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LABOR MARKET IN LATIN AMERICA AND THE CARIBBEAN: THE MISSING REFORM

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I. Introduction

After the "Lost Decade" Latin America and the Caribbean (LAC) initiated a complex reform process. Democracies returned to the continent and many countries moved away from the import substitution model (see Table 1). The so called "Washington Consensus" spread through Latin America and established three main ideas in economic policy: macroeconomic discipline, a market economy, and openness to the world, at least in respect of trade and foreign direct investment. These ideas, already a cornerstone in OECD countries at that time, were contrary to the previous Latin American economic thinkingThis earlier paradigm claimed first, that developing countries may benefit from inflation as a tax to boost investment; second that there is a leading role for the state in initiating industrialization; and third that import substitution was fundamental to getting rid of raw materials dependence. The new paradigm refuted all these ideas but surprisingly did not emphasize, or even mention as an important element, labor markets.[1]

Table 1: Timing of Democratic Transition and Economic Reform in Selected Latin American Countries

Country	Timing of Democratic Transition	Initiation of Economic Reform
Argentina	1983	1989
Bolivia	1982	1985/1990s
Brazil	1985	1994
Chile	1990	1976-1980-1990
Colombia	—	1990
Ecuador	1980	1990
Mexico	2000	1985/1990s
Paraguay	1989	1991
Peru	1980	1992
Uruguay	1985	1991
Venezuela	—	1989

Source: Based on Cook (2007).

Due to the "Washington Consensus", fiscal discipline, tax reforms, trade and capital flow liberalization, privatization of most estate owned enterprises, and deregulation of financial and goods market were at the top of policy debates after the first half of the 1980s. As we show below, most countries were able to pass pro-market reforms in most areas with the exception of labor markets. Even though not directly addressed, the expectations of reformers were that the shift to a more competitive environment would reduce inefficiencies, increase productivity and spur growth, thusincreasing

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[1] Williamson (1990), Kuczynsky and Williamson (2003) and Fischer (2003).

labor demand and employment in Latin America. In particular higher productivity would increase the marginal product of labor and therefore would imply higher wages.[2]

To put this idea in perspective, we compare Latin America with others groups of countries, using the classification provided by Schneider (2008) (See Box 1). This classification emphasizes the political economy structure of countries. In particular, Latin America is classified as "hierarchical market economies" (HME, including almost all countries in LA); "Liberal Market Economies" (LME including the United States,United Kingdom and its settler colonies); "Coordinated market economies" (CME, including most of the countries of northern Europe and Japan); "Mediterranean market economies" (MME including France, Italy, Spain, Portugal and Greece); and South Eastern Economies (SEA, including all the countries located in the South East Asia.). In this paper, we abuse terms by using HME or LAC indistinctly since both classifications have minor differences in the countries considered.

After the debt crises in the 1980s many countries made deep pro-market reforms in HME although few and timid reforms were done in the labor market. Even though GPD per capita growth was extremely low in Latin America during the 1980s, an average annual rate of -0.9percent, whereas in the CME and LME countries it was around 2percent, employment grew by a healthy 29percent during whole period in HME (see Table 2). The high level of inflation and informality seemed to grease labor markets and therefore limitations in these markets did not seem to be an obstacle to reap the benefits of other structural reforms, like trade liberalization. At the time it was not seen as necessary to spend scarce political capital on labor market reforms.

Once sound macroeconomic policies were in place and most countries opened their economies, labor market did eventually issues raise obstacles for future growth: low human capital, almost null training, lack of flexibility in formal labor markets, dual labor markets, etc.[3]But the momentum for pro-market reforms had waned. Lack of transparency in some reforms, in particular as regards privatization and poor performance in labor markets, reduced public support for pro-market reforms. The "Washington Consensus" became a bad word in Latin American politics[4]. The lack of public support and the opposition of unions, that mainly represented public sector workers and employees from large and regulated firms, blocked any attempt to extend reforms to labor markets.[5]

As pointed by Cook (2007) most labor legislation was originally crafted to reflect government-employer-worker relationships embedded in more protected national economies. Post "Washington Consensus" fiscal discipline, trade openness,together with over regulated labor markets, forceLAC economies to find alternative solutions to deal with this new reality. The number of people working in the informal sector increased throughout the region in the 1990s.[6]Informality reduced pressure on labor

[2] See for example Saavedra (2003).
[3] See for example WDI (2009) and Doing Bussines, WB (2010).
[4] Williamson (2004).
[5] Madrid (2003).
[6] ILO (1999).

market reforms, but increased other chronic Latin American problems. The region entered a vicious circle: highly regulated labor markets and informality. In addition, the region seemed to get used to high levels of unemployment and low labor market participation.[7]

During the current century, favorable external conditions for the region, in particular high commodities prices, imply high GDP and employment growth reducing the pressure for labor market reforms. The global financial crises had only transitory effects on unemployment in LAC. Strong and rapid recovery in the whole region has generated a current unemployment rate of only 8.1 percent[8].

BOX 1: GROUP OF COUNTRIES

Defining Group of Countries

This chapter classifies the countries into different types of “varieties of capitalism"to improve the comparison between them. This clarifies the results obtained when comparing Latin America and other countries of interest.

Our general framework is based on the "varieties capitalism" approach develop by Hall and Soskice (2001). They distinguish between "liberal market economies" (LME including the United States, Britain and its settler colonies) and "coordinated market economies "(CME, including most of the countries of northern Europe and Japan). Following Schneider (2009), Amable (2003), Lane and Myant (2007), we consider the Mediterranean market economies (MME including France, Italy, Spain, Portugal and Greece) and South Eastern Economies (SEA including all the countries located in the South East Asia.)[9].

