

JOBs for Growth



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SECOND EDITION

This edition includes some changes from the formatting of the first edition. Changes in the calculation of non-wage costs have also been introduced, affecting Figures 2.6–2.10, 4.5, and 5.7. These changes are due to several adjustments that can be summarized as follows: 1. the inclusion of contributions to training institutions in Nicaragua and Paraguay; 2. changes in taxable income for the calculation of premiums (gross income in some cases and income net of the additional year-end bonus in others); 3. adjustments in the upper and lower thresholds for determining taxable income, which affect the calculation of the total contribution rate (as established by law, largely dependent on the minimum wage).

Furthermore, specific adjustments were made for some countries. In Nicaragua, the advance notice penalty was eliminated, as it is not provided for in labor law, and in Jamaica, an adjustment was made in the working population obtained from the Labour Force Survey (which was employed to calculate the 2012 GDP per worker).

In Figure 5.2, the indicator labeled “other special costs in the event of collective dismissals” for Nicaragua (Item 21 in the calculation of the “protection against collective dismissals of regular workers” indicator) was adjusted from 0 to 0.5. Finally, small changes were made in Figure 2.17, as in some countries, the rate reflected the percentage of employees who received job training out of the total population (15-64 years old) rather than out of employees of the same age group. Jamaica was excluded from this Figure, since the survey only contains data for the inactive population.

The Spanish acronym for youths who are neither in education nor working is “NINIs”; the usual English acronym refers to youths “not in education, employment, or training” (or “NEETs”). However, translating NINIs as NEETs would not be accurate, as the household surveys in Latin America and the Caribbean (LAC) do not capture whether people are enrolled in training institutions. Therefore, this book does not use the standard English acronym NEET. The same applies to youths who are “neither in education, nor working, nor looking for work”; the Spanish acronym for this group is “NININI” while the closest English acronym (“NLFET” or “neither in the labor force nor in education or training”) includes youths in training, who are not possible to capture in LAC countries.

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Foreword

The opening decade of the 21st century was a time of prosperity in Latin America and the Caribbean (LAC), as reflected in higher-than-average economic growth and lower poverty levels relative to those of previous decades. This phenomenon was due, on the one hand, to better macroeconomic management, and on the other hand, to the worldwide commodity boom, which benefited the region's countries that were net exporters of food, oil, and minerals. These changes, however, were not accompanied by an increase in productivity; the forecasts of low growth for the region underscore the precariousness of the progress made and, even worse, may herald a reversal of some social gains.

Since 2009, the region has been grappling with an adverse international environment. While unemployment rates rose at the start of the global financial crisis, within a few years, they returned to their pre-crisis levels. Nevertheless, the unemployment rate does not adequately describe the problems in the labor market. Unemployment in the region is low because the unemployed quickly find new work, but this work often consists of jobs with lower wages or fewer benefits—usually in the informal sector. In fact, this book demonstrates that, notwithstanding higher economic growth, the region's labor markets continue to exhibit a combination of high informal employment and high job instability. Thus, even though formal employment in the region rose during the last decade from a long-term perspective, employment in the informal sector has fallen little and is still a reality for more than half the working population. Furthermore, on average, 25% of the workers in Latin America and the Caribbean have been at the same job for less than a year, and roughly one-third of the workers employed by a firm at a given time are no longer working there after one year. Therefore, while the aggregate unemployment rate is low, high labor turnover in the region means that most workers are unemployed at some point or another, often resulting in losses in income and wages, which leads to significant welfare costs. These costs

are particularly high due to the general lack of an unemployment safety net and the dearth of active policies to promote reintegration into the workforce. Furthermore, the region suffers from low human capital accumulation and low workplace productivity, all of which entail welfare costs for individuals and economic costs for businesses and countries.

What is at the root of this situation? This book recognizes that there are many causes. However, it focuses on one that is clearly fundamental: the interaction between the labor market and labor policy. The central premise of the book is that a labor policy centered on creating value and assisting individuals at key points in their working lives could lead to better work trajectories—that is, jobs for growth—from the perspectives of workers, businesses, and countries.

Much can and should be done to create more and better jobs in Latin America and the Caribbean. To accomplish this, it is essential to consider economic policy in general and labor policy in particular, with a focus on boosting productivity. Such an effort would make it possible to reinforce the gains of the past 20 years. Moreover, this effort could involve providing more protection for workers, thus ensuring that increases in productivity are accompanied by greater individual well-being.

A series of policies are available that can boost productivity in the region. Pagés (2010) mentions, among others: promoting deeper and more secure credit markets, lowering transportation costs, promoting better social policy, and implementing productive development policies—policies that are explored in greater detail in Crespi, Fernández-Arias, and Stein (2014). Here, a new economic driver is proposed: a labor policy that boosts productivity.

This book presents new evidence that will help the reader understand some of the factors constraining today's labor-market performance. To create a formal job—that is, one with the benefits and protections established by law—the right conditions must be present. However, the cost of formally hiring workers in the region is high relative to their productivity. The basic cost of hiring a formal salaried worker (represented by the gross minimum wage plus the costs of the employer's social security, year-end bonuses, vacation time, and potential dismissals) averages 39% of the gross domestic product (GDP) per worker and is as much as 70% in some countries. It is therefore no surprise that the countries with higher wage and non-wage costs (relative to their productivity) are those with a lower proportion of formal jobs and a higher proportion of non-salaried workers.

Furthermore, in certain countries of the region, informal jobs are de facto subsidized by a series of social insurance programs (erroneously called “non-contributory”). The combination of taxes on formality and subsidies for informality is exactly the opposite of what the region needs.

This lack of a capacity to create formal employment is accompanied by high turnover, causing workers to change jobs frequently (and transition often between formal and informal employment). This turnover does not generally translate into positive career paths in which workers leave jobs for better ones or informal jobs for formal ones. The low levels of workplace training, together with the short duration of the jobs, directly affects workers’ capacity to accumulate human capital and their ability, jointly with the firm, to be more productive along with their employers.

Here, the State can play an important role by implementing labor policies to create the right incentives for investing in human capital, in turn leading to an increase in productivity and formal jobs. This book describes current policy instruments in the region and compares them with those observed in the countries of the Organization for Economic Cooperation and Development (OECD), grouping these instruments for its objective: increasing and equalizing opportunities for access to formal jobs and promoting productive labor stability.

An existing battery of policies in the region is designed to foster labor insertion and productive labor stability through a smoother transition from the educational system to the labor market, thus facilitating the exchange of information on job vacancies and workers; reducing labor costs; or promoting skill acquisition for people outside the labor market to boost their productivity, and with it, their employability.

All these policies are promising in terms of their impact and cost-effectiveness. However, LAC countries do not invest enough in this type of instrument and they fail to evaluate such instruments systematically so that we can know precisely how effective they are. A pending task is to expand the scope and effectiveness of the current instruments to promote secure insertion and greater stability for workers in formal businesses.

This book offers some suggestions for enhancing the role of labor policies in promoting jobs for growth. These suggestions are grounded in a basic premise: labor policies should be designed and implemented with a comprehensive approach. In some countries, this implies adjusting the cost of the

social insurance package; in others, this involves developing mechanisms to facilitate job searches and good matches between workers and vacancies. Every country needs to promote a strategy for continuous training that enables workers to gain skills and continue learning in the workplace and that simultaneously fosters value creation for business and the economy as a whole.

Santiago Levy
Vice President for Sectors and Knowledge
Inter-American Development Bank
Washington D.C., September 2015

Introduction

Jobs are essential for the growth of individuals and countries alike. Achieving personal fulfillment is harder without a job, just as an economy as a whole cannot develop without the impetus of the labor market. These two perspectives unquestionably go hand in hand: from the individual perspective, finding a good job is a legitimate aspiration for anyone who wishes to support oneself and one's family; from the societal perspective, creating more and better jobs is essential to the achievement of lasting and equitable growth. Jobs for Growth rests on this dual vision. This book examines the performance of the region's labor market and, based on this analysis, proposes an integrated package of measures for both personal growth (through successful career paths) and economic growth (through more high-quality jobs and higher productivity).

Over the past two decades, the bullish economic cycle has yielded undeniable gains for labor markets in Latin America and the Caribbean (LAC), among them lower unemployment, improved job creation, and a substantial increase in wages. However, the situation on the horizon—stagnation of the region's growth and weaknesses in the global macroeconomic outlook—have increased the urgency to find solutions to today's most pressing labor problems. This volume shows that, despite the still-low unemployment rates, the region may find itself trapped in a vicious cycle of poor-quality jobs—a phenomenon especially visible in the high percentage of informal jobs (which are defined in this publication as those without access to social security benefits) and in the high proportion of very short-lived jobs. As the title Jobs for Growth indicates, breaking this cycle will require comprehensive policies that boost productivity.

The ground gained in the recent era of prosperity may be lost

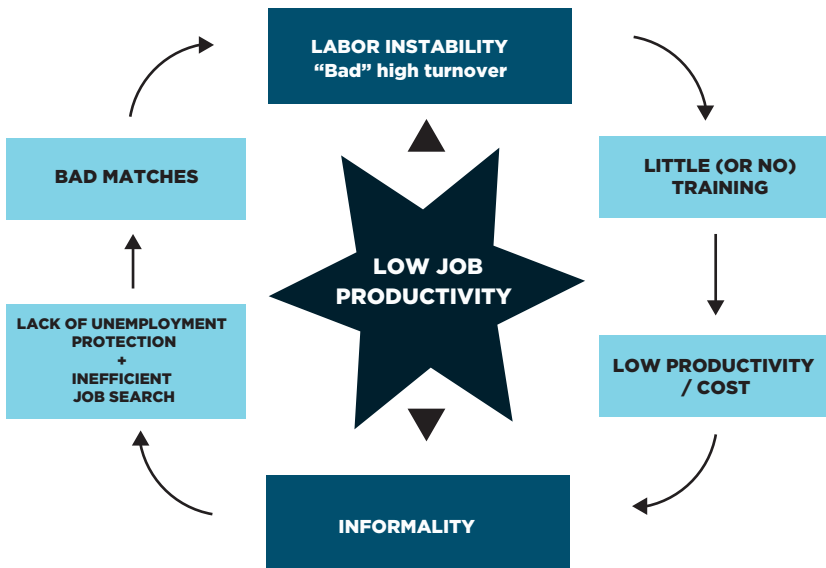
Labor-market indicators have reflected the economic growth that the region has experienced in the first 15 years of the 21st century—growth that, in the last 10 years, has led to a reduction in poverty of almost 20 percentage points (IDB, 2015c) and a 7% decline in inequality as measured by the Gini coefficient (World Bank, 2015a). Nonetheless, weaknesses persist that, given the changes already on the horizon, may cause the region to lose the ground it has gained. As detailed in Chapter 1, a substantial portion of the economic growth in LAC was due countries being able to employ a higher percentage of their population rather than to an increase in productivity. Moreover, the most marked improvements in labor-market indicators occurred in the countries that benefited the most from the commodity boom—a period that is now over. The demographic dividend, another factor driving the economy, will also be ending soon. Given this new context, the region must foster greater gains in productivity if it is to perpetuate and expand upon the progress it made during the recent era of prosperity (IDB, 2015; OECD, CEPAL, and CAF, 2015).

Likewise, despite the recent period of growth, serious problems persist in the region's labor market. The substantial reduction in poverty and inequality over the past two decades has given rise to a middle class that represents 68% of the population (30% in the middle class and 38% in a vulnerable middle class that can either descend into poverty or move up into the invulnerable middle class; Ferreira et al., 2013). This middle class, however, works largely in the informal sector and is therefore highly vulnerable to the risks associated with illness, poverty in old age, and unemployment. If the higher unemployment that the International Labour Organization (ILO) predicted in 2014 materializes, many households that recently joined the middle class will be at risk of falling back into poverty. Furthermore, the jobs created, even the formal ones, are highly unstable, which magnifies and expands insecurity beyond informality. In addition, some groups in certain countries (e.g., youth, women, and workers with little education) have low rates of participation in the market. Securing jobs for these workers is an important prerequisite for their social inclusion. At the same time, to these countries, such workers' employment represents an enormous growth potential that should not go by the wayside.

The vicious cycle of informal jobs and instability

Chapter 2 shows that despite the low-unemployment situation, there is extremely high job turnover, with harmful consequences for both individual welfare and the productivity of the region's economies. The LAC countries suffer from high labor instability, low investment in workers' human capital, little protection against unemployment, high informality, and low productivity (elements that probably fuel one another). This traps millions of workers in a situation marked by poverty, inequity, lack of opportunities, and low economic growth (see Diagram 1).

Diagram 1 The vicious cycle of low-quality jobs



Source: Prepared by the authors.

