10 percent increase in the minimum wage (exceeding inflation) can reduce employment in proportions that vary widely from country to country, but that in some cases can be as high as 12 percent.¹³

If a high minimum wage level leads to reduced employment demand, it will also affect compliance with regulatory requirements because displaced workers and the affected enterprises will benefit from collusion to evade the regulations. Noncompliance will be higher the greater the divergence between the minimum wage and the market level for wages, and will also depend on the government's institutional capacity for oversight and enforcement.

It follows that the selected minimum wage level is the principal determining factor in its efficiency and its potential impact on income distribution. Excessively high minimum wages can have job destroying effects and prove to be ineffective in raising income levels of the poor.

Is the Minimum Wage in Some Countries Too High?

Answering this question for Latin America requires comparing the minimum wage in each country with the average wage level, which reflects general worker productivity conditions. In 1995 and 1996, minimum wage levels in most Latin American countries represented less than half the average minimum wage level (Figure 6.8). In Bolivia, Brazil and Argentina, the minimum wage was less than 30 percent of the average wage, and in Chile, Mexico and Peru, it was between 30 and 40 percent. These proportions are low in comparison with industrial countries. However, in a number of Latin American countries, the minimum wage exceeded the average by 50 percent, and in the extreme case of Venezuela in 1995, it represented approximately 90 percent of the average wage, well above the level in any industrial country.

High minimum wage levels will only affect remuneration of high-income workers. In fact, in Honduras, Paraguay, El Salvador and Venezuela, those who earn

¹² See Brown, Gilroy, and Kohen (1982), Hamermesh (1982), Wellington (1991), Card (1992), and Card and Krueger (1994) for the effects of the minimum wage in the United States; Schaafsma and Welsh (1983) for Canada; Bazen and Martin (1991) for France; and Dolado, et al. (1996) for France, the Netherlands, England and Spain.

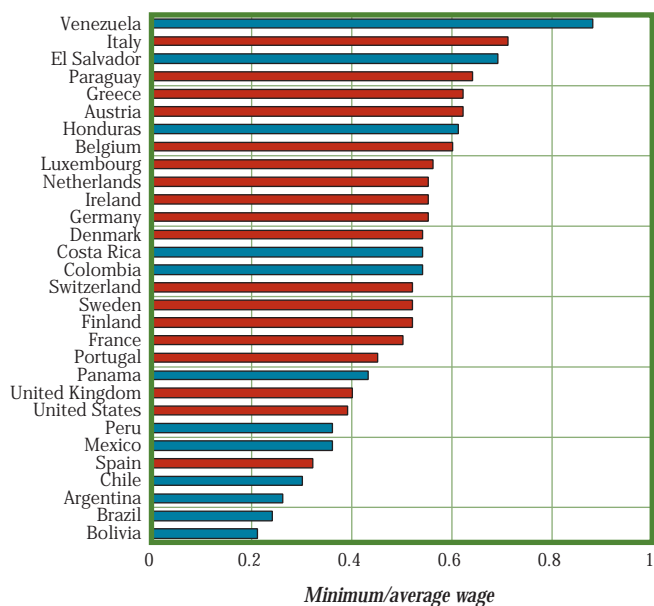
¹³ On the subject of Puerto Rico, see studies by Santiago (1989) and Castillo-Freeman and Freeman (1990). For Mexico and Colombia, see Bell (1997).

BOX 6.2. Minimum Wages and Income Inequality: The Discussion

There is intense debate both in industrial and developing countries as to whether minimum wages constitute an effective mechanism for distributing income and protecting the income of the poorest workers. Evidence for Latin America suggests that changes in the minimum wage have a discernable effect on income distribution, although the magnitude is low (see Box 6.3). Overall evidence on the impact of minimum wages on income distribution points to some positive but small declines in inequality and somewhat larger positive effects on poverty. In the United States, for example, the discussion evolves around whether the sharp decline in the real value of minimum wages during the 1980s can explain the increase in wage and income inequality experienced during that period. The evidence is far from conclusive. Dinardo, Fortin and Lemieux (1996) find that the decline in the real value of the minimum wage explains about one-third of the change in wage inequality, but Horrigan and Mincy (1993) find modest effects on earnings inequality and virtually no effects on family income inequality. Regarding minimum wages and income distribution in developing countries, World Bank (1995) states that while minimum wages might help protect the incomes of the poorest workers in industrial countries, they clearly do not do so in developing countries. The claim is that the workers affected by minimum wage provisions are