In relation to Latin America, we use the definitions used by Schneider and Karcher (2009) and Schneider (2009). The extensive debate on "varieties of capitalism" offers some conceptual and theoretical innovations that can be fruitfully employed to analyze the distinctive institutional foundations of capitalism in this region. Following the authors we might call LAC as “hierarchical market economies” (HME). This perspective allows us to identify four key characteristics of HME in Latin American taking into account business structure with access to essential inputs like capital, technology and labor. In particular, they are diversified business groups, multinational enterprises (MNE), unskilled labor, and atomistic labor relations. Overall non-market, the hierarchical relationships business groups and multinational corporations are central to the organization of capital and technology in Latin America, and are also pervasive in the labor market regulation, union representation and labor relations. As Schneider (2009) notes, these four characteristics of HME have in common the dependence on the hierarchy and a particular interactions, creating a new variety of capitalism, other than those identified in the developed and other developing regions. In particular, our objective here is not to establish a within variety of Latin American capitalism.

All the groups (CME, LME, MME, SEA and HME) have strengths and distinctive weaknesses derived from different organization of capital markets, labor markets, education and skills, business to business relationships and labor relations and complementarily between these fundamental institutions of capitalism.

The document has been structured as follow. Section II shows the evolution of output and labor markets during the last decades inLatin America. Section III, the core of this study, presents labor market reforms during this period. It provides some evidence that informality and inflation greased the labour market in the 80s reducing the urgency to reform them. In particular it shows the way that inflation, unions and

[7] WDI (2009).
[8] IMF, WEO (2010).

privatization worked to slow down the process of executing the labor market reforms in LAC. Then, the section presents evidence how labor markets reacted to “Washington Consensus” reforms: mainly an increase of informality. An important point in this section is to establish that the above conclusion was made based upon the “insiderand outsider” theory. Section IVdescribesthe vicious circle generated by highly regulated labor markets and informality.

II. Output and Labor Market performance during the last decades

For Latin America the seventies is a transition between the booming sixties, where Gross Domestic Product (GDP) per capita grew at 2.5 percents per year[10], and the eighties known as the "Lost Decade". As Table 2 shows, during the eighties growth per capita was negative, unemployment rose, and inflation was remarkably stubborn. During the nineties, economic performance improved for the region as a whole. This upward trend continued during the first decade of the 21th Century, which has been one of the best decades for the region in over half a century. Surprisingly, as we shows in this section, employment did not follow in tandem with output performance during the 1990s.

As it is shown in Table 2, in relation to CME, LME, MME and SEA, HME had an average performance in the 1970's in term of GDP per capita growth. For HME countries output per capita grew on average at 2.4 percent per year, a rate of growth lower than the one presented by CME, MME and in particular lower compared to SEA countries that grew at 4.8 percent per year. This average outcome in output is not reflected on employment. During this period LAC presents the fastest growth in employment, on average employment rate grew at 3.3 percent per year, even more than in SEA.

Table 2: Growth of Employment and GDP per cápita in Perspective.

Group of Countries	Avg. Annual Growth of Employment rate in he 70s	Avg. Annual Growth of GDP per capita in the 70s	Avg. Annual Growth of Employment rate in he 80s	Avg. Annual Growth of GDP per capita in the 80s	Avg. Annual Growth of Employment rate in he 90s	Avg. Annual Growth of GDP per capita in the 90s	Avg. Annual Growth of Employment rate in he 00s	Avg. Annual Growth of GDP per capita in the 00s
HME	3.3%	2.4%	2.9%	-0.9%	2.0%	1.6%	2.7%	2.7%
CME	0.5%	3.0%	0.8%	2.2%	0.4%	1.8%	0.9%	1.7%
LME	1.6%	2.1%	1.0%	2.0%	1.4%	2.5%	1.8%	1.9%
MME	0.7%	3.8%	0.7%	2.0%	0.8%	1.8%	1.5%	1.7%
SEA	2.7%	4.9%	2.8%	1.7%	2.6%	3.4%	2.8%	4.2%

Notes: * Until year 2008.
Source: World Development Indicators 2009 and Penn World Tables 6.3

Liquidity generated by petro-dollar overflow the region. Most countries run huge fiscal and current account deficits at the beginning of the 1980s. These deficits were financed by foreign banks, increasing the external debt of the region. As we present in Table 3, the average public deficit in the region was -4.4 percent during the beginning of the 1980s. On the other hand, the current account deficit was almost -4.7percent. By 1982 the external debt, which was mainly denominated in US dollars, became a problem for some countries in the regions.

When Mexico announced in 1982 that it could not pay its foreign debt, capital flows into Latin America and the Caribbean came to an abrupt end, forcing every country in the region to go through severe macroeconomic adjustment processes.

[10] WDI (2009).

Table 3: Current Account Balance and Fiscal Deficit

Group of Countries	1980		1982		1983	
	CA Balance	Fiscal Deficit	CA Balance	Fiscal Deficit	CA Balance	Fiscal Deficit
HME	-4.7%	-4.4%	-6.3%	-9.4%	-3.5%	-8.3%
CME	-2.1%	-2.6%	-0.1%	-4.5%	0.9%	-4.2%
LME	-3.0%	-4.3%	-2.6%	-5.4%	-2.3%	-6.1%
MME	-2.7%	-3.5%	-2.7%	-6.8%	-1.5%	-6.8%
EEE	-5.9%	-1.9%	-3.1%	-2.5%	-4.3%	-0.9%
SEA	-3.0%	-5.2%	-6.6%	-9.0%	-7.7%	-6.9%

Source: IMF and Easterly et al. (1999).

When the FED increase the interest rate to control inflation in the United State, Latin America's external debt became unsustainable, and capital flows to LAC vanish. Current account deficits reverted from 6.3 percent during 1982 to a -3.5 percent surplus in 1983. This huge reversion of the current account was made possible by a collapse of output and drastic cuts on fiscal expenditure in the region. Between 1982 and 1984, HME contracted the fiscal deficit by around 2 percentage points; thus the fiscal crisis induced a pro cyclical fiscal policy.