Not only is it important not to wait for economic growth to resolve this situation, it may be that the labor market itself is contributing to the low growth in the region's productivity. From a macroeconomic standpoint, two channels are needed for productivity growth: one is the reallocation of workers from less productive jobs to more productive ones; the other is growth in the productivity of each job. Both channels, however, seem to be blocked by problems in the labor market.

On the one hand, the figures show an enormous reallocation of workers in LAC. One in every four prime-age workers (ages 25–54) has spent one year or less at his or her current job, compared with one in six in the United States and one in eight in the OECD countries. This extremely high turnover results in major welfare losses; this reallocation also does not appear conducive to increases in productivity. Roughly half of all worker transitions are to poorer jobs from the standpoint of wages or benefits, suggesting that these are less productive jobs. Among people aged 25–44 who have had or have looked for a job, from 20% to 40% of men and from 40% to 60% of women have been unemployed or inactive at least once in the past five years due to this high turnover. Furthermore, more than half of these people have had an informal job. Moreover, due in good part to this high turnover, the region's social protection systems are ineffective at reducing the welfare costs of unemployment. Therefore, despite the region's low unemployment rates, more than half of workers say they are worried or very worried about losing their jobs (Latinobarómetro, 2013).

The second channel of productivity growth is also impaired. High turnover discourages workers and businesses from investing in workers' human capital. Only one in every nine workers in the region receives some type of education or training through the course of a year; the average for the OECD countries is over 50%. This low level of investment makes it harder to boost workers' productivity when they are in an employment relationship, and it may also encourage high turnover.

Jobs for Growth posits that the high informality and instability of the employment situation in LAC are not endemic ills that the region should live with and that the situation can and should be remedied, since it has negative consequences for economic performance and welfare. Focusing energies on overcoming these problems should be a basic social and economic policy objective.

Informality has economic, social, and fiscal repercussions. The current situation implies enormous difficulties for the design of social insurance mechanisms, with their consequent impact on welfare. It also poses major obstacles for citizens trying to accumulate sufficient savings for old age in a context in which the proportion of the population that is of working age will begin to fall sharply in 2020 and in which the over-65 population will triple in the next 35 years (Bosch, Melguizo, and Pagés, 2013). From a macroeconomic standpoint, a lack of adequate savings can reduce the resources allocated to the financing of productive projects, thus hindering economic growth (IDB, 2013).

Another consequence of informality is the need to create programs to provide some type of coverage for informal workers, which can entail serious fiscal consequences (Bosch, Melguizo, and Pagés, 2013). Moreover, non-contributory programs to guarantee the welfare of informal workers can in themselves promote higher levels of informality, which in turn can have adverse consequences for value added and growth (Levy, 2008; Bosch and Campos-Vázquez, 2014; Camacho, Conover, and Hoyos, 2009; Amarante, Arim, and Dean, 2011; Bosch, Maldonado, and Schady, 2013). Finally, Chapter 2 shows that informal workers are much less likely to receive any type of training, reducing their chances of professional development and growth in the workplace. Overcoming the status quo and promoting productive, formal jobs would result in greater welfare and higher growth in the region.

High job instability also has adverse effects on welfare and, quite possibly, productivity. High job rotation implies high welfare costs for workers, who must constantly be looking for work and suffering the potential consequences of not finding it. Moreover, a stable job is often associated with long-term decisions, such as buying a house with credit or starting a family. Given the macroeconomic outlook and the low growth rates projected for this year and beyond, in the absence of policies to boost productivity, the unemployment rate is likely to rise again, and the concern about job instability is likely to be even greater. Moreover, as stated earlier, excessive turnover can discourage investment in workers' human capital and cause them to end up in jobs in which they are unproductive—all this in detriment to productivity and growth. Hence, it is necessary to invest in optimized tools that reduce excessive turnover and enable workers who involuntarily lose their jobs to rapidly and effectively re-enter the workforce in a formal job.

The region needs labor policies that boost productivity

Greater job formality and stability can be achieved if economic policy in general, and labor policy in particular, concentrate more on promoting productivity. Jobs for Growth argues that promoting higher productivity among all current and potential workers would enable those who are not working to achieve greater and better insertion in the labor market and to get more formal and more stable jobs, with substantial gains in per capita growth.

The region has a series of policies in place to boost productivity. These policies include promoting deeper and more secure credit markets, lowering transportation costs, promoting a better social policy, and devising productive development policies (Pagés, 2010; Crespi, Fernández-Arias, and Stein, 2014). This book proposes a new economic driver: a labor policy that boosts productivity.

Labor policy in the region has had eminently redistributive objectives with less emphasis on the search for productivity. It has generally been characterized by a protective approach and has been implemented largely through legislation and regulations aimed at reconfiguring the balance of power between workers and employers, thus heightening workers' negotiating power, which is the weakest part of the employment relationship. In this book, the authors argue that, while such changes are essential, particularly in a region characterized by vast inequalities, they are not enough to achieve sustainable improvements in employment quality and welfare in the region. Redistributive labor policies are designed to reallocate the pieces of an existing pie, but they generally do little to make the pie larger. Therefore, though the objective is to secure greater gains for workers, it is essential to supplement labor policies that have redistributive purposes with others that promote growth; this is the main objective of this study. The economic evidence unambiguously shows that productivity is the engine of growth (Pagés, 2010; Crespi, Fernández-Arias, and Stein, 2014) and that growth has little to do with sweat or physical effort and much to do with making more effective and intelligent use of resources (such as labor force and capital). Thus, labor policies that boost productivity seek to increase the value created by businesses and workers, thereby enhancing growth, improving job quality, and increasing welfare.

How the region's labor markets work

Jobs for Growth defends the idea that developing truly effective labor policies that can boost productivity requires a better understanding of how the labor market works. In the redistributive context, it is possible (though not always desirable) to intervene without knowing the sources of value creation in the labor market. It is enough to see how to distribute the surplus. However, when the goal is to create greater value, it is essential to know which mechanisms generate value and how to better support them (without undermining them) with a good policy design that is tailored to the situation and the needs of each country.

Therefore, while the ultimate objective of this book is to offer recommendations on how to develop a labor policy that boosts productivity, it begins with an analysis of how the region's labor markets work (see Chapter 2) to understand why they generate so much short-lived, informal employment. Next, it identifies the drivers that can be used to substantially improve the current situation—arguing that for a market to work properly, job productivity must be high enough to defray the costs of formal employment. Moreover, to generate stable employment, the value generated by the employment relationship must be higher than the cost of dissolving it (dismissal cost). Chapter 2 describes two ways of attaining greater formality. The first is to achieve gains in job productivity that cover the costs of wages, health care, pensions, training, and unemployment insurance. The second is to reduce the cost of formal employment (“flexibilization”) by cutting workers’ wages and access to social benefits. This book comes down clearly on the side of the former, understanding that non-wage costs and regulations are essential for promoting greater access to benefits to reduce risk—key aspects of welfare. It shows, however, that informality is partly a response to a situation in which both the aspiration of welfare and the laws designed to promote it are inconsistent with productivity. Thus, it is documented in these pages that, as the ambitions concerning the benefits to be sustained and promoted grow, so too do the improvements and investments that will be required to boost productivity. In some cases, it may also be necessary to adjust the level of benefits or the way they are financed. More effective enforcement of labor laws is another way to increase formality.

We also show that there are two ways of promoting greater labor stability. The first is to stimulate greater job productivity, promoting, *inter alia*, continuous training for workers to ensure that the value of maintaining the employment relationship is higher than the value of dissolving it. The second is to raise the cost of dismissal to discourage dismissals without cause. This book advocates the first option while acknowledging that there should be a cost to dissolving the employment relationship. It also calls for the development of better mechanisms for income protection and workers’ re-entry into the workforce to facilitate the speedy and effective re-entry of people who lose their jobs. This will, in the aggregate, achieve job reallocation that promotes productivity gains, a phenomenon which still pends in the region today.

Chapter 3 identifies market failures that may be affecting labor-market performance in LAC. It also argues that these failures, which are common in many countries, are magnified in the region due to a context of low levels of education in the labor force, high informality, and a still-limited capacity

to design and implement effective labor policies to overcome these market failures. Labor policies aimed at overcoming these market and state failures have the potential to boost productivity and increase welfare.

Given these considerations, the book examines current labor policies in the region. Chapter 4 reviews policies that are being implemented to increase or equalize opportunities for formal employment. It argues that active labor-market policies are still in their infancy and that these policies lack the resources needed to manage a situation in which workers have little information about where to find job opportunities and simultaneously are unproductive, due in part to serious deficiencies in the region's educational systems. Therefore, current policies are not enough to promote better labor market intermediation, strong links between young people and their first jobs, and improved entry and re-entry of unemployed workers into the labor market. The countries of the region, moreover, have few systems in place for monitoring, managing, and evaluating active labor market policies that would shed light on their performance and cost-effectiveness.

Another major obstacle to workers accessing formal jobs is inadequate income support for the unemployed. Income support systems for the unemployed protect only a select minority of formal workers; the vast majority of workers, therefore, lack the mechanisms necessary to keep searching for formal jobs and thus must take any jobs they can find in the informal sector.

At the same time, in many countries, the cost of hiring a formal worker is high relative to that worker's job productivity, and labor law enforcement is weak. Therefore, given the low productivity and employability of many workers when they enter the labor market, the weakness of active employment policies, and the high cost of formal employment, many worker–employer matches simply do not achieve the productivity required to defray the costs of formality. This helps explain why most workers spend much of their working lives in the informal sector.

Chapter 5 examines the region's mechanisms for achieving more stable and productive employment (what we call “productive job stability”). This concept does not imply a stable job for life; as we know, technology and globalization have made change part of the reality of all workers (see Box 1). This book advocates for jobs that enable people to grow and, when necessary, move to another, better job. Regulating unjustified dismissals is the most common way of encouraging more secure employment relationships in LAC. The degree of protection granted by law is only slightly lower than that of the OECD

countries, and in some aspects and countries, it is even higher. Labor laws can reduce turnover and there is evidence that turnover would be even higher in the absence of such laws. However, a very stringent dismissal law can produce adverse effects that must be considered. Therefore, Chapter 5 also examines continuous training policies, since, as noted in Chapter 2, upgrading workers' skills is an effective tool for boosting productivity throughout a worker's life and thereby reducing involuntary job loss. The information on investments in worker training by employers, individuals, and the state is quite deficient. However, the little that exists shows that poor implementation of such policies reduces their effectiveness. It is therefore likely that they do little to boost productivity and mitigate worker turnover in the region. This may partly explain why turnover in the region is high, even with laws that protect against dismissal. Given these circumstances, this book posits the need to rethink the policy mix needed to achieve greater productive job stability.

Box 1. New labor market trends

The globalization of production in vast transnational value chains makes countries and their circumstances more interconnected than ever. Events on one side of the planet have instant repercussions on the other side. Opportunities have opened up that were unimaginable just a few years ago. Firms and individuals can now do business with people in remote areas via the Internet, increasing their potential client and supplier bases on a global scale. This also means, however, that adverse events spread at lightning speed, potentially multiplying the risks to which individuals are exposed. Mechanisms must be created to ensure that employment relationships are robust enough to withstand unexpected shocks and that workers receive the necessary support to weather transitions that will enable them to successfully resume their career paths.

The possibility that work performed by humans will increasingly be taken over by robots is also an extraordinary challenge (Autor, 2010; Brynjolfsson and McAfee, 2015; Freeman, 2014; Frey and Osborne, 2013). Operations such as driving a car, which just 10 years ago were assumed to be completely beyond the reach of machines, are today a reality. Such advances will require enormous resiliency on the part of workers so that they can adapt and take advantage of this new reality.

Another emerging trend in the new millennium is the shared economy. Tom Goodwin, Senior Vice President of Strategy and Innovation at Havas Media, began an essay saying: “Uber, the world’s largest taxi company owns no vehicles. Facebook, the world’s most popular media owner creates no content. Alibaba, the most valuable retailer has no inventory. And Airbnb, the world’s largest accommodation provider owns no real estate. Something interesting is happening.”

This has serious implications for the world and the region. The disruption created by these platforms can increase the capacity to create value in the service sector, where advances in technology have traditionally had little effect. However, technology blurs the employer–employee relationship and the traditional concept of formality that underpins economies’ social contracts. The region will have to find a better way of adapting labor policies to this new reality, balancing the goal of capitalizing on the opportunities it brings with that of providing proactive risk management to reduce the potential harm to people.