really the most needy. Moreover, by reducing formal sector employment, minimum wages exert downward pressure on the wages of informal poor workers. However, there is little evidence that minimum wages might yield declines in wage inequality in developing countries. Bell (1996) documents that in Colombia, minimum wage increases were accompanied by a decline in inequality even when the economy was going through recession. On the empirical side, Lustig and McLeod (1997) find that in a sample of about 30 developing countries, an increase in statutory minimum wages is associated with a decrease in the level of poverty. They describe various channels for which this effect may arise. Besides the direct impact of minimum wages, they cite mechanisms that link higher minimum wages with higher wages for informal workers. Demand-link models, for instance, state that an upward push in formal sector wages might increase the demand for informal sector products, leading to an increase in informal sector demand and wages. Finally, Ramos and Almeida Reis (1995) undertake an exercise of simulation to assess the impact of minimum wage policy in Brazil very similar to the one performed by Horrigan and Mincy for the United States. As did Horrigan and Mincy, they find that minimum wages have positive but small effects on income inequality.

Figure 6.8. Minimum Wage in OECD Countries and in Latin America in the 1990s



Source: OECD: *European Industrial Relations and OIT Yearbook*. Latin America: *Ministries of Labor*.

minimum wage are moderate-income workers in the third labor income quintile.¹⁴ Even in Mexico, Panama and Costa Rica, where the minimum wage represents a smaller proportion of average wages, it applies to workers in the second quintile, and not the poorest. The minimum wage level should be relatively low, less than 40 percent of the average wage, so that, at least in principle, it favorably affects remuneration among the lowest-income workers.

Effectiveness of High Minimum Wages Is Limited

Where minimum wages are higher with relation to average wages, noncompliance with the regulatory system is greatest: in Paraguay and El Salvador, approximately half of workers earn wages under 80 percent of the minimum, which is true for 30 to 40 of every 100 workers in Honduras and Venezuela. By contrast, noncompliance levels fall below 10 percent in countries where the minimum wage is below 30 percent of the average wage (Figure 6.9). Judging from the ratio of relative minimum wage level compliance, a 10 percent minimum wage reduction can in-

¹⁴ All calculations in the rest of this section reflect minimum wage data for 1994, 1995 or 1996, depending on the country.

Box 6.3. Minimum Wages in Latin America: Trends and Effects on Inequality

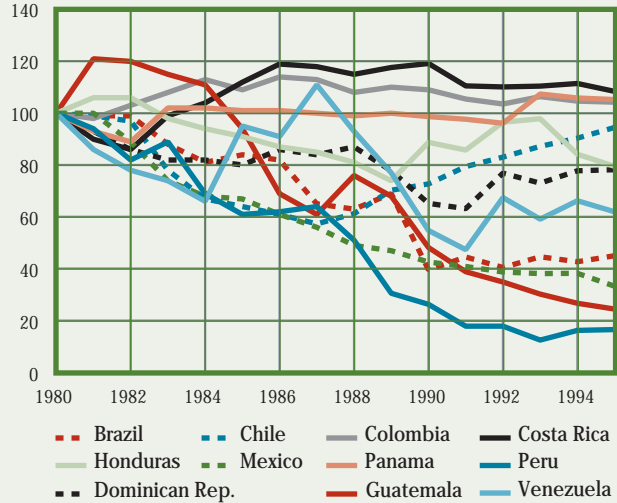
The purchasing power of the minimum wage in most Latin American countries is now much lower than it was during the early 1980s. The debt crisis and subsequent adjustment processes led to decreases in minimum wages, which were only partially corrected during the 1990s. Only Colombia, Costa Rica and Panama succeeded in maintaining relatively stable minimum wages in real terms (see Figure 1).

An econometric analysis indicates that reductions in minimum wage purchasing power have been inversely associated with increases in income concentration (and vice versa) in all 11 countries considered (after isolating the influence of a number of other variables that may even have affected distribution—see Appendix 6.5). However, the effects have been surprisingly modest. For every 10 percent minimum wage reduction, the income concentration index has increased by just under 0.2 points (equivalent to approximately 0.4 percent of the initial inequality level).