During the "Lost Decade" GDP per capita in LAC fell by -0.9 percent while in South East Asia countries GDP per capita growth was above 1.7 percent. It is important to note that even though GDP growth in the eighties was negative in LAC, employment growth was relative high, and similar to SEA. On average employment grew at 2.9 percent per year, although huge differences can be observed. In Chile employment collapse and unemployment rose to over 30 percent, but in Brazil employment growth was 30 percentin the decade and unemployment wason average 5.3 percent[11]. For most countries, labor markets adjusted to the "Debt Crisis" through real wages.On average in the region real wage fell by 28 percent during the1980s[12]. Employment did not seem to be a problem during this period, labor market cleared in most HME. High inflation allowed countries to cut real wages.[13]

From the mid-1980s to the mid-1990s Latin America experienced a profound economic revolution as import restrictions were drastically reduced, financial markets liberalized and numerous state enterprises privatized. The economic effects of these structural reforms show up in Latin American performance during the 1990s. GDP per capita in the region grew on average 1.6 percent per year, 2.5 percentage points faster than during the previous decade (-0.9 percent). This large reversal in output did not show up in term of employment. On average employment rates grew by only 2.0 percent per year during the 1990s, one percent point lower than employment growth rate during the eighties when it was 2.9 percent per year. This recovery without employment has been one of the reasons behind the increasing opposition to pro-market reforms in HME.

[11] Ramos (2003).
[12] Source: ECLAC, on the basis of official figures. In U.S. Agency for International Development Washington D.C. (1996).
[13] For example in Chile, where most contracts and wages are indexed to past inflation, real wages did not fall as much compared to others countries. In Chile most of the adjustment was made through higher unemployment.

Finally, HME present a good economic performance during this new century. High term of trade and good financial regulation —as evidenced during the last global financial crises— implied an average per-capita growth of 2.7 percent, only below SEA countries.[14] If we focus in the period 2002-2008, the region grew 5.4 percent on average, and unemployment fell to 7.5 percent in 2008.

[14] For the 2000s we considered the period 2000-2008.

III. Reform Process in LAC during the 1980 and 1990s

Structural reforms became widespread in the region during the 1990s. After the "Lost Decade" in LAC, when almost all the countries had run large deficits that led to balance of payments crises and high inflation, fiscal discipline became one of the main goals of governments in the region. Table 4 compares fiscal deficits during 1975-1984 and 1984-1995. For LAC the simple average of fiscal deficits during the first half of the 1980s was -6.5 percent of GDP, extremely high compared to Euro Area countries where the average fiscal deficit was only -3.8 percent of GDP. Liberal Market Economies (LME) also presented lower fiscal deficits, shifting from an average of -4.4 in the period 1975-1984 to an average of -2.8 in the period 1985-1994. In the nineties, countries in LAC reordered their public expenditure priorities, switching expenditure in a pro-poor way, from things like indiscriminate subsidies to basic health and education.

Table 4: Market Oriented Reforms in LAC in Contrast to other Regions

Country	Avg. Fiscal Défit (%GDP)		Avg. Trade Tariff		Privatization Effort Index	
	1975-1984	1985-1994	1986	1999	1988	1999
Argentina	-10.78	-5.90	39.50	11.00	0.00	0.39
Bolivia	-14.40	-5.77	21.90	9.00	0.00	0.90
Brazil	-4.60	-4.45	74.10	13.30	0.00	0.50
Chile	0.21	0.46	20.20	10.00	0.03	0.16
Colombia	-4.52	-1.98	46.40	11.80	0.00	0.23
Ecuador	-3.95	-4.48	41.40	12.90	0.00	0.03
Mexico	-7.65	-2.88	27.80	10.10	0.05	0.27
Peru	-6.18	-6.38	63.00	13.00	0.00	0.60
El Salvador	.	.	23.00	5.70	0.00	0.36
Uruguay	.	.	35.70	4.60	0.00	0.00
Venezuela,	.	.	30.60	12.60	0.00	0.27
LAC	**-6.48**	**-3.92**	**38.51**	**10.36**	**0.01**	**0.34**
Austria	-2.73	-2.90	9.09	3.15		
Belgium	-8.60	-7.35	.			
Denmark	-3.50	0.55	8.24			
Finland	1.22	1.05	.	4.53		
France	-1.71	-1.98	8.44			
Germany	-3.07	-1.15		4.53		
Italy	-10.57	-11.10	8.24			
Netherlan	-4.34	-5.42	8.54	4.45		
Spain	-3.00	-3.92	8.24			
Sweden	-1.85	2.05		4.31		
Euro area	**-3.82**	**-3.02**	**8.47**	**4.19**		
Canada	-3.55	-4.28	.	4.61		
United Sta	-1.92	-2.40	4.28	8.14		
HME	-6.57	-4.02			0.01	0.34
CME	-2.58	-0.85				
LME	-4.39	-2.85				
MME	-5.13	-7.93				
SEA	-6.46	-3.93				

Source and Notes: World Development Indicators (WDI), Lora(2001), UNIDO (from Nicita y Oleaga, 2005). Consolidated public deficits as percent of GDP from Easterly et al. (1994). The privatization effort Index is calculated by Lora (2001).

Furthermore, fiscal discipline came with tax reforms during this period in LAC. The goal was to increase the tax base and to reduce marginal tax rates. Table 5 shows how the maximum business tax rate fell for most LACcountries between 1985 and 1999. Tax reform in addition to fiscal rationalization implied important changes in aggregate labor demand in most countries in LAC.

During this reform period domestic markets were liberalized. Countries started to cut tariff and trade barriers. As Table 4 presents, the average tariff fell from 38.5 percent in 1986 to 10.4 percent in 1999. This process continued during the new century. The main aim of trade liberalization was to increase productivity and competition in the region.

Reallocation is at the heart of productivity gains from openness as factor deployment becomes more efficient, in particular labor. Inefficient firms in import competing industries exposed to tariff reductions experience lower profitability of some projects and thus reduce the level of employment, and in some cases they are forced to shut down all production facilities. At the same time, the increased openness creates new export opportunities for other producers leading to expansion of both better-positioned incumbents and new startups. Competition is also likely to increase the elasticity of employment to changes in relative prices, including those generated by real exchange rate fluctuations. All of these effects taken together suggest greater requirement of factor reallocation in response to trade liberalization: in sum, more flexible labor markets.