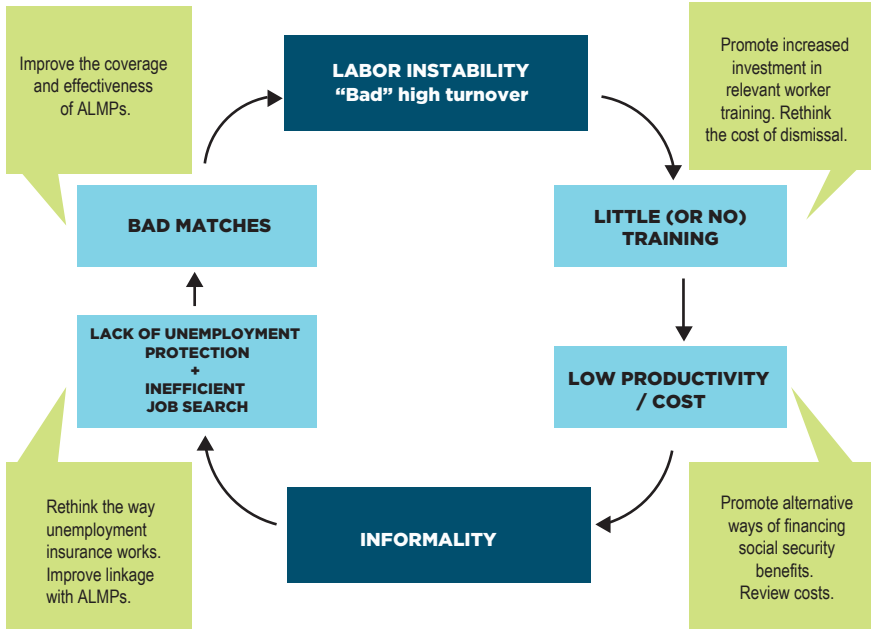
Jobs for growth: labor policies for successful career paths

A labor policy that boosts productivity must support workers and promote their success throughout their careers. One objective of this book is to conceptualize an integrated package of labor policies to boost productivity and break the vicious cycle described earlier. This package meets the goal of creating more—and above all, better—jobs for the entire population as a mechanism for overcoming poverty, reducing inequality, and stimulating greater social and economic development (see Diagram 2).

Within this context, Chapter 6 argues that the region needs a comprehensive, people-centered vision of labor policy, promoting successful career paths throughout workers’ lives. Consequently, a labor policy aimed at boosting job productivity to promote workers’ welfare must ensure that they continue to improve their situations and their capacity to create value (for their countries and themselves) throughout their lives and various transitions. Thus, while it is not easy to define what constitutes a good job or a successful career path, we subscribe to the concept of decent work (Box 2), which was developed by the ILO, and we stress the temporal perspective—a good job is not defined simply by its present conditions but by its capacity to put the person

who holds it on a lifelong upward career path, thereby contributing to greater economic and social development.

Diagram 2 How to develop a productivity-boosting labor policy



Source: Prepared by the authors.
ALMPs = Active labor market policies.

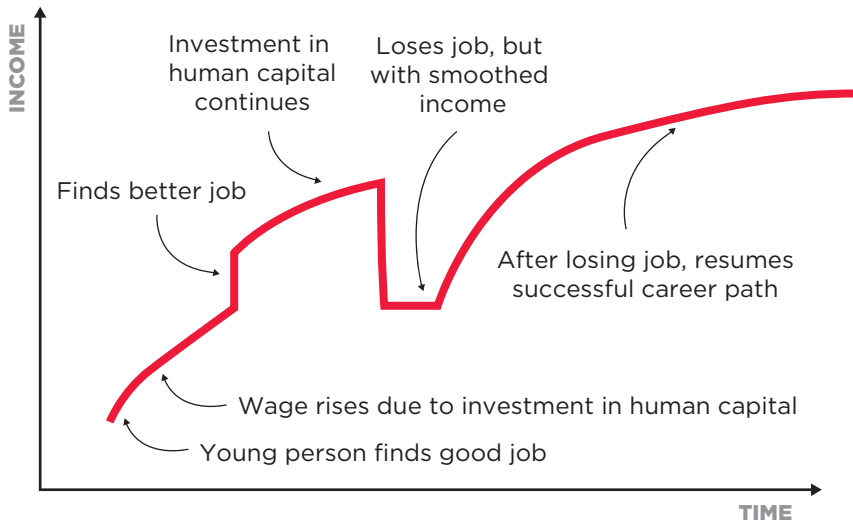
Box 2. The concept of decent work

According to the ILO, having decent work means having “opportunities for work that is productive and delivers a fair income, security in the workplace and social protection for families, better prospects for personal development and social integration, freedom for people to express their concerns, organize and participate in the decisions that affect their lives and equality of opportunity and treatment for all women and men.”

Source: ILO, <http://www.ilo.org/global/topics/decent-work/lang--en/index.htm>.

Ensuring successful career paths requires guaranteeing that workers start out their working lives in formal jobs that coincide with their aspirations and education and that offer them the protections of social security and labor laws; it also requires that workers' skill sets meet the requirements of their positions. Thus, before entering the labor market, workers must receive training in areas that have employment opportunities and acquire skills that employers value to ensure rapid and effective entry into the labor market. This also implies that, once employed, workers must be encouraged to continue their training and learning in the workplace, as this has two positive effects: it promotes value creation and reduces the probability of involuntary job loss. Moreover, if workers involuntarily lose their jobs, labor policy should facilitate their speedy and effective placement in another suitable formal job, which will enable them to keep growing along a successful career path (see Diagram 3).

Diagram 3 A stylized successful career path



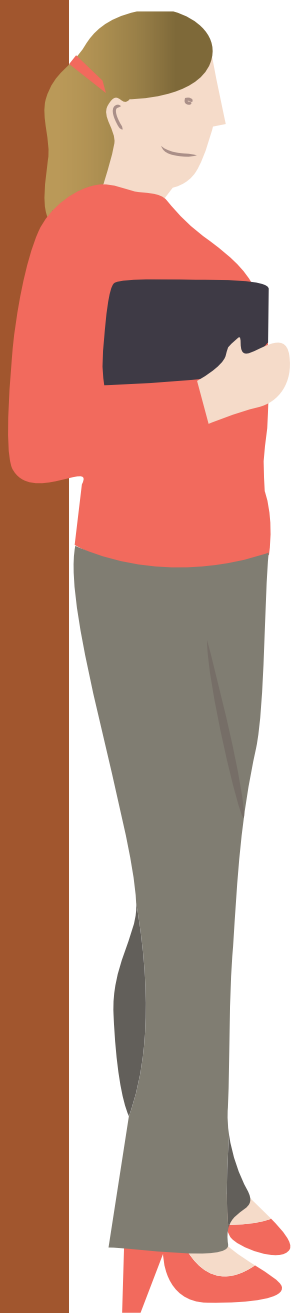
Source: Prepared by the authors.

Comprehensive policies are necessary to achieve this successful career path, as it requires the coordination of a series of mutually complementary elements. Otherwise, there is a danger that efforts to improve one aspect of the career path will prove counterproductive due to unanticipated impacts on other aspects. For example, it would make no sense to promote the job stability of active workers if doing so discouraged formal hiring. It would likewise make no sense to promote formal employment if doing so resulted in unstable formal jobs. Nor would it be desirable to protect income during unemployment if this support substantially reduced the incentives to find new jobs. Chapter 6 therefore proposes a comprehensive labor policy package aimed at increasing formal employment and access to it while simultaneously achieving greater job stability—a policy package that, in turn, would promote higher levels of productivity and welfare.

Centering labor policy on creating successful career paths, boosting productivity, and improving risk management is all the more important given the trends indicating that increasing the capacity to create value may also increase the risk that workers will suffer (see Box 1).

Achieving successful career paths requires employers to be treated as partners rather than adversaries in the task of value creation. One aspect that differentiates a labor policy that fosters redistribution from one that boosts productivity is that, while the former may entail an adversarial approach—if one party gains, the other loses—the latter requires a cooperative approach in which employers and employees work hand-in-hand to create value. This requires that the labor policy also regards firms (not just workers) as clients and beneficiaries. To meet this objective, the region's ministries of labor must have the technical know-how and operational capacity to handle these new roles and methods of operation.

Furthermore, labor policy that boosts productivity cannot be independent of a country's other development policies. On the contrary, it must be coordinated with strategies related to areas such as business development, clusters, innovation, capital market development, and education. This will require ministries of labor to coordinate proactively both within government and with the private-sector and civil-society organizations that work in productive development to ensure that workers and firms create greater value together. This is, in fact, the goal of this book: to create jobs that foster the growth of workers and countries in the region.



Chapter 1.

Labor markets in Latin America and the Caribbean: progress, but with dark clouds on the horizon

Summary

This chapter presents the evolution of the region's labor market over the past 20 years, a period marked by strong economic growth and remarkable progress in job creation, unemployment reduction, formality expansion, and wage increases. Notwithstanding this progress, labor productivity in this period has fallen relative to the rest of the world. This chapter argues that, if substantial changes are not made in the structure of the region's labor policies, it will be very hard to maintain these positive trends, which could even be reversed.

Introduction

The evolution of the labor market and, in particular, the quantity and quality of jobs, has major implications for poverty, inequality, and insurance against the risks of illness, poverty in old age, and unemployment. Moreover, the degree of stability (or its flip side, the precariousness of jobs) has a considerable influence on individuals' welfare and on their ability to make long-term decisions, such as starting a family, investing in their children's education, or buying a house. Consequently, the critical task of expanding the emerging middle class in Latin America and the Caribbean (LAC) requires the creation of more and better jobs.

At the same time, the evolution in the types of jobs the economy creates also has major implications for economic development. As more low-productivity jobs are replaced by higher-productivity jobs, economies grow faster and people have more access to better opportunities.

This chapter examines the evolution of the labor market over the past two decades (1993-2013). The second decade in this period was marked by substantial economic growth and remarkable progress in job creation, unemployment reduction, formality expansion, and wage increases. However, in the same period, job productivity fell relative to the rest of the world. Thus, this chapter points to major concerns about the sustainability of these gains. It also notes that a high proportion of employment is in the informal sector and that many of the jobs created in the region are short-lived—even when they are formal jobs. This has enormous implications for welfare and for the region's capacity to develop mechanisms that protect against this instability.

A wide variety of information sources were consulted during the preparation of this chapter (see the appendix of data sources) to assess how workers and firms come together to create value added in the region and to assess the implications for welfare, productivity, and efficient resource allocation in the economy.

The past decade has produced significant improvements in the labor market

After mediocre growth in the 1990s, the LAC region has enjoyed a period of economic growth, poverty reduction, and to a lesser extent, declining inequality in the first 15 years of the 21st century, giving rise to a historic expansion of the middle class. Despite the global crisis of 2009—a year in which the region’s gross domestic product (GDP) fell by 1.6%—since 2000, the region has grown at an average rate of 3% annually; poverty has also fallen by 20 percentage points (from 43.2% to 23.3%) in this period (IDB, 2015c); inequality has similarly declined (there was a 7% decrease in the Gini coefficient, according to World Bank (2015a) calculations); and 50 million people have joined the middle class (Ferreira et al., 2013). Numerous studies concur that this is the result of, on the one hand, better macroeconomic management, and on the other, the global commodity boom, which benefited the countries of the region that are net producers of food, oil, and minerals. The labor market converted economic growth to poverty reduction and middle-class growth. The expansion of labor income is behind both the 58% reduction in poverty before the crisis and the 49% reduction after it (World Bank, 2015a).

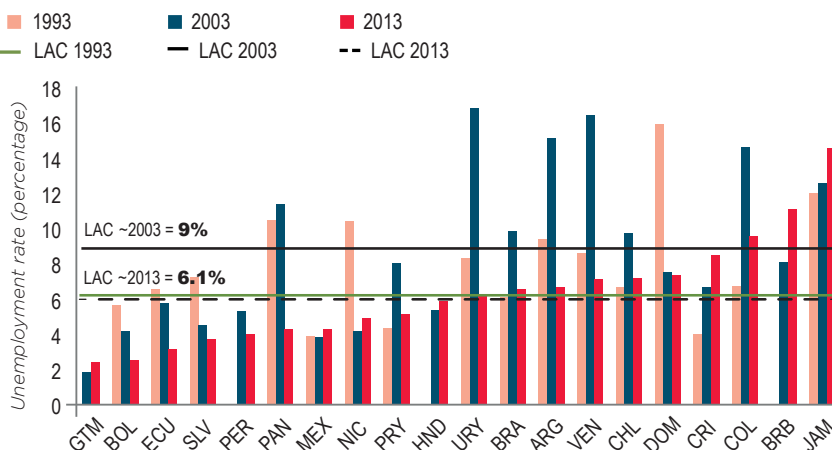
Beyond economic growth, lower fertility rates and the growth of non-labor income have also contributed to the reduction in poverty and the growth of the middle class (World Bank, 2015a). Compared with people still living in poverty, those in the new middle class are more educated, and a higher percentage of them have formal jobs, live in urban areas, and (among women) have fewer children (Ferreira et al., 2013).