Other studies, both of Latin America and at the international level, have found that while minimum wage increases may effectively reduce poverty in the short term, they cannot be used indiscriminately for that purpose, as they can generate unemployment and reduce growth, adversely affecting the poor in the long term (Morley, 1992 and 1997; de Janvry and Sadoulet, 1995; Lustig and McLeod, 1997).

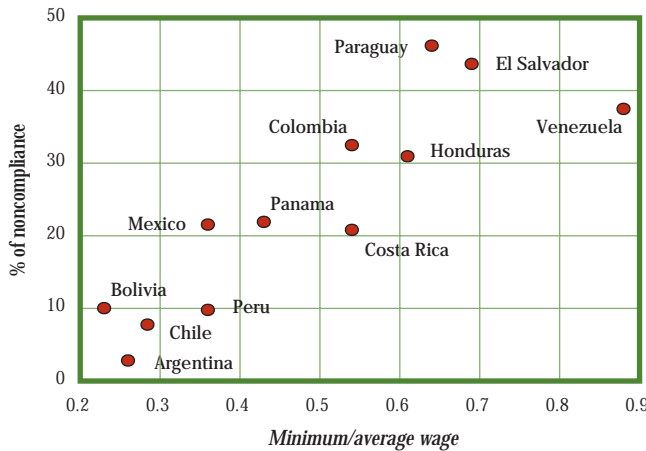
In Latin America, minimum wages have distributive effects through a number of different channels that normally have little to do with the nature of this instrument. In many countries, they serve as a basis to define the amounts of pensions

Figure 1. Minimum Wage Index



and other transfers, to adjust civil servants' wages, or to establish rates for public services. And in inflationary situations, minimum wage adjustments may influence other wages and prices. All of these factors are indicative that minimum wages constitute an untargeted income distribution instrument.

Figure 6.9. Noncompliance and the Minimum Wage Level



Source: IDB calculations based on most recent household surveys.

crease compliance by approximately eight points. Although this figure is merely indicative, it suggests that evasion is quite sensitive to incentives. It is mutually beneficial for enterprises and workers at risk or in unemployment situations to agree to remunerations below the minimum wage.

It is commonly believed that noncompliance with wage standards is limited to small-scale enterprises and informal concerns, reflecting a highly simplified theoretical conception according to which a minimum wage requirement above the equilibrium labor market wage leads to the appearance of an informal sector that evades the regulations.¹⁵ Reality is quite different, as much minimum wage evasion occurs in large enterprises.¹⁶ As indi-

¹⁵ This theory was proposed by Welch (1976) to explain why the minimum wage did not seem to generate unemployment in the United States to the extent that might be expected based on the single market model.

¹⁶ As also observed by Ashenfelter and Smith (1979) in the United States, demonstrating the limitation of the simple segmentation approach.

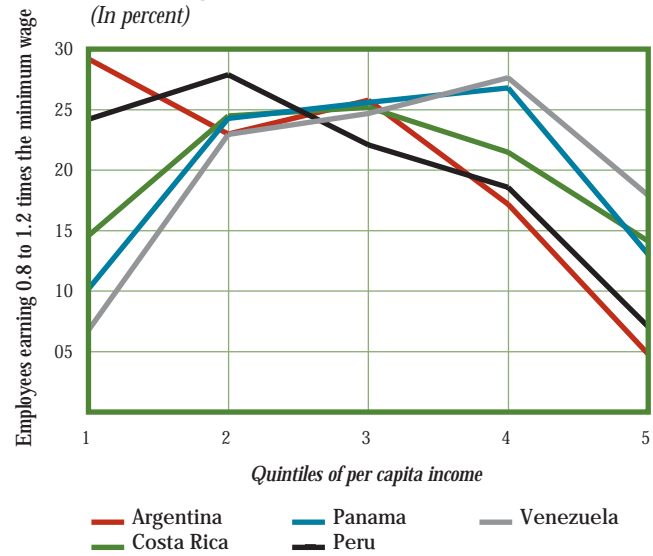
cated above, labor regulations are just one of the factors that influence the existence and scope of the informal sector. Typically, 40 percent of workers paid less than 80 percent of the minimum wage work in enterprises with 10 or more employees. In El Salvador and Venezuela, six of every 10 workers paid less than 80 percent of the minimum wage are employed by large enterprises.¹⁷ In Brazil, Panama and Paraguay, young workers can legally be paid below minimum wage (in the former two countries, they must be apprentices). However, in many cases, observed noncompliance is tantamount to evasion of the law. Governments lack the resources to supervise compliance and impose fines on violators. Insufficient supervision tends to occur in very large and unrepresentative enterprises. While unions can perform supervisory functions, the levels of unionization are insufficient in most countries to make an impact. In addition, unions are concentrated in high-wage enterprises, where few workers are directly affected by minimum wage regulations.