As in trade the region underwent a huge transformation in term of publicly owned enterprises. The need to raise the efficiency of the production system in the context of an increasingly competitive international market, combined with the financial difficulties of the State and the public demand for better social services, create relentless pressure for change in the way the State's functions are performed and public utilities provided. Privatization not only involved public utilities but also other sector like, mining in Brazil, manufacturing in Mexico and oil-gas in Bolivia. In Table 4 we present the privatization effort measured as the cumulative value of the sales and transfers of companies (starting in 1986) as a proportion of GDP for the year in question.[15]These privatization processes implied reallocation of workers. In some cases, employment level in privatized firms fell by more than 25 percent.[16]

Box 2: Trade Liberalization and Labor Productivity

In this Box we will mainly follow different chapters of IDB (2004).

The core of trade liberalization was the lowering of barriers to imports that formerly sought to protect domestic production, especially in manufacturing. Between the mid-1980s and the beginning of the1990s, countries in Latin America began trade liberalization programs, with reductions of at least 15 percentage points in the average tariff rate, which fell from an average of 49 percent in the pre-reform years to 11 percent in 1999. The dispersion of tariffs was also significantly reduced, although in most countries tariffs remain higher for consumer goods than for intermediate and capital goods, and are higher for agricultural goods than for industrial goods.

By the end of the 1990s, only two countries (out of 24 for which information is available) had an average

[15] Lora(2001).

[16] ILO (1999).

tariff of more than 15 percent. Nontariff trade restrictions, which were applied to 37.6 percent of imports in the pre-reform period, affected only 6.3 percent of imports by the mid-1990s (IDB,2004). Lower tariff and nontariff restrictions enabled imports to rise as a percentage of gross domestic product (GDP) in most countries. For the Latin American and Caribbean region as a whole, imports increased from 23 percent in 1983-85 to 36 percent in 1998-2000. It should be noted that during this period, export-to-GDP ratios also increased, albeit by much less, from 23 to 30 percent (IDB, 2004). The aim of liberalization was to reallocate resources from previously protected sectors toward more efficient sectors, especially export sectors. In almost all countries in the region, exports actually did perform much better in the 1990s than during the previous decade. Nevertheless, the prevailing opinion is that the export sector did not manage to make up for the destruction of employment in the previously protected sectors and that the jobs created have been inferior in terms of pay, stability, and other labor conditions.

Also, it is relevant to examine the impact of market-oriented reforms on plant survival. While trade liberalization increases plant exit, financial and other reforms reduce the probability of exit. In addition, trade liberalization increases the likelihood of exit for plants facing low demand and relatively high input prices. By contrast, financial and other reforms increase the role of efficiency and reduce the role of demand and input prices in determining plant survival. Trade liberalization squeezes out of operation plants with low profit margins. At the same time, improved factor market flexibility (capital and labor market deregulations) and private sector incentives (lower tax burdens and privatization) make plant physical efficiency relatively more important in accounting for plant survival relative to demand and input prices. This is probably due to more productive plants being able to expand at the expense of less productive ones (IDB, 2004).

Countries also liberalized interest ratesending the financial repression that characterized financial markets during the 1970s and 1980s. Restrictions to inward foreign investment were also abolished in many cases, and countries aimed at competitive exchange rate. Summing up, Latin America underwent a significant economic transformation during this period.

Table 5: Tax Rates in LAC

	PIT 1986 (%)	PIT 2001 (%)	EIT 1986 (%)	EIT 2001 (%)	VAT Intro (%)	VAT 2001 (%)
Argentina	45	35	33	35	16	21
Bolivia	30	13	30	25	10	14.92
Brazil	60	27.5	35	15	15	20.5
Chile	57	45	37	15	20	18
Colombia	49	35	40	35	10	16
Costa Rica	50	25	50	30	6	12
Dom.Rep.	73	25	46	25	4	12
Ecuador	40	15	40	25	10	13
ElSalvador.	60	30	30	25	7	12
Guatemala	48	31	42	31	3	12
Honduras	40	25	40	35	10	15
México	55	40	42	35	6	15
Nicaragua	50	25	45	25	5	5
Panama	56	30	50	30	12	10
Peru	49	20	40	30	15	18
Uruguay	0	6	30	30	14	23
Venezuela	45	34	67.7	34	10	14.5
Average	**49.20**	**27.70**	**41.00**	**28.30**	**10.20**	**14.70**
OECD	**52.80**	**41.20**	**42.80**	**31.80**	.	.

Source and Notes: Stotsky and WoldeMariam (2002). Personal Income Tax (PIT) rates are top marginal rate. Enterprise (EIT) rates are also top rate. VAT rate is "standard" rate. Uruguay has no PIT except on income from agriculture and commissions. Years shown are approximate in some cases.

As Rodrik (1996) already observed, a number of countries in Latin America adopted more trade and financial liberalization policies and more privatizations in a short period than the East Asian countries did in three decades. Even in the tax area he pointed out noteworthy reforms. In contrast with the four previous reform areas, during the same period, in the labor market the changes have been few and smaller in scope (See Figure 1). Various authorsalso comment that the region did not embrace significant labor market reforms during this period[17]. Heckman and Pages (2004) find that, in general, there is no clear sequencing pattern between trade reform and labor market reforms. The same authors do find, however, that many labor market reforms tended to take place during periods of negative economic growth, and that many reforms that strengthened workers' rights took place in the period following the return to democracy.