Labor market indicators have also reflected this improvement. The unemployment rate has fallen in the past 20 years (Figure 1.1), and the countries of the region have emerged from the global economic crisis with much lower unemployment rates than those seen today in the high-income countries. Average unemployment fell from 9% in 2003 to 6% in 2013. In countries such as Bolivia, Ecuador, El Salvador, and Guatemala, unemployment is virtually nonexistent, with rates below 4%.

The figures also show a very positive evolution in employment. During the period from 1993 to 2013, the working population grew by 8 percentage points—4 points in the first decade and 4 points in the second (Figure 1.2). Certain countries, such as Bolivia, El Salvador, Honduras, Paraguay, and

Figure 1.1 Evolution of unemployment rates by country, 1993–2013 (percentage)

Ages 15–64



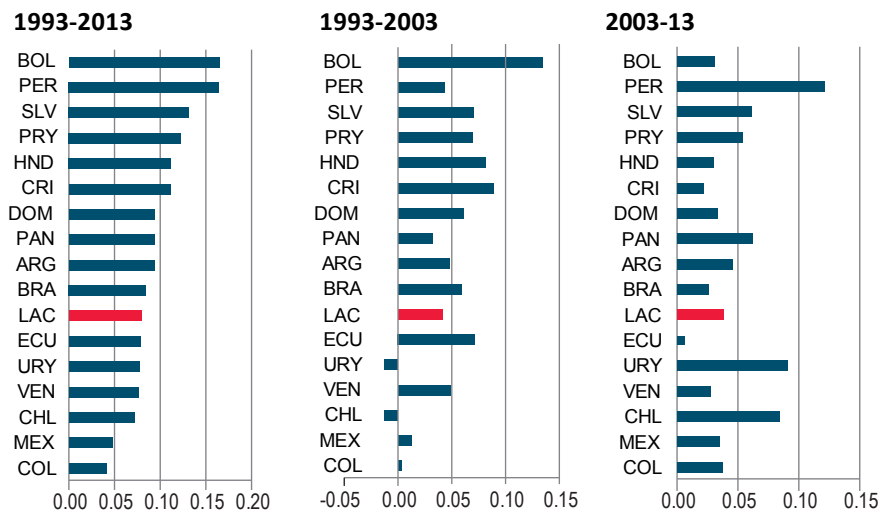
Source: IDB (2015b).

Note: The unemployment figures computed in the harmonized IDB Labor Markets and Social Security Information System (SIMS) refer to open unemployment and may differ from each country's official calculations.

LAC = Latin America and the Caribbean

Figure 1.2 Change in the percentage of the employed population, 1993–2013, by subperiod

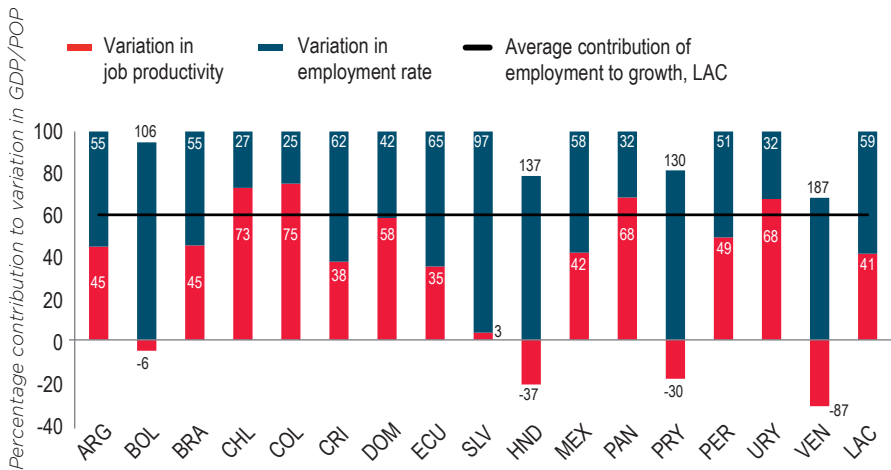
Variation (in percentage points)



Source: Prepared by the authors with data from the World Bank (2015b).

Peru, had growth of more than 10 percentage points during the period from 1993 to 2013, although with widely varying patterns in each subperiod. The fact that the countries of the region were able to employ a greater proportion of their populations explains much of the growth of the past decade. Gains in labor productivity explain only 40% of the growth in the 1993–2013 period (see the Methodologies appendix). Thus, on average in the region, the increase in the working population explains 60% of the growth of the past 20 years (Figure 1.3). In some countries, especially Bolivia, El Salvador, Honduras, Paraguay, and Venezuela, job growth accounts for practically all—or even more than 100%—of the growth, as the output per worker fell in those countries during that period. At the other extreme, in Colombia and Chile, workers' entry into the labor market explains only about a quarter of the total growth.

Figure 1.3 Growth in GDP per capita attributable to higher productivity and employment, 1993–2013 (percentage)



Source: Prepared by the authors with data from the World Bank (2015b).

Note: Calculation according to the Methodologies appendix.

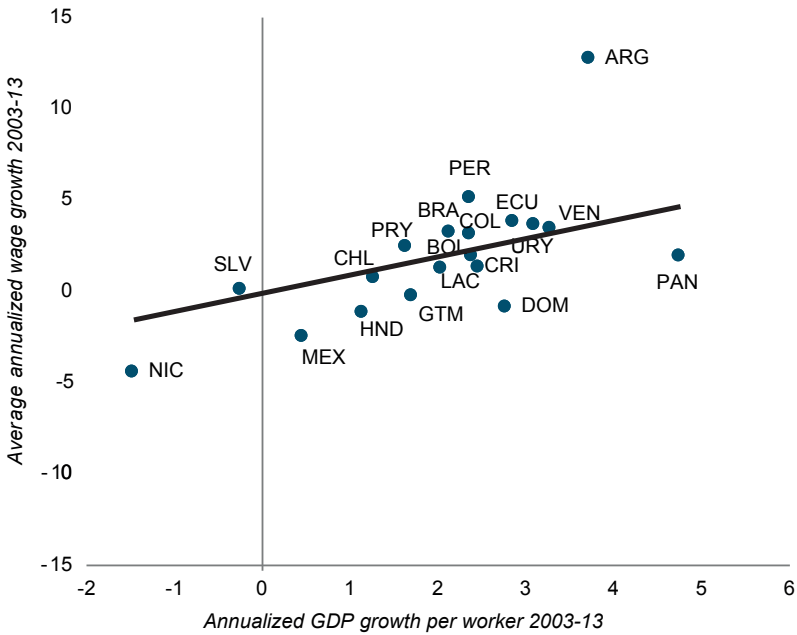
Real wages rose at a good pace during the period from 2003 to 2013. Average wage growth in LAC was 2% per year during that period, almost equal to the rate of GDP growth per worker and far higher than the -0.38% average annual loss experienced during the period from 1993 to 2003. In several countries in the region, the increase in wages was even higher than the increase in GDP per worker (Figure 1.4).

The increase in the real minimum wage in some countries in the region was also partly responsible for the overall wage increase (World Bank, 2015a). On average, the real minimum wage in the region grew by 3% annually during the period from 2003 to 2013 (Figure 1.5)—approximately one percentage point higher than the increase in GDP per worker. In some countries, such as Argentina and Uruguay, the growth was more than 10% annually, while in others, such as the Dominican Republic, El Salvador, Jamaica, Mexico, and Paraguay, there was low or negative growth.

Great progress was also made in formal job creation. When judging the evolution of the region's labor market, one of the basic aspects to look at is the evolution of formality. The importance of this issue lies in the fact that having a formal job gives workers access to a series of protections—for example, against the risks of illness, poverty in old age, and in some cases, unemployment—along with the other protections stipulated in the labor code. Although, in recent years, the expansion of non-contributory health programs for workers with no access to social security has reduced gaps in protection, the health services package is still much better for people who have access to social security through their job.

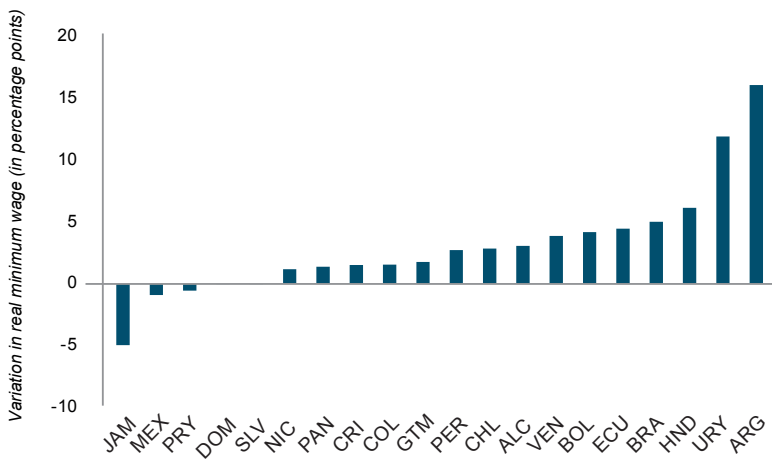
Given how pension systems are structured, the only way of securing a pension for old age that serves as a reasonable substitute for wages is through participation in contributory systems that are connected with formal employment. However, its importance is not limited to social protection. Therefore, at the macroeconomic level, the only way to obtain the savings required to deal with the steadily aging population is through higher levels of formal employment (Bosch, Melguizo, and Pagés, 2013). Furthermore, as will be discussed later, one of the characteristics of the region's labor market is high job instability. Again, given the design of protection mechanisms and the fiscal restrictions, establishing appropriate unemployment protection mechanisms is very difficult without an increase in formal employment. Finally, it is important to consider the negative repercussions of informal employment on fiscal revenue and productivity (Pagés, 2010; Busso, Fazio, and Levy, 2012).

Figure 1.4 Growth in average wage and GDP per worker, 2003-13 (percentage)



Source: Prepared by the authors with data from the IDB (2015b) and IMF (2015).

Figure 1.5 Increase in the annual real minimum wage, 2003-13



Source: Prepared by the authors with data from the IDB (2015b) and IMF (2015).

The period from 2003 to 2013 was one of the most fertile in a long time in terms of formal job creation in the region. The gains in formality during this period were quite spectacular. The region increased its percentage of formal workers from 38% in 2003 to 45% in 2013 (Figure 1.6). During this time, the number of workers in the region grew by 48 million (from 196 million to 244 million), and the number of formal workers increased by 35 million. Eight countries in the region (Argentina, Bolivia, Brazil, Costa Rica, the Dominican Republic, Ecuador, Paraguay, and Uruguay) increased their percentage of formal workers by more than 10 percentage points.

However, there are strong indications that these trends will be hard to sustain going forward

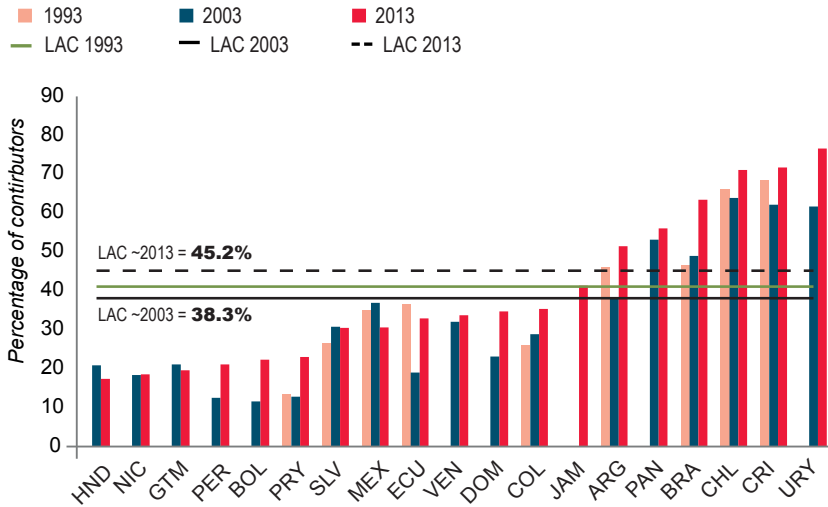
Despite the drop in oil prices and substantial growth in the United States, LAC region's projected growth for the coming years, both short- and medium-term, is not as positive as it was in the last decade (Figure 1.7). The conditions created by the commodity boom in the region during the period from 2003 to 2008 are unlikely to be repeated. With the growth slowdown in China, low growth in the European Union, and the lack of a recovery in Japan, the outlook for the global economy continues to be moderate (IDB, 2015a). Projections for 2015 point to little growth in LAC countries. Furthermore, the International Labour Organization (ILO) reports that in 2014, one million jobs failed to be created in LAC (ILO, 2014b). The outlook for the future is therefore much less rosy, and there is even concern that some of the gains will be reversed (ILO, 2014b; IDB, 2015; World Bank, 2015a).

