Labor Market Reforms and the Poor

- by -

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I. Labor Regulations in Historical Perspective

On June 25, 1938, President Franklin D. Roosevelt signed into law the Fair Labor Standards Act (FLSA). The FLSA was a landmark piece of American labor legislation. It established a national minimum wage of 25 cents per hour (then equal to 40 percent of the average wage in manufacturing); set a full-time standard work week of 40 hours with "time and a half" payment required for additional hours; and prohibited child labor in activities involving interstate commerce.[1] In order to win passage in the US Congress, the act had many exemptions. Southern opposition to the bill, for example, required that farm labor be excluded from the bill's coverage, an exemption to federal minimum wage laws that remains in effect today. Domestic workers also were not protected by the legislation.

Support for the FLSA came from many quarters. It was part of President Roosevelt's progressive New Deal legislation intended to combat the economic ills of the Great Depression which left "…one-third of a nation ill-housed, ill-clad, and ill-nourished." Social reformers saw labor legislation as a necessary means to balance the bargaining position between powerless workers faced by powerful employers. But other interests also were at work. Economic historians point to a North-South divide on the FLSA, with Northern industrialists fearful of low-wage Southern competition. The FLSA's minimum wage provisions were intended less to raise low wages than to protect the profits of Northern firms. From this perspective, the FLSA served as an internal tariff on goods produced in the low-wage American South.[2]

The passage of the FLSA and the beginning of federal regulations on the labor market occurred when the US already was emerging, according to today's definitions, into a high income economy. Other contemporary OECD economies, including Australia and the United Kingdom, passed comparable legislation a few decades earlier, but they too had achieved relatively high per capita income levels before enacting such regulations. This stands in contrast to many developing economies which have regulated their labor markets much earlier in the development process.

As was the case for the American FLSA, the motivations behind labor regulations in low and middle income settings are varied. Some see labor regulations as a necessary intervention to protect the welfare of workers, whether from uneven market power, labor market discrimination, insufficient or asymmetric information, or inadequate insurance from risk.[3] Alternatively, labor legislation may result from the attempt to improve the

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[1] The FLSA was not the first piece of U.S. labor legislation. Various state wage regulations and several federal acts covering government contracts and workers preceded it. What distinguishes the FLSA was its national coverage and ability to survive legal challenges to its constitutionality. Levitan and Belous (1979) provide a history of US labor legislation leading up to the FLSA.

[2] An analysis of the political economy of the passage of the FLSA appears in Seltzer (1995).

[3] In expanding upon arguments that favor labor regulations, the 1995 WDR explains,

circumstances of a relatively small group of "insiders" – workers with political power who have wage-paying jobs in the formal sector as opposed to the majority of labor, "outsiders", who receive low returns for their efforts in the informal or rural sectors. Labor regulations, by raising labor costs and discouraging employment growth, may harm rather than help low income households. Reform rather than the enactment or enforcement of labor legislation may then be necessary to help the poor. (Box 1: Why is European Unemployment so High?)

II. Labor Regulations in Low and Middle Income Economies

Labor regulations encompass far more than the FLSA's setting of minimum wages, a standard work-week and minimum ages of work. In a survey of labor market legislation in Latin America and the Caribbean (LAC), Cox-Edwards (1993) writes,

> Textbooks usually mention minimum wages as the predominant labor market distortion to be removed in market-oriented reforms. But this is not the most pressing issue in Latin America today. With few exceptions, minimum wages have declined throughout the region in the past few years and have largely become non-binding…. The most serious labor market distortions in Latin America can be classified in three categories: employment protection laws that impose limits on temporary hiring and impose substantial costs on dismissals; high payroll taxes; and antagonistic labor-management relations that encourage confrontation and costly settlement procedures. (p. ii)

Examples of such regulations include two year limits on non-renewable temporary contracts in Ecuador, Nicaragua and Peru; payroll taxes of 46 percent in Argentina and 20 percent in Colombia; and the existence of union shops in a large number of LAC countries.[4] Cox-Edwards also reports the existence of mandatory non-wage