To summarize, the higher the minimum wage levels with relation to the average wage earned by all workers, the greater the noncompliance. Young workers, who are less educated, along with those employed in small enterprises, are the most likely to remain below this level. However, compliance is far from perfect in large-scale enterprises. Noncompliance with wage regulations softens the impact on employment, but also reduces the possibility for the minimum wage to operate as an income protection mechanism for poorer workers.

Minimum Wage Earners Are Often Not the Poor

Aside from problems of compliance and potential job destruction effects, the minimum wage is a fairly tenuous instrument for protecting the incomes of poor families. Even when the minimum wage is very low, workers who earn it are not exclusively (and often not even in the majority) from poorer families. In the best of cases, when the minimum wage is fairly low, such as in Argentina, only 30 percent of the wage earners paid near the minimum wage level (0.8 to 1.2 times this amount) are members of families in the poorest quintile of the population. Just above 20 percent belong to the second poorest quintile, and the rest are members of middle- and upper-class families (Figure 6.10). More than half of those who earn the minimum wage are not heads of household, but rather young people who may or may not come from families whose fathers are low earners. In countries with high minimum wage levels, such as Venezuela, more minimum wage earners are adult heads of household, although most are in the middle and upper categories. Youth who

Figure 6.10. Minimum Wage Incidence according to Per Capita Household Income (In percent)



Source: IDB calculations based on recent household surveys.

earn minimum wages are predominantly highly educated and come from wealthy households. In other words, a high minimum wage is targeted more at the wealthy than a low minimum wage is at the poor.

In these conditions, an increase in the minimum wage affects income distribution modestly, even with the assumption that it is totally effective and does not adversely affect employment. With these assumptions, a 10 percent minimum wage increase in Argentina would reduce the Gini wage income concentration coefficient by 0.04 percentage points, and the Gini household income concentration coefficient by 0.0035 percentage points, quite a modest change. Similarly, in Costa Rica, the Gini wage coefficient would be reduced by .035, and in other countries the reduction would be somewhat lower.¹⁸ These calculations only reflect the direct effect of a minimum wage on wages of workers at this income level, but do not include any indirect effect that they may have as a reference price for other incomes (for example, informal sector wages or social security transfers). However, although indirect effects are not considered, these changes are similar in magnitude to those obtained from the time series analysis (results are summarized in Box 6.3).

¹⁷ We used 80 percent of the minimum as a cutoff line, as the wages actually received by workers can be affected by social security contributions and other deductions paid by workers.

¹⁸ These results are based on Pagés (1998).

What the Minimum Wage Can Do

As we have observed, the minimum wage is a very limited income redistribution instrument. Part of the problem is that a single minimum wage does not reflect differences in household structures. Of course, minimum wages that vary with the number of dependents or other household characteristics would be both unmanageable and counterproductive, as they would cause enterprises to discriminate against those in greatest need. A better solution is to establish a lower minimum wage for youth, as is done in European countries (and in Paraguay, among countries in the region). This would make it possible to address the main problem of the targeting of the minimum wage based on its effects on the income of youth in middle- and high-income families. This approach could also reduce youth unemployment, as enterprises would prefer, given a minimum wage, to employ more experienced workers and to hire youth on a selective basis. Young people, in turn, would find it more advantageous to keep looking for formal sector employment, given its relative advantages over other activities.

The minimum wage is limited in its ability to protect the income of the poor, as well as in income redistribution, because of evasion problems, potential adverse effects on employment and insufficient targeting. These problems are less severe, although they are not eliminated, when the minimum wage is set at moderate levels and when a lower minimum wage for youth is established.