Furthermore, a breakdown by decade shows that the improvement in the indicators is due largely to the recovery in employment and formalization during the first decade of the 21st century from the lows of the 1990s. Around 37% of the increase in the formalization rate between 2003 and 2013 involved the recovery of losses sustained in the period from 1993 to 2003.¹ In fact, an analysis of the evolution of the regional formality rate over the past two decades shows that the rate rose from 41% to 46%—less than 0.25 percentage points per year. Even today, more than half the jobs in the region are informal, and at the present rate, universal formalization in the region would take about 180 years. In this context, progress in formalization has stagnated since 2013 (ILO, 2013b; ILO, 2014b).

¹ This was calculated with the only eight countries that have comparable data from 1993 (Argentina, Brazil, Chile, Colombia, Costa Rica, El Salvador, Mexico and Paraguay). From 1993 to 2003, formality rate decreased from 41% to 38%. From 2003 to 2013, it rose from 38% to 46%.

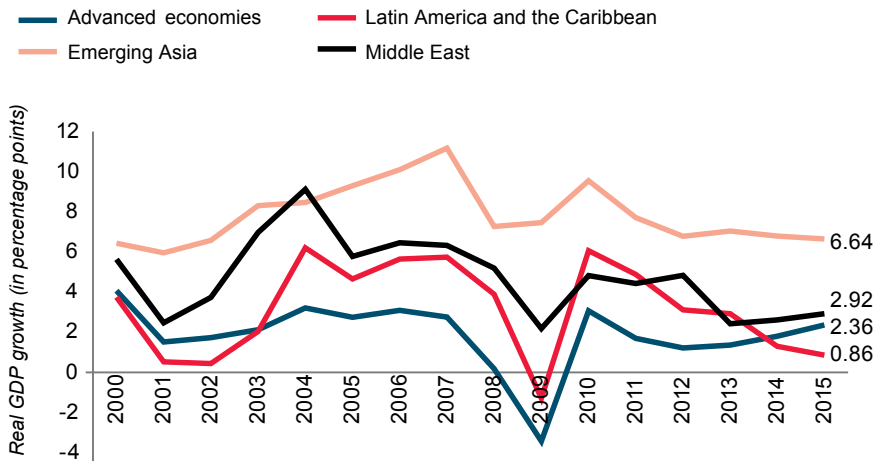
Figure 1.6 Workers who contribute to social security, 1993–2013 (percentage)

Ages 15–64



Source: IDB (2015b).

Figure 1.7 Real GDP growth, by region (percentage)



Source: IMF (2015).

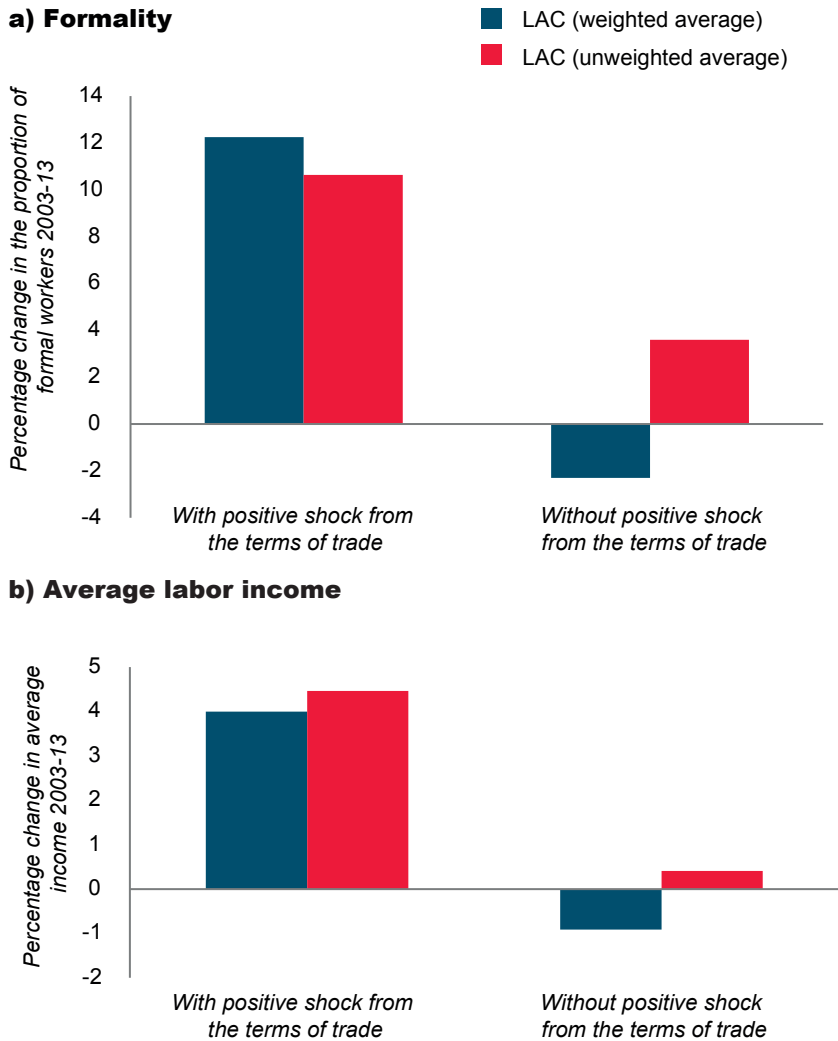
Another factor that throws a shadow over the continuity of the labor market's good results in employment and wages is that much of the improvement in employment indicators was concentrated exclusively in the countries that benefitted from the commodity boom. Almost 90% of the formal employment created in the region (30 million jobs) was in countries exposed to positive terms-of-trade shocks. These countries increased their formality rate by 11 percentage points on average, in contrast to a 4-percentage-point increase in the other countries (Figure 1.8). The wage increases were also exclusive to this group—4% annually versus 0.41% annually in the countries that did not benefit from the tail wind of commodity prices (authors' calculations based on data from the World Bank, 2015a).

In the absence of external factors that drive the economy, the region will have to foster greater gains in productivity, a veritable Achilles heel for LAC (Pagés, 2010; Crespi, Fernández-Arias, and Stein, 2014). Labor productivity, the engine of sustainable growth, has been rather mediocre; in fact, it has been higher in every other region of the world with the exception of the Middle East (Figure 1.9). If these trends do not change, the region's labor productivity will be surpassed by the global average by the end of this decade (ILO, 2013b). Furthermore, without substantial changes, estimated GDP growth rates for the coming years are on the order of half those observed during the commodity boom (The Economist, 27 June 2015)—in other words, they will be insufficient to sustain the progress made in poverty reduction and equity. It is estimated that, to achieve rates similar to those of that period, increases in total factor productivity (TFP) on the order of 2.7 percent annually will be required. That is more than double the figure achieved during the past decade, which was a little over 1% per year (IDB, 2015). A recent World Bank report shows that the decline in poverty and inequality in the region has stagnated in recent years (World Bank, 2015).

Another engine of growth, the demographic dividend, which is responsible for much of the growth mentioned, is also winding down. The working population (as a percentage of the total population) has grown from 62% in 2000 to 67% in 2015. However, the demographic dividend is now in its final stages. The percentage of the population that is of working age is estimated to begin to stagnate in 2020 and then to fall, driven by the rapid aging of the population (Figure 1.10).

Furthermore, whether the rapid growth of women's participation in the labor market—one of the reasons for the rising employment rate in recent decades—will continue is unknown. It is estimated that a quarter of the growth

Figure 1.8 Real GDP growth per worker, percentage of formal workers, and labor income by country group due to the positive shock from the terms of trade, 2003-13



Source: Prepared by the authors using the World Bank classification of countries with positive or negative shocks from the terms of trade (World Bank, 2015a).

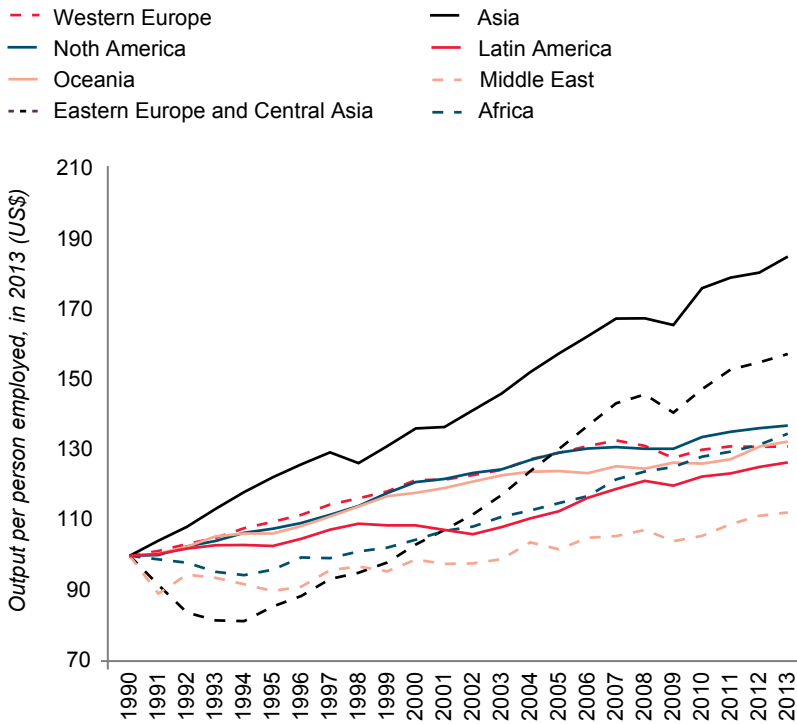
Note: The figure shows the variation in the formality rate for 2003 to 2013 (Figure a) and labor income (Figure b). The countries that experienced a positive shock from the terms of trade are those reporting an annualized growth of over 2% in these terms in the period from 2003 to 2013 (Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, and Peru). The countries that did not experience a positive shock from the terms of trade are: Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, and Uruguay.

in the past 20 years is due to women's entry into the labor market, with average participation rates in the region climbing from 47% to 58%. Women's contribution to growth in Bolivia, El Salvador, Mexico, and Venezuela has been even greater. However, looking down the road, participation rates in LAC are reaching levels very similar to those of the OECD countries; growth figures like those of the past will be very unlikely without deliberate policies to bring more women into the labor market, especially for those who face greater barriers to entry.

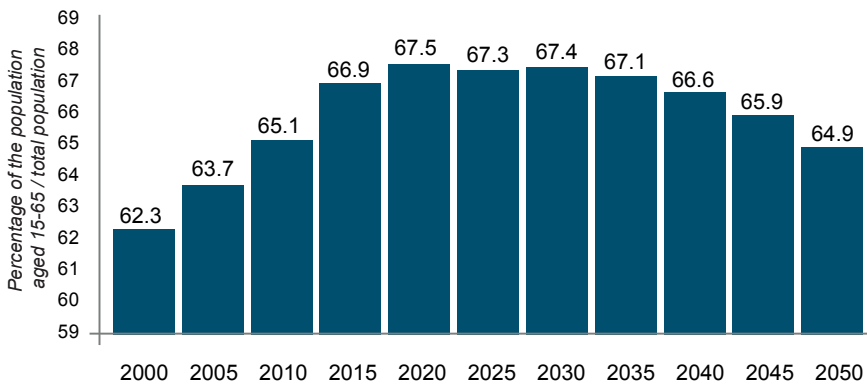
The quality of jobs is still low

Another source of weakness is that fact that, despite the gains in formality over the past decade, middle-class jobs in much of the region are predominantly informal and therefore offer little protection against the risks of illness, poverty in old age, and unemployment. Notwithstanding the growth of the region's middle class, one of its serious weaknesses is that it is largely disconnected from social insurance mechanisms. Roughly half of the emerging middle class (workers earning between US\$10 and US\$50 per day) have informal jobs, and 65% of the vulnerable middle class (with an income of US\$4 to US\$10 per day) do as well (Figure 1.11). The highest levels of informality are observed in Bolivia, Nicaragua, Paraguay, and Peru, where more than 60% of middle-class workers and more than 78% of vulnerable middle-class workers do not contribute to social security. A second group, with informality levels of 45% to 55%, consists of Colombia, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, and Venezuela. Finally, Brazil, Chile, Costa Rica, Panama, and Uruguay have a middle class with lower levels of informality, between 20% and 30%.