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> When market power is uneven, it is usually workers who find themselves in a weak position relative to firms, unable to protect themselves from unjust treatment. This also leads to efficiency losses as workers become less likely to invest in firm-specific skills. Uneven market power becomes an even greater problem for workers belonging to groups that traditionally have little voice in society – children, women, and ethnic and religious minorities. Discrimination leads to market outcomes that are not only inequitable but inefficient: it limits the contribution of women and minority groups to economic development. Inefficiencies increase when workers and some employers are poorly informed about their work environment, particularly in regard to health and safety hazards. Finally, workers and their families are typically unable to insure themselves adequately against the risk of income loss due to unemployment, disability or old age. (p. 70)

[4] A union shop requires all employees to be union members. Some union shops are implicit, that is, a worker's contract with a firm automatically is governed by the union's collective bargaining agreement, whether or not the individual worker decides to join the union. Cox-Edwards (1993), Table 3.1, describes the framework for collective bargaining in ten LAC economies.

compensation such as annual vacation time (30 days in Peru), maternity leave (24 weeks in Brazil) and employer funded child care (for firms of 20 or more employees in Venezuela.) The key question concerning these benefits is who pays for them: employers in the form of lower profits; workers in the form of higher benefits and lower wages; or workers outside the formal labor market who might benefit from higher labor demand if total labor costs were lower.

Countries in Latin America are not alone in possessing extensive labor market regulations. Indonesia has had a minimum wage since the early 1970s, and also possesses regulations on the length of the work week, overtime pay, child labor, occupational health and safety and collective bargaining (Nayar 1996). India is notorious for its labor regulations, especially its job security provisions (Fallon and Lucas 1991). Several Southern Africa economies (especially South Africa and Zimbabwe) and countries in the CFA zone in West Africa also have a long history of labor legislation and regulations. For the latter group, Rama (1998) notes,

> The CFA zone is characterized by some of the heaviest labor market regulations in the world applied to some of its tiniest formal sectors….For decades, labor market policies in CFA countries were characterized by four main features: extended reliance on minimum wages, detailed salary grids by occupation and experience for all in sectors with collective bargaining, centralized hiring mechanisms, and stringent constraints on firing. (pp. 3,5)

The questions raised by these regulations in their various settings is what impact do they have on wages, employment opportunities and, ultimately, the well-being of the poor.

III. The Impact of Labor Market Regulations: Competing Arguments

In order to assess the impact of labor market reforms on the poor, it is necessary to determine the impact of labor market regulations on labor market outcomes. In an important review article, Freeman (1992) caricatures the debate over labor regulations as a fight between the World Bank Distortion View versus the ILO Institutional View. He describes the opposing positions as follows:

> On one side are economists who see unregulated labor markets as neoclassical bourses in which government regulation of wages, mandated contributions to social funds, job security, and collective bargaining create "distortions" in an otherwise ideal world….On the opposite side are institutionally oriented economists who believe that the social aspects of labor markets create such large divergences from the competitive ideal as to make the model a poor measuring rod for policy. These analysts stress the potential benefits of intervention, hold that regulated markets adjust better than unregulated markets to shocks, and endorse tripartite consultations and collective bargaining as the best way to determine labor outcomes. When efficiency conflicts with the social protection of labor, they place greater weight on the latter. (p. 118)

The Distortion View argues that labor market policies tend to raise labor costs and reduce labor demand in the formal sector, while increasing labor supply and depressing labor income in the informal and rural sectors (where most of the poor are engaged.) In addition to the efficiency losses resulting from such misallocations of labor, labor policy also gives rise to deadweight losses associated with interest group rent-seeking (e.g., as a result of attempts by "insiders" to gain even more protective job security legislation), a diminished capacity to adjust to shocks due to a regulation induced loss of labor market flexibility, and a lowering of overall investment rates as a result of labor policy's redistribution of economic rents from capital to labor.

Taken together the theoretical arguments of the Distortion View imply that labor regulations hurt both wage and employment growth, and, while some workers may benefit from regulations, labor as a group will not. The poor especially are likely to be hurt from a lowering of labor demand since labor time is their primary, or even sole, asset.