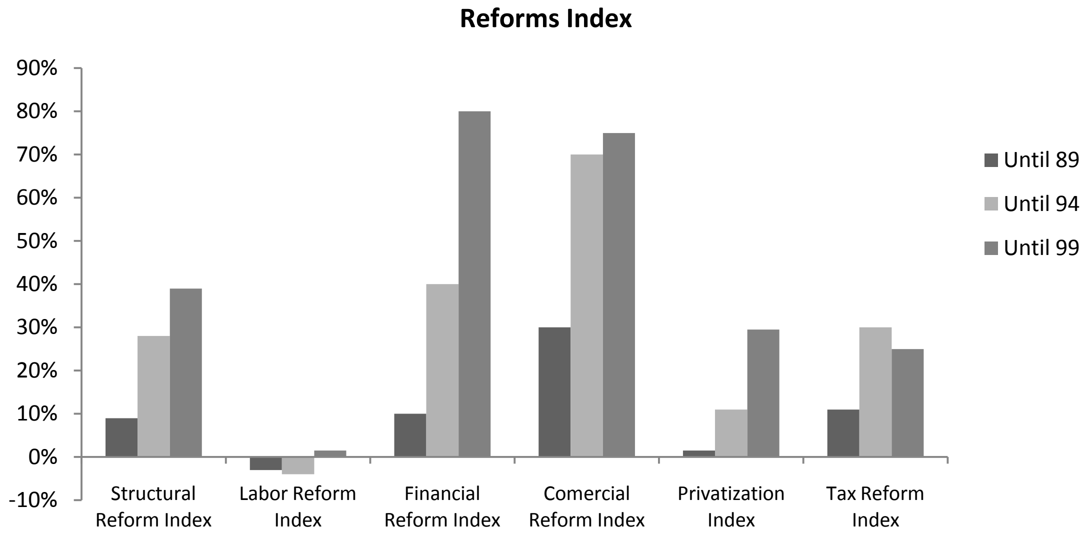
To quantify the magnitude of the whole reform process after the "Lost Decade", we presents Lora 2001´s reforms index for the region (Figure 1). This index summarizes the advance of structural reform on tax, privatization, trade, financial market and labor market. It goes from 0 (null) to 1 (full advance). Figure 1 point out that the region went into a deep reform process during the second half of the 1980s and the 1990s. Until 1990, the region had utilized almost 10percent of the available "margin of reform".[18] By 1999, this figure is almost 40percent. The deepest reform process was on trade, were the margin utilized is almost 80percent in 1999. As we already mentioned, LAC drastically cut tariff and non-tariff barriers. Lora´s indices show that LAC countries

[17] For example, Krueger (2004), Saavedra (2003) and Lora (2001), Rodrik (2001, 2006). Kuczynski and Williamson (2003) and World Bank (2005).

[18] Lora (2001) defines "margin of reform" as the difference between the maximum possible value of the index (which is 1) and the current value.

embraced deep reforms toward more market oriented economies in all areas but labor where the changes were minors.

Figure 1: Lora's Reforms Index



Source: Lora (2001).

Some countries implemented labor reforms, but legislative changes differed drastically in depth and even in direction. In many countries we do not observed changes and in other we observed reforms that made labor market regulation even more stringent. Lora (2001) pointed out that only six countries have made substantial labor reforms between the mid-1980s and 1999: Chile (1979 and 1991) Argentina (1991), Colombia (1991), Guatemala (1990), Panama (1995), Peru (1991) and Venezuela (1998). Although, some of them have subsequently been reverted during this century. This is the case of Argentina. While Menem in the 1990s pursued flexibility in the labor market, Kirchner in the beginning of the 2000s aimed to reverse these changes.

Why the labor market was not a political/policy worry during the 1980s and beginning of the 1990s?

We argue there are four main reasons for this "lack of interest" in labor reform during this period.

Employment Performance during the "Lost Decade"

First, as we already mentioned, despite the fact that GPD per capita growth in Latin America was extremely low during the 1980s (an annual average of -0.9 percent), employment grew by a healthy average annual rate of 2.9 percent during the same period. Labor markets were not the problem behind the "Lost Decade", they accommodated the output collapse that followed the debt crises. At the time it did not seem necessary to spend scarce political capital on labor reforms. Fiscal discipline, trade openness and more competition seemed more important reforms.

Inflation and Informality as Substitute of *de jure* Labor Flexibility

Second, high inflation and informality in HME allowed labor markets to adjust through wages and not employment in most countries during the "Lost Decade". These same characteristics plus compensation packages in most unionized sectors seemed to be sufficient to take advantage of structural reforms proposed by the "Washington Consensus", like trade openness and privatization.High inflation would allow relative wages to adjust after relative prices change due to reforms, and informality would allow labor to move from contracting sectors to industries with increasing demand.

Fiscal deficit in the HME, financed in part with inflation, allowed most countries to grease their labor market. Inflation does not only allow countries to adjust real wages, but as shown by Loboguerrero and Panizza (2006), inflation also reduces the sensitivity of employment to changes in outputin countries with highly regulated labor markets (employment protection laws). In addition to inflation, the higher level of informality and lack of rule of law in many countries made labor markets in LAC, *de facto*, flexible.[19]

Table 6 shows that informality at the beginning of the 1980s was as high as 28.8 percent in LAC and it increased after the Debt Crisis and the first stage of trade openness. High levels of informality allowed wages to adjust and, more important, workers to move from one firms/sector to another. This *de facto* labor flexibility helped labor markets to adjust during the "Lost Decade" and the structural reform periods, although it put most of the adjustment burden on workers.[20] Related with high informality in LAC, Table 8 shows that HME has the lowest level of rule of law compared to other regions.

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[19] Caballero et al. (2004a) show that employment protection laws reduce job reallocation, although this effect is statistically and economically significant in countries with high rule of law. Micco and Pages (2006), using a completely different approach, find similar results.

[20] In the 1980s LAC presented almost no unemployment protection systems (see Vodopivec (2004)).

Table 6: Historical Informality in Labor Market.

	% of self-employed in non-agricultural employment				
Country	**70s**	**80s**	**90s**	**00s**	**Latest**
Argentina	23.7		29.3	25.3	25.3
Bolivia	42.9		59.0	53.6	53.6
Brazil	20.8	20.9	30.8	35.7	35.7
Chile	20.3	19.7	29.1	32.0	32.0
Colombia			48.7	49.3	49.3
Cuba	1.3	1.0			1.0
Ecuador	36.4	39.9	49.3		49.3
Mexico	28.2	41.8	33.9	29.9	29.9
Peru	35.4	31.3			31.3
Uruguay	22.5	22.0		19.5	19.5
Venezuela	24.5	26.8	39.5	40.3	40.3
HME	28.0	28.8	41.8	33.7	33.4
Austria	10.4	7.3	8.0	9.5	9.5
Belgium	15.2	13.8		13.9	13.9
Denmark	13.8	7.9			7.9
Finland	8.8	5.9	8.9	10.9	10.9
France	11.2	10.4	11.3	8.6	8.6
Germany	10.4	8.4	9.8	11.3	11.3
Italy	19.7	19.7	25.8	25.1	25.1
Netherlands	10.4	9.3	8.8	11.3	11.3
Spain	16.2	21.1	18.5	19.3	19.3
Sweden	5.5	2.9	9.2		9.2
CME,MME*	12.2	10.7	12.5	13.7	12.7
USA	6.0	5.6	7.4	7.5	7.5
Canada	5.1	4.6	6.9	15.6	15.6
LME*	5.6	5.1	7.2	11.6	11.6
SEA	33.6	33.9	33.2	34.2	

Notes: * Selected Countries

Source: OECD (2009). See Document "Is Informal Normal? Towards More and Better Jobs in Developing Countries" for details of years considering in each country.