Another characteristic of jobs in the region is high instability. An important indicator of the quality of a job is its stability. While few would argue in favor of jobs for life and—for, as will be seen in Chapter 2 the constant reallocation of workers to more productive jobs is an important channel of growth—the prospects of an employment relationship and the risk of involuntary job loss are basic factors affecting welfare. In a recent report, the OECD includes the degree of job stability as one of the dimensions of the quality of employment (OECD, 2014a). Moreover, job stability is highly valued in Latin America, at least judging by the constitutions of many countries, which contain specific provisions to protect income, safeguard employment, and/or provide an income for workers who have been dismissed by their employers (Box 1.1)—a protection that is rarely found in constitutions in other regions.

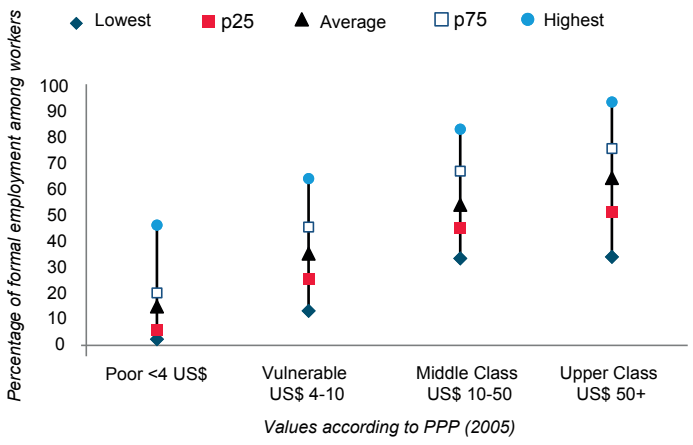
Figure 1.9 Trend in labor productivity by region, 1990–2013

Source: The Conference Board Total Economy Database™ (2014).

Figure 1.10 Proportion of the total population that is aged 15–65, Latin America and the Caribbean

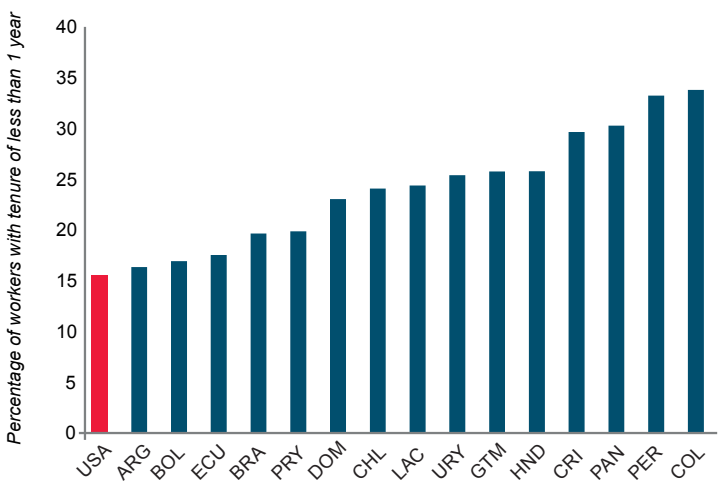
Source: Prepared by the authors with Celade data.

Figure 1.11 Percentage of formal workers by income category, LAC-18, 2013



Source: Prepared by the authors based on household surveys, circa 2013.
 Note: The percentiles refer to the distribution of formality among countries for each subgroup. For example: on average, 15% of the workers who earn less than US\$4 per day are formal. Some 75% of the countries in LAC are below 20% formality in this group of workers. Among poor countries, the figure for the country with the highest formality is 47%.
 LAC-18 = Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, and Venezuela
 PPP= purchasing power parity

Figure 1.12 Percentage of workers aged 25–54 who have one year of tenure or less in their current jobs, 2013

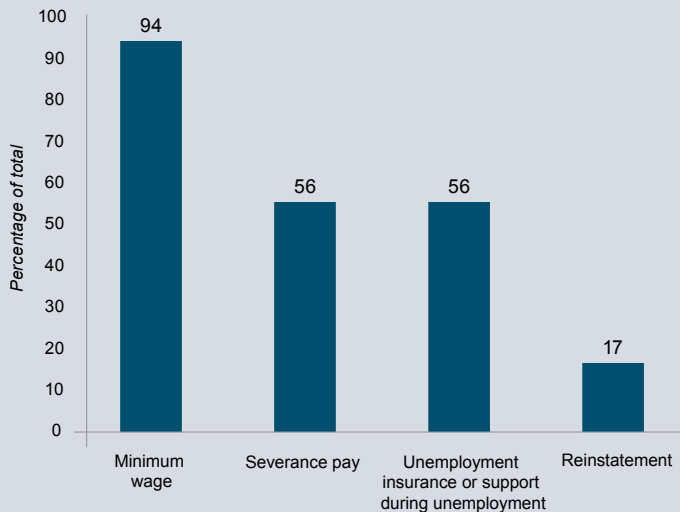


Source: Prepared by the authors based on household surveys, circa 2013.

Box 1.1. Constitutional protections for workers in Latin America

The countries in the region place a high value on worker protection, which is why many of their constitutions have specific provisions to safeguard income, protect jobs, and/or provide an income for workers who have been dismissed by their employers. 17 of Latin America's 18 constitutions have specific provisions governing the minimum wage, and the constitutions of more than half the countries mention compensation for dismissal and support during unemployment (Figure 1.1.1). Three of the 18 constitutions even have specific provisions allowing for workers who have been dismissed without justification to demand reinstatement or rehiring, effectively rescinding the dismissal. No non-Latin American OECD country, even those with high severance pay for dismissal, has provisions governing dismissal, reinstatement/rehiring, or the minimum wage in its constitution.

Figure 1.1.1 Percentage of constitutions in Latin America that have labor policy provisions



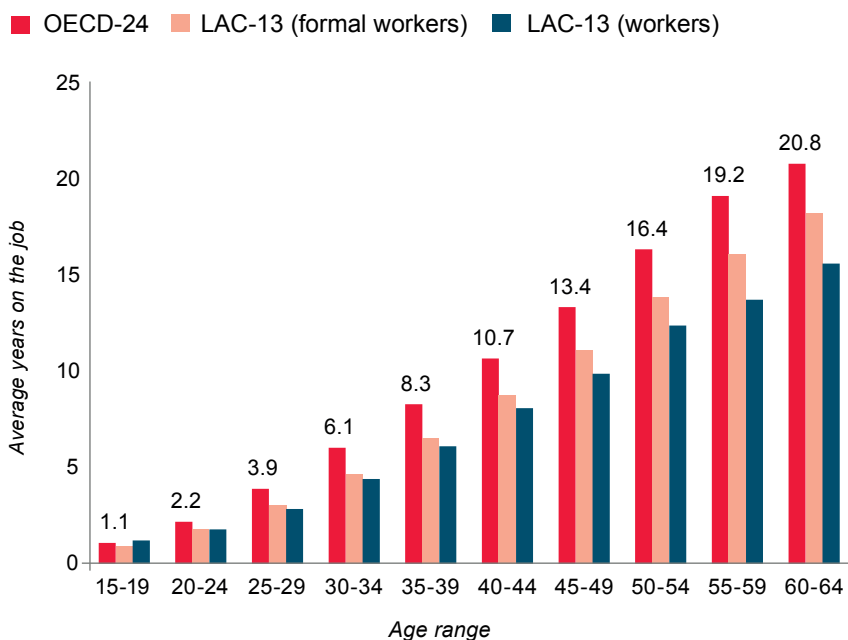
Source: Prepared by the authors, based on the national constitutions of 18 countries.

In this context, the figures show that the employment created in the region is very short-lived. About one in every four (24.4%) prime-age workers (24–54 years) has been with his or her current firm for one year or less (Figure 1.12); this is compared to around 15% in the United States and one in six,

on average, in the OECD countries. In some countries, such as Peru and Colombia, one in every three workers has spent less than one year with his or her current firm.

This means that workers in LAC spend roughly 40% less time at their jobs than those in the OECD countries (Figure 1.13). In fact, midway through working life (ages 25–54), the average LAC worker has had his or her job for 35% less time than the average worker in the OECD countries. This shorter tenure is largely due to the high incidence of informal jobs, which have much shorter terms than formal jobs and those in developed countries. However, the duration of formal jobs, the most stable part of the labor market in principle, is also 20% lower in LAC countries than the average for all jobs in the OECD countries, indicating very high turnover in the region even in the formal sector of the economy. Box 1.2 presents some factors associated with longer or shorter tenures in a job.

Figure 1.13 Average tenure of workers in their current jobs (LAC and OECD), 2012



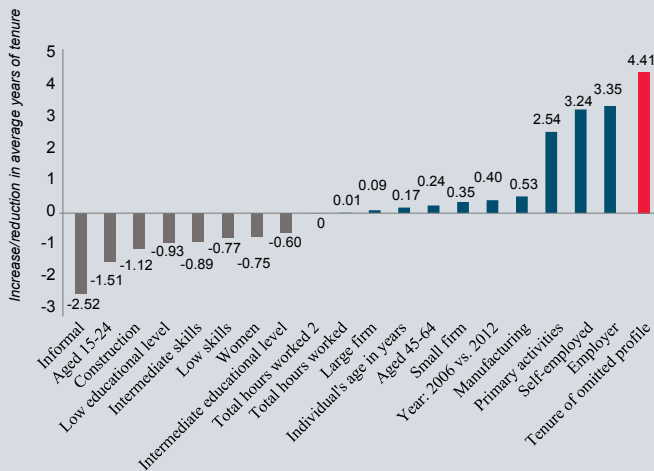
Source: Prepared by the authors based on OECD (2015) and household surveys in LAC, circa 2012.
 Note: The OECD countries are Austria, Belgium, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Luxembourg, the Netherlands, Norway, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, Switzerland, and the United Kingdom. The LAC-13 countries are Bolivia, Brazil, Chile, Colombia, the Dominican Republic, Ecuador, Guatemala, Honduras, Mexico, Panama, Paraguay, Peru, and Uruguay.

Box 1.2. An interpretation of the variable length of tenure in a firm

The data on length of tenure in a firm have generally been used in the literature to describe the stability and security of jobs in the labor market, interpreting longer worker tenure in a firm as greater security and shorter tenure as less security. While a worker's average tenure in a firm conveys information about security and turnover in the labor market, there are certain limitations to using the data this way. For example, in recessions or periods of lower job security, the proportion of workers with lengthy employment may increase, as the workers most likely to be dismissed are those with less time on the job. Similarly, in periods of sustained economic growth, average tenure can decrease when new opportunities open up for workers to transition to other jobs.

In addition, it is unclear whether there is a linear relationship between a worker's tenure in a firm and his or her productivity. On the one hand, an employment relationship that is more stable implies greater learning on the part of the firm's workers, as well as greater incentives to train those workers, due to the consequent increases in human capital and its productivity. On the other hand, employment relationships that last much longer can mean unproductive partnerships that cannot be dissolved due to the high cost of separation.

Figure 1.2.1 Conditional correlations between worker tenure and personal characteristics



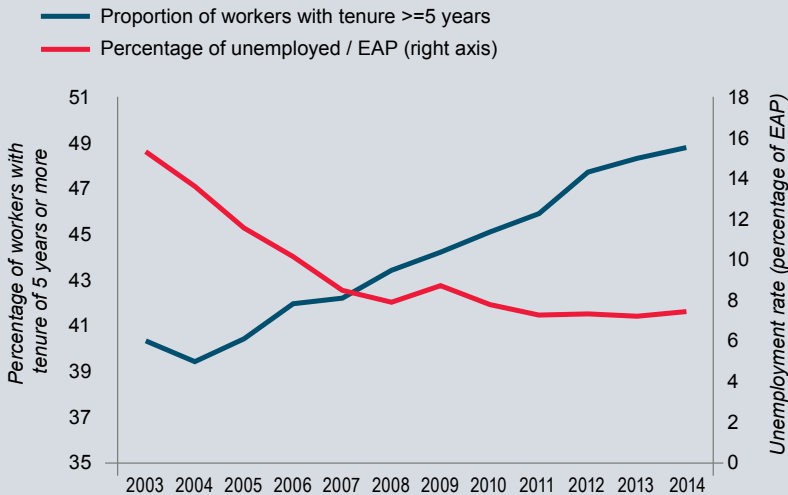
Source: Gualavisi and Oliveri (2015), based on household surveys in Latin America.

Note: The omitted profile corresponds to a male worker who is aged 25 to 44, has a high level of education, works in the formal sector, is highly skilled, works an average of 43 hours per week, is salaried, and works in a medium-sized firm in the services sector.

In light of these considerations, some facts suggest that workers' tenure in a firm is positively correlated with security, job quality, and productivity. First, if adjusted for age, the average job tenure is positively correlated with income, education, and firm size. One additional year of schooling is associated with a 5% increase in job tenure. It is important to note that, while these associations cannot be interpreted as cause and effect, they do indicate that salaried workers with longer job tenures are more likely to be educated, have more formal jobs, and be employed in large firms or be self-employed. (see Figure 1.2.1).