Freeman, however, argues that the Distortion view employs a "selective use of economic theory," and its welfare conclusions are less robust than they first appear. He writes,

> those who believe that social security payroll taxes adversely affect savings and investment reject Ricardian equivalence; those who use nonwage costs to measure interventionist distortions reject the fungibility of modes of compensation; those who argue that employment protection laws have efficiency costs ignore Coase's theorem that property rights do not affect efficiency.
> (p. 120)

The Institutional View also is open to criticism, more for its lack of theory than for its selective use. A moral imperative for labor protection often is substituted for a more objective defense. Theory can play a greater role in assessing the Institutional perspective but too often it has not. Cost benefit analysis can be applied to the evaluation of programs such as unemployment insurance. Game theory offers insight into alternative bargaining arrangements and can identify the relative merits of differing institutional modes of wage-setting. "The game theory finding that modest differences in the rules of games (that is, institutions) can substantially affect outcomes implies that one cannot dismiss institutional claims as atheoretic, although the claims may be wrong. All of which means that we must look at evidence to decide who is closer to the truth." (Freeman (1992), p. 122)

IV. The Impact of Labor Market Regulations: The Evidence

The evidence on the impact of labor market regulations is no more conclusive than is theory. Based on analyses from the 1980s, Freeman's survey finds little evidence of the labor market rigidities that the Distortion View assumes result from labor regulations. In a wide range of developing countries, real wages – despite the prevalence of minimum wage orders – were not sticky and as macroeconomic situations worsened real wages

declined, often precipitously. Relative wages, especially differentials between the public and private sectors, but also by skill and education levels, similarly displayed considerable flexibility. Direct evidence on the consequences of specific regulations proved equivocal. Relaxation of job security legislation in Spain seems to have spurred employment growth, but similar legislation in Malaysia had little affect on employment, and findings on India and Zimbabwe appear contradictory.[5] Correlations between either the organization (industrial versus company) or strength of unions and macro-adjustments or enterprise performance also proved inconclusive.

Empirical work undertaken in the 1990s supports Freeman's earlier findings. A special issue of the *Journal of Labor Economics* (July 1997) is devoted to studies of labor market flexibility in developing countries. Several of the papers consider whether dismantling various labor regulations increases labor demand. Once again the results are mixed. Bell (1997) finds a statistically significant disemployment effect resulting from Colombia's minimum wages ("…the 10 percent rise in the real value of the minimum wage from 1981 to 1987 reduced employment of low skilled workers between 2% and 12%." (p. s4)) But in Mexico the real value of the minimum wage fell almost in half with little apparent effect on employment. Bell attributes these differences to the relative position of the minimum wage in the wage distributions of the two countries (relatively high in Colombia and low in Mexico) and to a much higher degree of noncompliance in Mexico. Rama (1996) examines the impact of minimum wages in Indonesia and gets results that fall closer to those on Mexico than on Colombia. He finds that a doubling of the Indonesian minimum wage led to a 10 percent increase in average wages and a 2 percent decrease in wage employment. These magnitudes suggest a moderate effect, not a large labor market distortion, resulting from Indonesia's minimum wage.

Papers by Gruber (1997) and by MacIsaac and Rama (1997) in the *Journal of Labor Economics* volume consider the incidence of regulations. Gruber studies the privatization of Chile's social security program which, beginning in 1981, shifted most of the financing of the program from payroll taxes to general revenues, causing the payroll tax to fall from 30 to 5 percent. If the incidence of these payroll taxes bears heavily on employers, this reduction should lower labor costs and produce, *ceteris paribus*, a commensurate increase in labor demand. Gruber finds that it did not. Workers bore the burden of the tax and when rates were lowered effectively all the benefit accrued to workers in the form of higher wages. Gruber concludes, "changes in employer taxes had essentially no effect on employment." (p. s3)

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[5] "Fallon and Lucas (1991) estimated wage and employment adjustment equations before and after passage of job security laws in India and Zimbabwe and found little evidence that the laws affected wages or speeds of adjustment but considerable evidence that they reduced total employment in relation to output – an odd finding, since job security provisions that do not affect wages or the speed of adjustment carry no extra cost that would deter employment." (Freeman 1991, p. 129)

MacIsaac and Rama (1997) reach a similar conclusion. Their focus is on the incidence of nonwage benefits mandated by Ecuador's cumbersome labor legislation, where bonus payments (the "teens"), cost-of-living adjustments, transport allowances and social security contributions are all required and, in principle, could push-up take home pay by 75 percent for a minimum-wage worker. Instead, the fungibility of compensation results in labor costs increasing, on average, by only an estimated 8 percent as workers absorb most of the mandated benefits in the form of lower base wages. Like Gruber, and unlike the conclusions of Cox-Edwards earlier, the results obtained by MacIsaac and Rama suggest that many labor regulations neither have the presumed large and negative effect on employment nor have they proven capable of significantly improving the well-being of those workers covered by these statutes.