Lack of Worker Bargaining Power and *de facto*Lack of Labor Protection

Thirdly, as pointed by Schneider (2009), most workers in HME are unlikely to have plant-level union representation, both because union density is low and because even where unions do exist, they often do not have much of a formal presence on the shop floor. In addition, in privatized sectors with high levels of formality and unions, like utilities, special retirement and compensation plans for workers were implemented. These plans did not required changes in national labor legislations.

Labor relations in Latin America are fragmented and often alienated because most workers have short-term links to companies and weak or no horizontal linkages to other workers through unions.[21]Among other things, the rotation of workers is high and Latin American economies are characterized by a large number of micro and small enterprises.[22] Few countries in the region have special institutions for micro-coordinationwithincompanies, and "organized labor is extremely weak"[23]. As a result, labor relations and employment are individualized. Turnover and small firms are major contributing factorsto spread out labor relations. Finally, as Tables 6 and 7 shows, many people work in the informal sector without unions or legal protections.

[21] In Chile, unions cover only 13 percent of workers. For large firms this number is 23 percent and for small firms 11 percent. By industries, Mining presents the highest percentage (40%) followed by Utilities with 19 percent. Source: “Encuesta de Previsión Social 2006”, www.microdatos.cl

[22] IDB (2010).

[23] Schneider (2009).

Table 7: Labor Strength in Selected Latin American Countries

Country	Union Members as % of Nonagricultural Labor Force 1980s	Union Members as % of Nonagricultural Labor Force 1990s	Union Members as % of Formal Sector Wage Earners	Dominant Union Structure	Number of Peak Confederations	Political-Strategic Orientation of Largest Peak Org.	Strength of Organized Labor
Argentina	48.7	25.4	65.6	Industry	Dominant	Conciliatory/militant(Split)	High
Brazil	.	32.1	66	Local	Multiple	Militant	High
Mexico	54.1	31	72.9	Industry/Local	Multiple	Conciliatory	Medium
Bolivia	.	16.4	59.7	Firm	Single	Militant	Medium
Chile	11.6	15.9	33	Firm	Single	Conciliatory	Low
Peru	.	7.5	18.3	Firm	Multiple	Militant	Low

Source: From O'Connel (1999) Union Members in the 1980s and the 1990s. Dominant union structure information is from McGuire (1997).The others variables is from Cook (2007) and the years for Argentina are from 1995; Brazil, 1991; Mexico, 1991; Bolivia, 1994; Chile, 1993; Peru, 1991.)

The previous ideas apply mainly to medium and small enterprises. Large firms, in regulated sectors have much higher levels of formality and unionization. Unions force more favorable contracts to workers that protect them against inflation, and introduce high adjustment costs[24]. This reality of larger firms contrast with the situation of the majority workers in HME, as discussed in the previous paragraph. This disparity is evidence of the existence of "insiders" and "outsiders" in the labor market[25]. Moreover, despite the magnitude of both workers types, the political influence of the insider group is clearly more important. For instance, this is the particular case of state owned firms. In the case of these sectors, electricity, telecom, water, etc, countries embraced a drastic process of privatization. As we discuss in the next section, to achieve these privatizations these processes included generous compensations package to insider worker.[26]

Privatization and Compensation Package

Fourth, as mentioned in the previous subsection, workers of privatized firms, which include mainly utilities with high degrees of unionization, received large compensation packages during the privatization process. These compensations packagesprovided the required flexibility to improve productivity through employment reallocation.[27]

As pointed by ILO 2004, utilities presented a high union density in HME countries. Unions resisted privatization movements at first. In many countries in the region, this resistance was countered by means of three basic strategies: offers of generous compensation for workers accepting voluntary retirement; a promise to re-employ large numbers of workers in the new operating company; and the earmarking of shares in the new company for workers from the former operator. This strategy allowed governments to gain workers’ support in these privatization processes, without changes in labor market regulation.

[24] Caballero et al. (2004a) and Caballero et al. (2004b) show that Job Security increase labor adjustment cost mainly in large firms in countries with higher level of rule of laws.

[25] For details about "insider and outsider" theory see Lindbeck and Snower (2002).

[26] Chong and Lopez-de-Silanes (2004).

[27] Chong and Lopez-de-Silanes (2004) show that in Latin America the direct employment by the median state-owned firm falls between 5 to 57 percent after privatization, depending on the country.

For example, in the electricity sector of Argentina, acceptance of the reform was facilitated by granting employees a 10 percent stake of most of the privatized enterprises. Due to these compensation payments, a sharp reduction in worker numbers was achieved. Also, before being privatized, Electrical Services of Greater Buenos Aires (SEGBA) experienced an employee fall of 22 percent, where 66 percent of the cases were dismissed or retired, while the rest were offered a special retirement. Those laid off received an average allocation of 10 percent above the statutory ¿limit?, reaching USD $ 9,912 each. The total amount paid by SEGBA in this way was USD$ 55.5 million, of which new private owners provided USD $ 52 million. One of the new private distribution companies compensated their employees with USD$ 30,000.After privatization, worker numbers were reduced by another 28 percent.[28]

To summarize, in the 1980s labor market looked *de facto* flexible and therefore they did not seem to require reform in the short and medium term. Trade, fiscal and financial reforms required a lot of political capital to be implemented, therefore there were neither political power nor the necessity to implement labor reforms that could create unrest among organized workers.[29] Thereafter, in the 1990s, there came the economic necessity to implement labor market reforms, but as we show in the next subsection the initial pro-market momentum was by then extinguished.