OTHER INCOME PROTECTION MECHANISMS FOR THE POOR

Are there other, less limited options? Wage supplements for low-income workers provide an alternative, although they do entail some problems. With this technique, low-income workers receive a wage supplement if their income is below a certain level. In Colombia, this system is financed with a payroll tax levied on all workers, which is also used to finance health, education and recreation programs administered by private “equalization funds.” In the United States, the earned income tax credit is a similar instrument, with the advantage that it serves as a negative tax for low-income workers, and is administered by the tax collection office. Under these schemes, the tax credit or supplement that workers receive can be adjusted to reflect the number of dependents or the income level without affecting the cost of a worker to the enterprise. However, these programs have serious disadvantages in that they encourage workers to report lower wages in order to receive higher subsidies. Accordingly, they require

greater administration and supervision than minimum wages. Apart from their high administrative costs, these systems can generate poverty traps, which occur when an increase in gross income is not reflected by a net gain because part of the subsidy is forgone. In this case, workers may become dependent on social welfare systems.

A similar option is to subsidize enterprises that contract workers whose wages are below a certain income level. The subsidy might operate as a payroll tax exemption, with the advantage that it stimulates, rather than discourages, demand for this type of worker. A further advantage is that, unlike the minimum wage, if the aim is to focus incentives on workers who have more dependents, enterprises would prefer them to other workers. In principle, employment subsidies should be granted only under new worker contracts to prevent transfers costly to enterprises in connection with existing jobs. Experience in industrial countries has shown that enterprises often simply replace existing workers with new ones, with few gains in terms of employment. Another problem is that this is a temporary system that lasts as long as the subsidy policies remain in effect. Last, poverty traps can also appear in this connection, as subsidies reduce the incentive for enterprises and workers to raise productivity and wages above the minimum level eligible for the subsidy.

There are other problems as well with subsidizing workers or companies in order to increase employment and incomes of the poorest workers. The limitation of any of these schemes is that fraud and evasion can only be kept under control with adequate information systems and supervision, which normally do not exist in the poorer countries. And in these countries, these types of programs are often not feasible because of the large proportion of unskilled, low-income workers.

Appendix 6.1. Econometric Results: Effect of the Labor Code on Employment				
Dependent variable:	Employment rate (Share of working age population)		Self-employment rate (Share of employment)	
	Labor rigidity index	-0.77 (-3.4)	-0.39 (-0.9)	0.63 (3.2)
GDP per capita		0.0002 (0.3)		-0.0005 (-2.5)
Dummy for Latin America		-6.11 (-0.5)		
No. of observations	34	27	24	23
Adjusted R ²	0.243	0.152	0.531	0.659
<i>Note:</i> T-statistics in parentheses. <i>Source:</i> Márquez and Pagés (1998).				

Appendix 6.2. Econometric Results: Effect of the Labor Code on Dependent Employment by Age Group, Chile, 1960-96				
Dependent variable:	Total employment (% growth)	Employment population aged		
		15-25 (% growth)	26-50 (% growth)	51-60 (% growth)
Labor rigidity index (log)	-0.002 (-1.44)	-0.009 (-3.08)	0.0007 (0.18)	0.004 (0.99)
Salary (change in log, lagged)	-0.023 (-1.43)	-0.015 (-1.21)	-0.018 (-1.067)	-0.014 (-0.75)
GDP growth	0.241 (8.22)	0.28 (7.142)	0.22 (4.61)	0.12 (2.13)
Adjusted R ²	0.53	0.63	0.35	0.21
Durbin-Watson	2.75	2.34	2.47	2.31
<i>Source:</i> Pagés and Montenegro (1998), based on household surveys from Santiago University. <i>Note:</i> In addition to the reported variables, a constant, a lag of the dependent variable and its interaction with the protection index are included in the regressions. T-statistics in parentheses.				