Independent evidence from surveys of business executives in many countries confirms the weak support for the Distortion View's worst case scenario of labor regulations escalating labor costs and inhibiting the growth of employment and investment. MacIsaac and Rama (1997) report that in a survey of 1000 large firms in Ecuador, labor regulations were mentioned infrequently as a concern of business managers. The same result was obtained for Cameroon by Gauthier (1995), for Senegal by Terrell and Svjenar (1989), and for the Ukraine by Kaufmann (1997).

The World Economic Forum's, *Africa Competitiveness Report 1998*, employs similar surveys. It finds that in a sample of twenty, mostly sub-Saharan economies, over two-thirds of the countries do not rank regulations on hiring and firing, or on working hours, as a significant constraint on business activity. For most of the countries labor regulations were ranked as less onerous to business than were other regulations. The exceptions, where labor regulations were perceived of as a significant problem, were in Southern Africa and included Mauritius, Namibia, South Africa and Zimbabwe. The World Economic Forum's, *Global Competitiveness Report, 1999*, poses similar questions to a broad group of developed and developing economies. India's business leaders, like their South African counterparts, repeatedly cite job security legislation as a significant impediment to their activities. In Latin America, Argentina, Colombia and Venezuela receive low scores on labor market flexibility while Brazil, Chile and Mexico rank more favorably.[6]

Available empirical studies suggest that labor regulations have caused weaker distortions and fewer debilitating effects on the labor market than predicted by the Distortion View. There are several reasons why this may be the case. First, labor policy is at least partially endogenous to economic circumstances. Concerning the use of minimum wages, Freeman writes, "The minimum floor proved to be sawdust – not hardwood, as distortionists feared." (p. 128) When governments realize the difficulty firms have meeting the levels of prevailing minimum wages, they permit inflation to erode guidelines pegged at nominal rates. Second, labor markets world-wide show considerable flexibility to market conditions regardless of their particular institutional or regulatory

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[6] World Economic Forum (1999), Tables 7.04 and 7.05

features. The fungibility of wages and benefits is a prime example. Third, compliance and enforcement are key determinants of the impact of labor regulations. Often, employers and employees both have an incentive to evade the law – employers to lower labor costs and employees to save their jobs. Given the administrative burden of enforcement, non-compliance is expected.[7] Describing the situation in the CFA zone, Rama (1998) writes, "…very few plants are visited to check that they do comply with labor standards. In the unlikely event of one such visit, some employers add, inspectors can be easily bribed to avoid paying a fine. Not surprisingly, employers do not feel unduly constrained by current labor regulations." (p.9)

Labor regulations can be designed which seriously misallocate resources, reduce investment and slow employment growth. But this does not mean they always will do so. Empirical studies report on individual cases, but not necessarily the worst cases. More careful scrutiny of country experience may reveal situations in which labor regulations exact a heavy price, especially on those "outsiders" who work beyond the reach of the labor code.

V. Labor Market Reforms and the Poor

Relative to the main elements in most structural adjustment programs – macroeconomic stabilization, trade liberalization, capital market reforms and privatizations – labor market reforms have not been high on the policy agenda. Few cases exist where restrictive job security legislation has been repealed or nonwage benefits formally suspended. (Box 2: Assessing Labor Reforms in Latin America) Reforms may evolve via reduced enforcement or, as in the case of minimum wages, the eroding effects of price inflation. Assessing the consequences of labor market reforms on the poor, thus, is hampered by a lack both of specific and well-defined cases, and of subsequent analysis. Since labor reforms cannot be easily scrutinized, the question that can be addressed is whether existing labor regulations either help or hurt the poor.

(a) Does Labor Legislation Help the Poor?