[28] ILO(1999).
[29] Loboguerrero and Panizza (2006)

Why, after privatization, trade openness and financial liberalization we do not observe important labor reforms in LAC?

By the end of the 1990s, fiscal discipline and trade openness was the norm in the region. The average inflation was 7.8 percent per year and the average trade tariff had fallen from around 50 percent in 1985 to almost 10 percent[30].

Trade liberalization implies large reallocation effects given the substantial increase in the exposure to international competition. One important aspect of the reallocation process generated by the removal of barriers to trade relates to the impact on job flows. As pointed by Haltiwanger et al. (2004),[31] the increased competition associated with international trade yields increases in the pace of job reallocation within sectors across Latin American countries. Firms faced a more volatile environment without high inflation to grease labor markets, and therefore required more flexible labor market regulation. But as shown by Table 8, labor market continued to be highly regulated, reflecting government-employer-worker relationships embedded in more protected national economies,[32] and no important reforms were introduced during the period.

Table 8: Regulation in Labor Markets

Group	HME	CME	LME	MME	EEE
Mean Wage in Industry (in Thousand Dollars)	5.65	32.09	26.17	17.92	2.26
Rule of Law Index	3.08	5.92	5.80	5.24	5.02
Unofficial Economy(%)	42.22	15.75	13.60	23.22	32.27
Union Density	0.21	0.56	0.31	0.26	0.49
Labor Union Power Index	0.47	0.55	0.17	0.59	0.57
Severance Payment (weeks)	8.13	5.00	1.33	5.50	13.00
Maternity Benefits (weeks)	12.65	19.56	30.75	17.40	22.86
Employment laws index	0.46	0.58	0.27	0.69	0.60
Collective relations laws index	0.50	0.48	0.29	0.60	0.51
Social security laws index	0.62	0.74	0.72	0.76	0.75
Civil rights index	0.72	0.62	0.64	0.74	0.80

Source: Mean wage industry (Avg. late 90s and beginning of 2000s) from Nicita and Olarreaga (2007); Rule of Law (year 1997) from Johnson et al. (1998); Unofficial Economy (different years upper middle of 90s), Labor Union Power Index(year 2004), Severance Payments(year 2004), Employment Laws Index(year 2004), Collective relations Laws Index(year 2004), Social Securiry Laws Index(year 2004) and Civil Rights Index(year 2004) from Botero et al. (2004); Maternity Benefits (year 2009) from ILO(2009).

[30] IMF, WEO (2011). Considering LAC without Bolivia (94%) and Ecuador (52%).
[31] See also Levinsohn (1999).
[32] See Cook (2007).

We argue there are three main reasons for this lack of labor reform in the post "Washington Consensus" period.

Increasing opposition to Pro-Market Reforms

During the nineties, inflation could not grease labor markets. At this moment, when labor market restriction became bidding in some countries the "Washington Consensus" paradigm became unpopular. Pro-market reform in general, and in particular labor market reforms did not have the needed political support any more.

Pro-market reforms stand accused of being one of the causes of the recovery without employment in the 1990s,[33] andthe attitude of Latin Americans toward pro-market reforms had become increasingly critical.[34] In 1998 only 50 percent of Latin Americans thought that privatization was beneficial for their country. This percentage dropped to 31 percent in 2001 and to 25 percent in 2003. By 1995, citizens preferred an economy driven by a mixed structure, in which the workers directly –or indirectly through the government- participate in the firms. Only 13.5 percent of the population preferred private enterprises without government intervention. In 1998, 77 percent of Latin Americans thought that a market economy was good for the country, by 2003, this percentage has dropped to 18 percent.[35]Moreover, as Table 9 shows, the majority in HME prefers the presence of the State to solve problems and create a countries' wealth.

Table 9: State vs. Market in LAC.

HME	2001(1)	2006 (2)
State	28%	16%
2	9%	7%
3	10%	9%
4	9%	11%
5	21%	32%
6	8%	7%
7	5%	5%
8	4%	5%
9	2%	2%
Market	4%	5%
Total	100%	100%

(1) to solve problems.
(2) to create wealth.
Source: Latinobarometer 2001 and 2006.

As pointed by Lora et al. (2004), this lack of public support induced political leaders to blame pro-market-neo-liberal policiesfor "poor" economic growth and unemployment in the region.InArgentina, Nestor Kirchner won the presidency in2003 campaigning against the neoliberal model imposed by the InternationalMonetary Fund (IMF), and in favor of a greaterrole for the state in the economy. In Bolivia, EvoMoralesdescribed hiselectoral campaign as representing "the victims of neoliberalism". In Venezuela and

[33] IDB (2010) claims that the 1990s is a "growthless" decade.
[34] See Lora, Panizza and Quispe-Agnoli (2004).
[35] These results come from the Latinobarometer annual surveys, which covers seventeen Latin American countries.

Ecuador, populist president, Hugo Chávez and Lucio Gutiérrez, campaignedon how neoliberal policies had brought "disaster" to their countries.

Once in power, some of these leaders reverted previous timid pro flexible labor market reforms, this was the case for Argentina under the government of Nestor Kirchner.

Positions against pro-market policies started to change by 2005 with the victory of President Ignacio Da Lula in Brazil, who took an eclectic economic position. Brazil, under the "Partido dos Trabalhadores", followed the experience of Chile keeping fiscal discipline and pro-market policies with a strong emphasis on social protection policies. Other elections in the continent confirm this change: President Alan Garcia in Perú (2006), Álvaro Uribe (2002)–Jose Manuel Santos in Colombia (2010), Felipe Calderon in México (2006), among others.

The shadow Economy and the Political Economy of Labor Reform.

As mentioned for the "Washington Consensus" period, informality may have played an important role providing flexibility to the labor market during the 1990s. Table 6 shows that informality in the region increased during this decade. This may be the reaction of Latin American economies to the increasing volatility in an environment of low inflation and high labor market regulation. Once high regulation becomes more binding and no reform emerged, firms reacted to this new environment increasing informal contracts.