Appendix 6.3A. Probability of Obtaining a Permanent Contract			
Estimation method: PROBIT			
Dependent variable:			
Dummy =1, if obtain a permanent contract			
= 0, if not			
Women			
	Chile	Mexico	Venezuela
Marital status (dummy = 1 if married)	-0.34 (-4.94)		-0.02 (-3.41)
Number of children	-0.2 (-8.95)	-0.005 (-1.18)	-0.006 (-3.41)
Men			
	Chile	Mexico	Venezuela
Marital status (dummy = 1 if married)	0.08 (14.60)		0.57 (6.84)
Number of children	-0.015 (-8.82)	0.13 (4.87)	-0.07 (-4.64)
<i>Note:</i> In addition to the above variables, five dummies of age, years of education, size of the firm, zone, occupation and sector of activity are included. T-statistics in parentheses.			
Dependent workers aged 15-65			
	Chile	Mexico	Venezuela
Age 25-35 (dummy = 1 if in this age)	0.06 (11.84)	0.09 (7.51)	0.049 (7.48)
Age 35-45 (dummy = 1 if in this age)	0.09 (16.64)	0.21 (14.91)	0.056 (7.54)
Age 45-55 (dummy = 1 if in this age)	0.11 (19.05)	0.19 (10.62)	0.067 (7.49)
Age 55-65 (dummy = 1 if in this age)	0.1 (13.54)	0.17 (6.38)	0.066 (4.91)
Years of education	0.14 (23.32)	0.025 (19.25)	0.0042 (4.76)
Marital status (dummy = 1 if married)	0.036 (8.15)		0.019 (3.22)
Zone (dummy = 1 if urban)	0.02 (3.85)	0.11 (10.06)	0.89 (10.82)
Gender (dummy = 1 if man)	0.014 (3.18)	0.013 (1.29)	-0.007 (-1.12)
Type of employment (dummy = 1 if formal)	0.04 (8.43)	0.54 (58.9)	0.111 (16.73)
Number of children	-0.015 (-11.52)	0.008 (3.44)	-0.006 (-5.19)
<i>Note:</i> In addition to the above variables, a constant and controls for occupation and sector of activity are included. T-statistics in parentheses.			
<i>Source:</i> IDB calculations based on recent household surveys.			

Appendix 6.3B. Wage Differentials Associated with Type of Contract			
Dependent variable: Hourly wage (log)			
Sample: Dependent workers aged 15-65			
Women			
	Chile	Mexico	Venezuela
Type of contract (dummy = 1 if has permanent contract)	0.06 (4.4)	0.33 (11.55)	0.19 (8.06)
Men			
	Chile	Mexico	Venezuela
Type of contract (dummy = 1 if has permanent contract)	0.176 (19.67)	0.23 (12.3)	0.17 (11.1)
Total sample			
	Chile	Mexico	Venezuela
Type of contract (dummy = 1 if has permanent contract)	0.13 (18.4)	0.27 (16.8)	0.171 (13.2)
Marital status (dummy =1 if married)	0.1 (15.9)		0.08 (7.87)
Zone (dummy = 1 if urban)	0.27 (29.3)	0.27 (18.1)	0.15 (10.42)
Type of employment (dummy = 1 if formal)	0.2 (24.9)	0.17 (11.3)	0.41 (35.01)
Gender (dummy = 1 if man)	0.21 (31.3)	0.24 (16.8)	0.16 (15.5)
<i>Note:</i> In addition to the above variables, a constant and controls for years of education, years of education squared, experience, experience squared, occupation and sector of activity are included. T-statistics in parentheses.			
<i>Source:</i> IDB calculations based on recent household surveys.			

**Appendix 6.4. Relationships between Labor Protection Indices by Country
and Earnings Differentials, Estimated by Type of Employment**

(For Urban Male Wage Earners)

	Men	Women
Employer, urban	-0.3765	-0.283
Employer, rural	-0.3508	-0.4215
Formal worker, urban	na	-0.1346
Self-employed, urban	-0.2845	-0.2167
Formal worker, rural	-0.6931	-0.2036
Informal worker, urban	-0.2217	-0.3983
Self-employed, rural	-0.1841	-0.2706
Informal worker, rural	-0.6717	-0.692

Source: IDB calculations based on household surveys, and Labor Rigidity Indices from Figure 6.1.

Note: Correlations are calculated for 14 countries for urban earnings and 11 countries for rural earnings. Earning differentials are estimated for each country controlling for education, experience and experience squared (see Chapter 2, where these results are reported).

**Appendix 6.5. Econometric Results:
Effect of the Minimum Wage on Income Distribution, 1981-95**

Dependent variable:	Gini coefficient of per capita income (Three-year average for 11 countries)			
Minimum wage index	-0.02 (-2.40)	-0.02 (-2.68)	-0.02 (-2.25)	-0.02 (-2.27)
Share of manufacturing and commerce in GDP		0.51 (2.29)		
GDP growth			2.7 (0.25)	
GDP volatility				-2.75 (-0.11)
Adjusted R ²	0.13	0.22	0.11	0.12
Durbin-Watson	2.38	2.61	2.38	2.47
No. of observations	37	37	37	37

Note: T-statistics in parentheses.

Source: Income distribution according to Deininger and Squire (1996); minimum wage from ECLAC; and macro variables from IDB's Economic and Social Database.

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