In most low and middle income settings, labor regulations are not likely to help the poor directly. In almost every country, at least half of those individuals who fall below the poverty line are not in the labor force, either because they are too young, too old, or unable to work because of disabilities or family responsibilities. The remainder of the poor are in the labor force but, outside of the high income countries, most of them will be active in the informal or rural sectors and engaged in work activity beyond the effective

[7] Noncompliance is not only a contemporary response to labor regulations, it also limited the effectiveness of the FLSA. Seltzer (1997) concludes that in the Southern lumber industry, "The majority of firms avoided paying the minimum wage either by [claiming they were] withdrawing from interstate commerce to take advantage of an exemption to the act or by illegally paying less than the minimum." (p. 414) These actions reduced the pay benefits of the FLSA to low wage Southern lumber workers but also reduced expected job losses in the industry.

reach of labor legislation. If labor regulations are to help these groups the effects will have to be indirect, either via a general increase in income and labor demand, or because benefits to formal sector workers trickle down via household transfers to poorer relatives. The ILO Institutional View maintains that regulations can promote social protection but they have not made the case that the poor stand as beneficiaries.

East Asian experience suggests that increasing the compensation of workers, including the lowest paid, does not depend on labor legislation. Korea is a good example. Over the past thirty years Korea's workers experienced some of the most rapid wage gains of any workers in history. Absolute poverty fell dramatically. Few of these benefits were realized because of labor regulations. On the contrary, Korea did not institute a minimum wage policy until 1988, by which time Korea already had achieved upper middle income status. Other labor protections also were absent, including a lack of freedom of association and little in the way of employment protection statutes. Korea might have done better instituting these provisions earlier and avoiding the destabilizing labor relations crisis that began in the second half of the 1980s.[8] But poverty reduction in Korea, and elsewhere in East Asia, did not depend on the existence of protective labor legislation.

(b) Does Labor Legislation Hurt the Poor?

If reform of labor legislation is called upon to alleviate poverty, then it should be the case that prevailing labor legislation is hurting the poor. The assumption usually is made that labor regulations encourage capital intensive means of production and reduce over all investment levels. Together, these consequences reduce the growth in labor demand, limit the expansion of productive employment, slow real wage growth and, hence, are detrimental to the poor.

These arguments are advanced in the World Bank's recently completed, *The Long March: A Reform Agenda for Latin America and the Caribbean in the Next Decade* (Burki and Perry, 1997; p. xi),

> Reforming labor markets includes enhancing flexibility in contracting, deploying and collective bargaining; reforming severance payment systems; and reducing taxation on labor use … The aim is to improve the efficiency of labor markets and to reduce anti-employment biases, which are the result of inadequate regulation that imposes excessive costs and risks on employers. *These reforms may significantly enhance the employment- creation effects of growth, and thus contribute in an important way to the reduction of poverty.* (emphasis added)

This same report associates high degrees of unemployment and informalization of employment with existing labor regulations in the region. (pp. 37-39) But are the effects

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[8] The economic consequences of Korea's authoritarian approach to labor are analyzed in Lindauer et al (1997), Chapters 1 and 6.

of labor legislation this pronounced and will reforms deliver the hoped for expansion in employment and reduction in poverty? The evidence urges caution in accepting such conclusions. Empirical studies tend to indicate relatively small effects of labor regulations on labor demand. The effects could be larger – and in some settings may be – but this will require that regulations are set at relatively high levels, that enforcement and compliance is strong, and that the formal sector represents a reasonably large share of the economy. These conditions may be met in some economies, especially in LAC and in Southern Africa, but are less likely to hold in many low-income settings elsewhere in Africa and Asia.

In the conclusion, *The Long March* voices a similar note of caution about the magnitude of the efficiency consequences of labor legislation and the expected gains from reforms, noting:

> While the arguments for labor market reforms in the [LAC] region are persuasive, it is important that such reforms not be seen as a panacea or as a new "theology" that imposes its own set of rigidities. The relative absence of solid empirical studies of the effects of the various proposed labor market reforms on job creation argues for caution…[And] even if labor market reforms can overcome political economy constraints and be enacted successfully, they are unlikely to be sufficient (even if they are necessary) to create a more labor-absorbing growth process. (p. 92)

VI. Conclusion

More rapid economic growth, with its associated increase in labor demand, is an important element in any strategy to alleviate absolute poverty. Labor regulations can affect labor demand by influencing the rate of investment or, for a given rate of economic growth, the subsequent derived demand for labor. Alternative schools of thought call for different approaches to enable labor legislation to encourage higher economic growth rates and more beneficial labor outcomes. The Distortion View sees "unfettered" labor markets as more efficient and calls for the repeal of policy induced restrictions. The Institutional View highlights labor market imperfections and recommends policy interventions appropriate to given stages of economic development. The evidence supporting the respective positions is not overwhelming.