Economic Boom During the 2000s

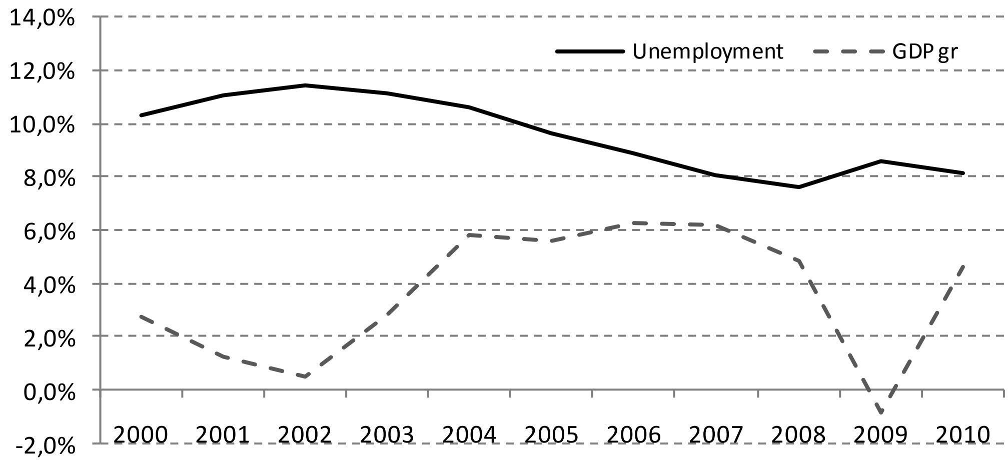
Most commodity-exporting countries of South America have faced highly favorable conditions during the 2000s. This includes countries such as Argentina, Chile, Peru, Ecuador, Colombia, Paraguay, Venezuela and Brazil. Since 2002 the region has evidenced an average annual growth rate of 5.4 percent until the financial crisis, during 2009 LAC's GDP fell on average by -1 percent, which compares favorably to developed countries (-2.5 percent)[36]. Favorable term of trade allowed the region to have a fast recovery during 2010 (+4.7 percent). This is particularly true for those with stronger fundamentals, who have easier access to external financing and stand to benefit the most from low global interest rates. The environment is least favorable for those countries with linkages to the U.S. (like some Central American countries).

Moreover, as Figure 2 shows,fast economic growth increased labor demand and reduced unemployment in the region. The unweighted average annual unemployment rate fell from 10.5 percent in 2002 to 7.5 percent in 2008. During the international crisis, unemployment increased but it started to decline the following year with the economic recovery of the region (8 percent)[37].

[36] IMF, WEO (2011).
[37] IMF, WEO (2011).

Better economic performance during the 2000s reduced pressure to reform labor markets and informality (see Table 2 and 6).

Figure 2: Unemployment and GDP growth.



Source: IMF. Note: Unweigthed average for Argentina, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Jamaica, México, Nicaragua,Panama, Paraguay, Peru, Venezuela.

IV. Insider-Outsider Workers, Job Benefits, Unions and Informality: a Vicious Circle

Most economists agree that highly regulated labor markets promote informality.[38] As labor regulations increase the opportunity costs of formal employment rise. In a context of weak enforcement, the costs for firms to remain completely or partially informal may be much lower than the costs of formal compliance. Enforcement is not applied equally to all firms. As pointed by Loayza et al. (2005), strict regulations are more likely to be enforced in large firms and in particularly in large foreign corporations.

In practice this equilibrium implies an inefficient allocation of resources and in less protection for workers. Firms with a lower probability to be inspected or that use bribesto avoid regulations, have lower costs. Not because they are more efficient but because they have a “privilege”. In the end, few workers benefit from the “protection” provided by stringent regulations.

As pointed by Schneider and Karcher (2010), labor markets’ characteristics in HME reinforce this equilibrium. First, firms’ possibility of using flexible, informal employment mutes business opposition to high levels of regulation. Although businessmen favor more flexible employment protection laws, the presence of informal employment within the firms and through subcontractors reduces the costs of employment protection laws and the incentive to push for reform. In the same line, given that enforcement is more likely for foreign firms, local business that takes illegal advantage of informality have a regulatory competitive advantage.

[38] See Schneider (2005), Loayza et al. (2005), Johnson et al. (2008) and IDB (2004).

Second, government and policy makers, knowing that the regulatory burden is too high and therefore reduce activity and employment, do not have huge incentives to enforce them.

Third, Gonzalez and Palomino (2006) argue that the informal economy grew during the first half of the 1990s because institutions of labor law enforcement were dismantled to relieve pressure on firms. VAT evasions during economic downturn might be evidence in the same line.[39]

Fourth, there are few organized workers and they have low power to define labor relationships. Unions are small, they are mainly in large firms, lack plant level representation, and unions´ confederations are politicized.[40] This is not surprising because in Latin America workers in the public sector have disproportionally high unionization rates and its labor relations are usually more politicized and influenced by legal developments since the employer is the state[41]. Large informal sectors reinforce the small size of unions and encourage them to focus on the narrow "insider" interests of workers in the formal and public sector.

These characteristics stress the insider/outsider issues of unions. Lacking leverage in direct negotiations with employers, unions invested heavily in ties to the state and political parties to promote extensive protective labor codes and wage setting mechanisms that favor them but rule for all workers.[42] High minimum wages with low level of enforcement in LAC and high level of severance payments serve as examples (see Table 8)[43].

Fifth, lack of unions in most workplaces reduces the pressure to increase inspections and enforcement of strict employment protection laws, thereby increasing informality.

To sum it up, the potential coalition for reforming the informal sector and labor regulation is weak. Informal workers are not organized, unions are small and mainly in the public sector businessman may avoid regulation through informality and more over for those who abuse of informality, strict labor regulation becomes a competitive advantage.

[39] Brondolo (2009).
[40] See Schneider and Karcher, 2010
[41] Freeman (1986) and Maceira and Murillo (2001).
[42] Murillo and Schrank (2005) and Cook (2007) claim that this political focus has often been effective in maintaining high labor regulations.
[43] IDB(2004).

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