Second, some experiences in the region show that the economic recovery and the decline in unemployment are closely associated with significant increases in the duration of jobs. The most paradigmatic case is perhaps that of Argentina, where in 2003, unemployment began to fall, dropping from 15% to 8%, while at the same time the percentage of long-term workers rose from 40% to 48% (see Figure 1.2.2).

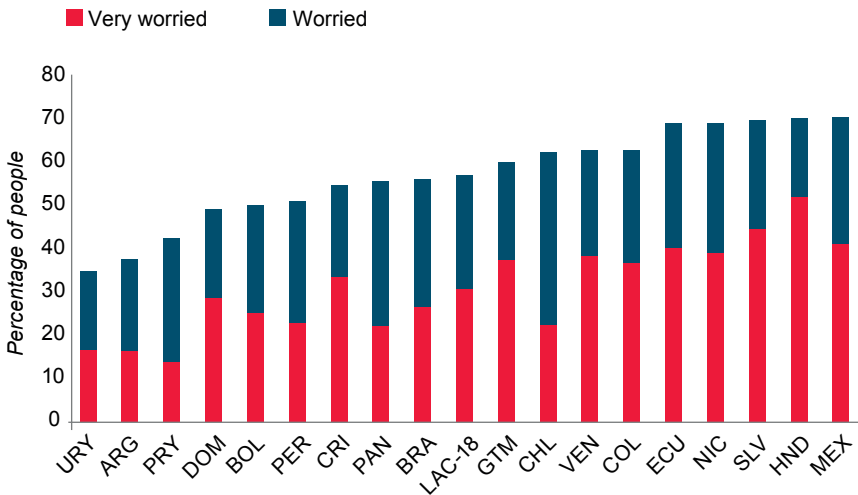
Figure 1.2.2 Argentina's unemployment rate and the proportion of workers aged 15-64 with tenure of five years or more



Source: Prepared by the authors, based on the Continuing Household Survey of Argentina.

Given this instability, especially for salaried workers, it comes as no surprise that the majority of workers in the region indicate that they are very anxious about the possibility of losing their job, despite the region's low unemployment figures. On average, more than half the workers in the region are either worried or very worried about the possibility of losing their job (Figure 1.14), and in seven countries, this figure is over 60%. This suggests that, despite low unemployment, individuals perceive a high degree of risk, which could be having a serious impact on their welfare. This topic is taken up again in Chapter 2.

Figure 1.14 Workers who are worried about losing their jobs or being unemployed in the next 12 months or who are currently not working (percentage)

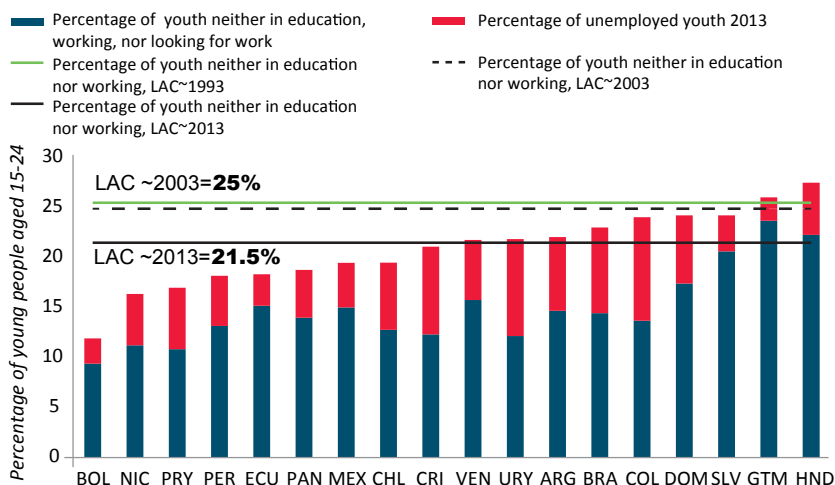


Source: Latinobarómetro (2013).

For some groups, finding a job is a challenge

In Latin America, 14.9 million young people, 77% of them women, are neither in education, nor working, nor looking for work. This figure, together with the number of unemployed youth (roughly 6.6 million), implies that 21.5% of the region's youth are neither in education nor working. The countries that are most affected (those that have a higher percentage than the 2013 average for Latin America) are Brazil, Colombia, the Dominican Republic, El Salvador, Guatemala, and Honduras; Argentina, Uruguay, and Venezuela are affected to a lesser extent (Figure 1.15).

Figure 1.15 Percentage of youths who are neither in education, nor working, nor looking for work, plus the unemployed, 2013



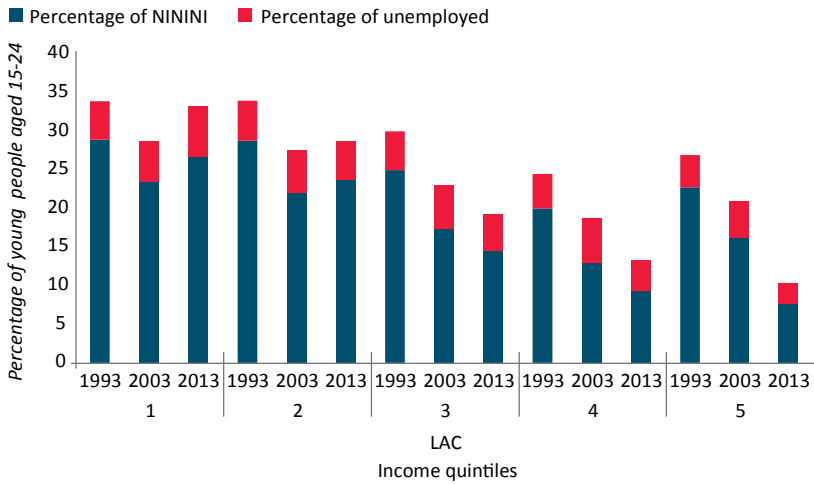
Source: IDB (2015b).

This problem is especially acute among low-income youth. The percentage of unemployed youths who are neither in education, nor working, nor looking for work increases as the economic situation of their household worsens (see Figure 1.16). For the region, on average, 33% of young people in the lowest income quintile belong to these groups, versus 13% in the 4th income quintile and 10% in the 5th income quintile. Providing productive jobs for this population represents a great opportunity for growth. The entry of youths who are neither in education, nor working, nor looking for work, and employed youths in the workforce, it is estimated, would boost the region’s GDP per capita by 5% on average (Figure 1.17; see the Methodologies appendix). However, this potential is even greater in some countries, with figures ranging from 7% to 9% of GDP per capita in the Dominican Republic, El Salvador, Honduras, and Venezuela.

This group’s lack of labor insertion is also a social problem. Joblessness and economic exclusion increase the risk of problems associated with risky behavior, such as drug use and violence (World Bank and UNODC, 2007; World Bank, 2011; UNDP, 2014). It is disturbing that, despite the improvement in the labor market, this problem has grown in the first two quintiles in the past decade (Figure 1.16).

Furthermore, young people tend to enter the labor market in informal jobs. In 2013, only 35% (15.9 million) of all working youths (45.2 million) had formal

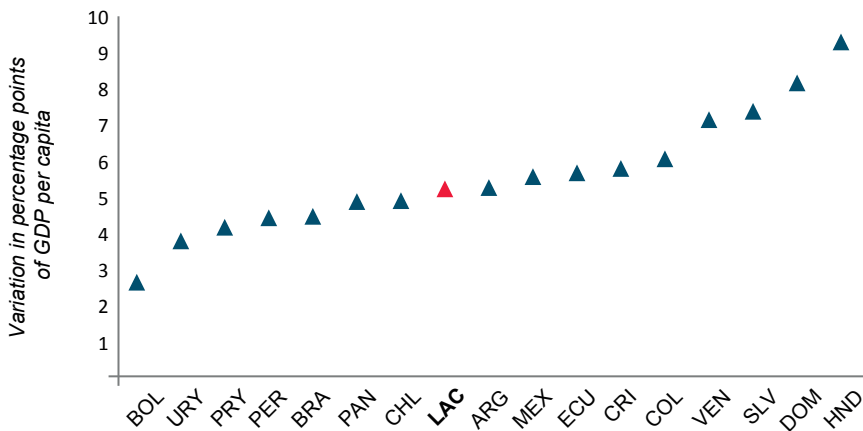
Figure 1.16 Percentage of the population aged 15–24 who are neither in education, nor working, nor looking for work, plus the unemployed, by household income quintile, 2003–13 (average for LAC)



Source: IDB (2015b).

Note: NININI is the Spanish acronym for “neither in education, nor working, nor looking for work.”

Figure 1.17 Potential increase in GDP per capita resulting from unemployed youths who are neither in education, nor working, nor looking for work entering into the workforce



Source: Prepared by the authors with data from the World Bank (2015b) and IDB (2015b).

Note: Youth productivity is assumed to be equal to a 0.62 proportion of the average.

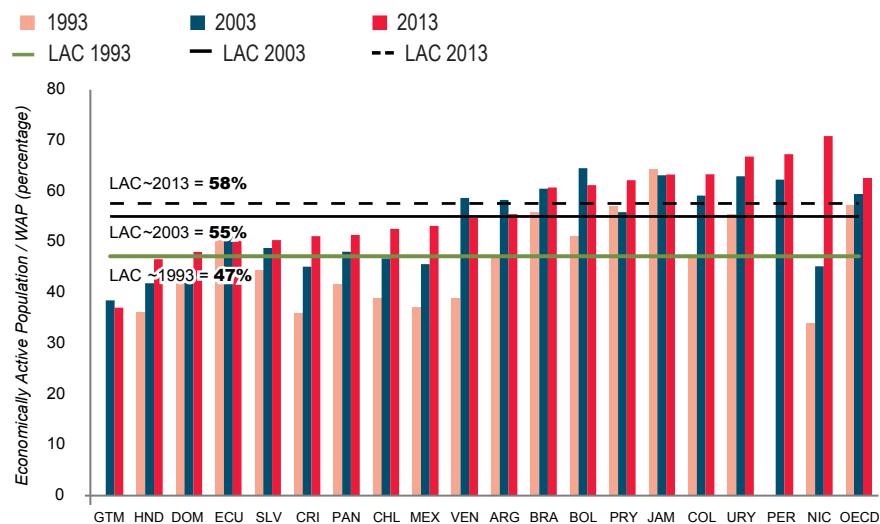
jobs. Lack of access to a job has a lasting impact: people who are unemployed or have informal jobs in their youth display poorer job performance as adults (Cruces, Ham, and Viollaz, 2012).

Women’s participation rates are still low in some LAC countries, and in all of them, unemployment rates are higher among women than among men. As mentioned earlier, the average participation rate for women is approaching the average rate in the OECD countries, but some countries still show wide gaps in workforce participation. Women’s participation rates are particularly low in the Dominican Republic, Ecuador, Guatemala, and Honduras (Figure 1.18). In addition, the unemployment rate among women is 30% higher, on average, than the rate among men. Unemployment among women fell from 11% in 2003 to 7.2% in 2013, reverting to levels very similar to those of 1993.

Another significant gap in terms of workforce participation in some LAC countries is found among people with lower levels of education. The participation rates among adults aged 25–64 with low levels of education (0–8 years of schooling), intermediate levels (9–13 years), and high levels (14 years or more) are 71%, 80%, and 86%, respectively (Figure 1.19). The countries reporting lower participation rates among adults with low levels of education are Chile, El Salvador, Guatemala, and Panama.

Figure 1.18 Women’s participation in the workforce in LAC and OECD countries, 1993–2013

Ages 15–64

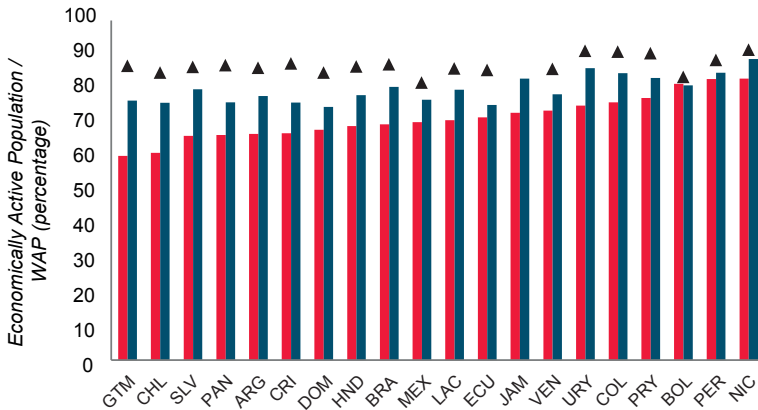


Source: IDB (2015b) and OECD (2015).
WAP= Working-age population

Figure 1.19 Adult participation in the workforce by educational level, 2013

Ages 25–64

■ Low ■ Intermediate ▲ High



Source: IDB (2015b).