Poverty alleviation may be best supported by adopting a middle ground. Greater labor market flexibility in low and middle income economies is not the cornerstone of rapid increases in labor demand. As Dabalen's (1999) recent review of Africa's experience makes clear, wage flexibility in the form of dramatic declines in real wages has not been met by a significant expansion in productive employment opportunities in Africa. Similarly for other regions, expectations of the consequences of reform of labor codes should be measured and modest. At best, such reforms are complements to other policy interventions designed to increase aggregate growth and the demand for labor.

The poverty implications of labor reforms also must be sensitive to country circumstances. In some settings labor reforms, whether repeal of existing legislation or development of adequate labor institutions, may rank relatively high on the policy agenda; in other settings it may not. In order to define a pro-poor package of labor policies, future research needs to identify better those conditions under which the presence or absence of prevailing labor regulations and institutions are a significant impediment to economic growth, increased labor demand and poverty alleviation.

Box 1: Why is European Unemployment so High?

> The institutions usually identified as contributors to high and persistent European unemployment include unemployment benefit systems and other welfare entitlement programs that discourage job search; high social insurance contributions that discourage employers from seeking employees (especially for low-paying jobs) and workers from seeking jobs; school systems that do a poor job of preparing students for entrance into the labor market and ineffective public sector training programs; insufficiently competitive product market and housing markets that restrain the demand for workers and reduce mobility; job security legislation that insulates incumbent employees from the forces of demand and supply; and union power, collective bargaining arrangements, and minimum wage laws that make wages unresponsive to market forces, prevent wage differentials from reflecting productivity differentials, and encourage the substitution of capital for labor. [Coe and Snower (1997), p.3]

This catalogue of the determinants of persistently poor labor market outcomes in Europe would seem to offer *prima facie* evidence for labor regulations similarly affecting labor markets in developing economies. But this inference may be unfounded. First, there is wide debate over the relative impact of the various factors in Coe and Snower's (1997) list. Second, among these factors, several have limited applicability in low and middle income settings. Generous unemployment compensation or other welfare program benefits, which may reduce labor force participation, are not a feature in developing economies. Third, if as a result of regulations, product markets (especially for services) are rendered uncompetitive or housing markets reduce worker mobility, labor regulations are not the root cause of high unemployment or slow wage growth.

Whether or not labor regulations account for a high share of European unemployment, they may not play the same role in other regions. Direct examination of the nature and impact of labor regulations in developing countries is required to make this assessment.

Box 2: Assessing Labor Reforms in Latin America

According to a recent study, Guasch (1999),

> Labor reforms in Chile, Colombia, and Peru made union representation contestable, extended the freedom to organize unions, and reduced the costs (or procedure-related uncertainties) of dismissals. All three countries reformed their labor codes to internalize the costs of labor disputes to the parties directly involved. In addition, Peru replaced the tradition of tripartite negotiations for "final offer" arbitration, eliminated job security laws, and reduced both the level and variance of severance payment packages for displaced workers. (p. 58)

Guasch dates these openings of the formal labor market as 1980-82 in Chile, 1990 in Colombia, and 1992-93 in Peru. He attributes some of the subsequent growth in wage employment, and decline in unemployment to the initial labor reforms. Guasch admits that "… not all the credit for the improvement in the employment outlook should be attributed to labor reforms, their contribution is nevertheless substantial." (p.59) This conclusion is based on an inability of "standard" output-employment elasticities to account for all the realized job growth. Guasch draws firm conclusions linking labor reforms and employment outcomes. But the evidence provided is little more than simple correlations. Identification of more robust statistical, if not causal, linkages are warranted before accepting these conclusions.

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