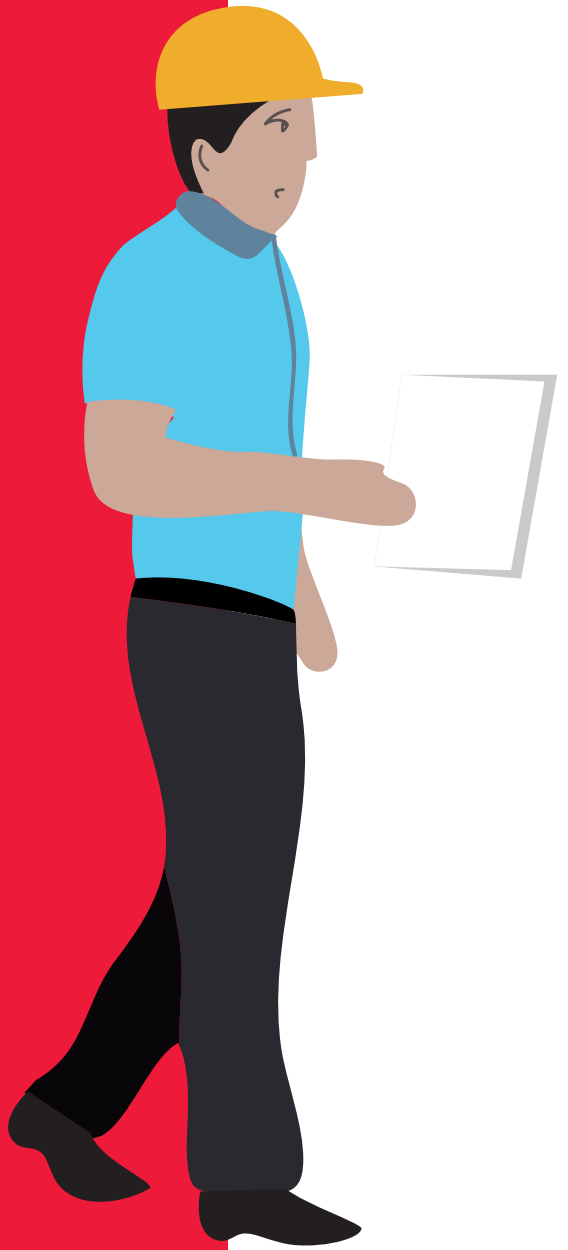
Note: The data for Jamaica do not permit the identification of people with higher education.

WAP= Working-age population

Conclusions

The past 20 years, and the past 10 in particular, have produced major gains in terms of lower unemployment, job creation, and significant wage increases, all of which have contributed to a substantial reduction in poverty and inequality in the region, giving birth to a middle class that represents 68% of the population. However, this middle class works largely in the informal sector and is therefore highly vulnerable to the risks associated with illness, poverty in old age, and unemployment. Moreover, the employment created is short-lived, and in some countries, certain groups (for example, youths, women, and workers with little education) have low levels of participation in the labor market. The incorporation of these workers into the labor market represents real potential for growth.

Searching for new sources of growth is even more important in a context such as today's, in which growth is showing signs of winding down. The end of the commodity boom and the ebbing demographic dividend both call for new solutions, which will require sustainable increases in productivity and greater incorporation of underrepresented groups in the labor market.



Chapter 2.

Why is there so much informal and unstable employment in the region?

Summary

The majority of jobs in the region are informal—so much so that in roughly 70% of cases the transition from unemployment or inactivity is to informal jobs. Moreover, one in every four prime-age workers has been with his firm for less than a year. This combination of factors leaves many workers, especially youth and people with less education, trapped in a vicious cycle of low-productivity jobs with no social insurance and little possibility of improving their lives. This chapter examines the causes of this equilibrium and its consequences for workers' welfare and the growth of the economy as a whole.

Introduction

The facts presented in the previous chapter show that, notwithstanding the progress in job creation, the formalization of employment, and wage growth, labor markets in the region are, to a great extent, still characterized by a high predominance of informal, short-lived employment and sluggish growth of job productivity.

Understanding the why of these trends, as well as the policies that can ameliorate this situation, requires an understanding of how the labor market works. At least four features distinguish the labor market from the typical goods market.

First, in the labor market people trade services for income. Since work is the only source of income for many people, a job is a key asset, and losing it poses a very serious risk to the consumption, standard of living, and welfare of workers and their families. In many cases, this leads to reluctance to consider the service trade a market, and efforts are often made to protect the employment relationship by making its dissolution very expensive.

Second, in today's modern conceptualization the labor market is defined as people looking for work and firms looking for workers to fill job vacancies. In this context, since the characteristics of workers and vacancies are not easily discernable, transaction costs are very high: for firms it is expensive to find the workers they need, and for workers it is expensive to find vacancies suited to their particular skills and interests.

Third, the employment relationship has been built on a foundation derived from aspects of the welfare state and the very social contract of the countries. Through formal employment—that is, a job through which contributions are made to the social security system—workers gain the right to health services, pensions, and disability and life insurance, in most cases losing these benefits if they become unemployed or shift to the informal sector.

In addition, in some countries a formal job gives workers the right to unemployment insurance, which mitigates the risk associated with the lack of work.¹

¹ Insofar as the region moves toward the adoption of non-contributory social policies—that is, benefits paid for from the general treasure—informal workers may also gain access to some health, pension, or unemployment benefits, though generally in lower amounts under inferior conditions.

Fourth and finally, prices in this market are often affected by a wide range of policies designed to promote redistribution between income from work and income from capital and between the incomes of workers themselves through intervention in the labor market. Thus, a substantial portion of the institutional apparatus and much of the social contract are linked to the labor market. The performance of this market has enormous consequences not only for the welfare of workers—the vast majority of the population—but, as seen below, for a country's growth, equity, and overall economic performance.

Given this complexity, this chapter presents a simple conceptual framework that will be useful for shedding light on the factors that can affect the performance of the labor market. The objective is to help the reader understand why, despite the improvements in some labor indicators cited in Chapter 1, most of the employment created in the region continues to be informal and unstable. This discussion is based in part on the Diamond, Mortensen, and Pissarides model (see Box 2.1) and is illustrated with new evidence about the functioning of the region's labor markets.

Box 2.1. Why did Diamond, Mortensen, and Pissarides win the Nobel Prize?

Peter Diamond, Dale Mortensen, and Christopher Pissarides won the 2010 Nobel Prize for their contribution to understanding market operations, especially those of the labor markets, through search costs.

According to classical theory, markets are a place where supply and demand immediately meet, with perfect information and no transaction costs. Hence, prices are determined by equalizing supply and demand, without surpluses or deficits. The real world can be very different, however, and the labor market is one of the more complicated cases. It is very hard for employers to know workers' skills or capacity to learn or effectively relate to others in the workplace. By the same token it is hard for workers to know exactly what the job will consist of and the context in which it will be performed. Recruitment processes attempt to reduce these information asymmetries, but it is possible that the wage that the employee aspires to may not be what the employer is willing to offer. In other words, a match between the worker and the employer is not achieved, the job seeker remains unemployed, and the vacancy stays unfilled.

In 1971, Peter Diamond published a seminal article that examined how prices are set in a market with search costs. His work inspired other researchers to explore the subject further and advance this sphere of knowledge. Continuing this work, Dale Mortensen and Christopher Pissarides developed and applied Diamond's principles to the labor market, contributing to an understanding of the determinants of unemployment and their evolution (Pissarides, 1985; Mortensen and Pissarides, 1994). Their work yielded what came to be known as the Diamond–Mortensen–Pissarides (DMP) model.

Today the DMP model is the most common tool for analyzing unemployment, wage setting, and the existence of job vacancies. Using this model, the effects of the different factors in the labor market on unemployment, the average length of unemployment periods, the number of vacancies, and the real wage can be estimated. When a job seeker and an employer find each other, the wage is determined by the situation in the labor market (the number of unemployed workers and job vacancies and the bargaining power of each party).

This structure has been broadened to understand labor markets with informal workers. A series of articles (Albrecht, Navarro, and Vroman, 2009; Ulyssea, 2013; Bosch and Esteban-Pretel, 2013; Meghir, Narita, and Robin, 2014) describes how these constant search processes can lead to formal or informal jobs. The basic premise of many of these models is that workers and firms have the option of entering into both formal and informal contracts. Deciding in favor of one or the other essentially depends on the productivity of the match and the relative costs of formality and informality. Models of this type explain well why many jobs in the region, especially those with low productivity, are informal.

Source: Prepared by the authors with information from the press release on the Nobel Prize for Economics 2010: http://www.kva.se/globalassets/priser/ekonomi/2010/pop_ek_en_10.pdf.

This conceptual framework is divided into two parts. The first looks closely at the search process, analyzes the potential reasons workers take formal and informal jobs, and explores the factors determining formality and informality patterns and trends in the region. The second examines the causes of worker separation from firms and discusses the factors that could explain why jobs in the region are so short-lived. Finally, the consequences of the nature of worker turnover in the region for individual workers and the economy as a whole are discussed.

The search for workers and vacancies, and the creation of formal employment

An often inefficient search with limited information

As stated in Chapter 1, at least one in every four workers in Latin America and the Caribbean in his prime (ages 24–54) has been at his current job for less than a year. This turnover makes it clear that in order to understand how the labor market works, it is important to understand the constant search and allocation of workers to jobs that characterize the process. At any given time an enormous number of people are looking for work in the region, while many firms with vacancies are looking for workers to fill them. Understanding this search process and how workers and firms are matched to create jobs is key to understanding the causes and effects of the constant reallocation of work. This search is plagued with obstacles, especially those related to the lack of information, which make it hard for firms and workers to find each other (Petrongolo and Pissarides, 2001). A worker who has little access to information about vacancies and therefore receives few job offers will be forced to accept less attractive offers with lower wages and/or fewer benefits. The more deficient the information channels, the poorer and less productive the matches between firms and workers will be.

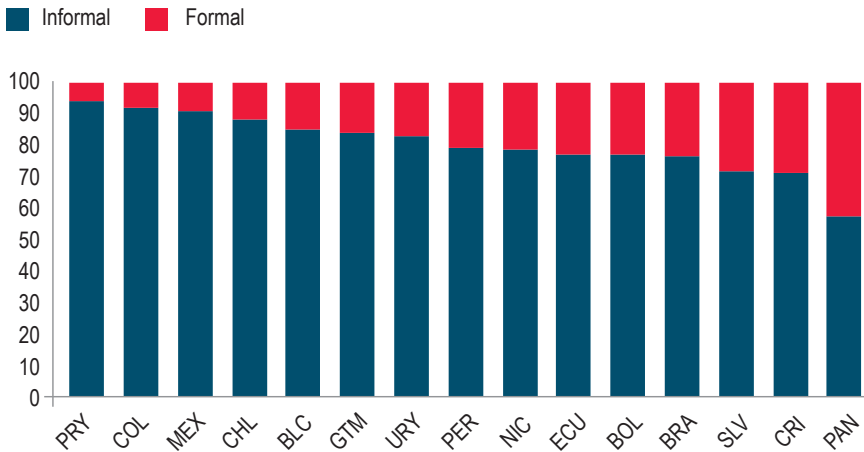
Furthermore, employers' hiring decisions are also affected by how easy or hard it is to find people with the requisite skills and characteristics for the job. In some cases, the cost of finding the right person can prove very high and increase the labor cost. This recruitment cost depends on the number of candidates in the market, how easy or hard it is to find them, and how complicated it is to determine whether a candidate has the characteristics, skills, and other requirements the employer is looking for. As recruitment costs rise, the number of positions opened by firms will fall. Alternatively, recruitment costs may fall—due, for example, to better labor market intermediation systems—and the number of vacancies and jobs will rise.

The search for jobs and candidates to fill vacancies in the region occurs very informally. Very few workers and firms use formal search procedures—that is, methods or mechanisms in which information about a vacancy is published (see Figures 2.1 and 2.2).² More than 70% of workers in LAC look for jobs through their networks of relatives and friends, which tends to perpetu-

² Methods such as answering newspaper or radio ads, searching online, or registering with employment agencies to search for jobs in the public or private sector. Informal search methods, in contrast, are those that utilize personal contacts or visits to firms (asking friends, relatives, or employers; personally visiting firms; etc.).

ate the initial inequalities (Mazza, 2011). The lack of mechanisms for disseminating information about job vacancies mainly affects people whose network of contacts consists primarily of people in unstable jobs. This becomes a vicious cycle of inequitable opportunities since these contacts generally have no connections to quality jobs.

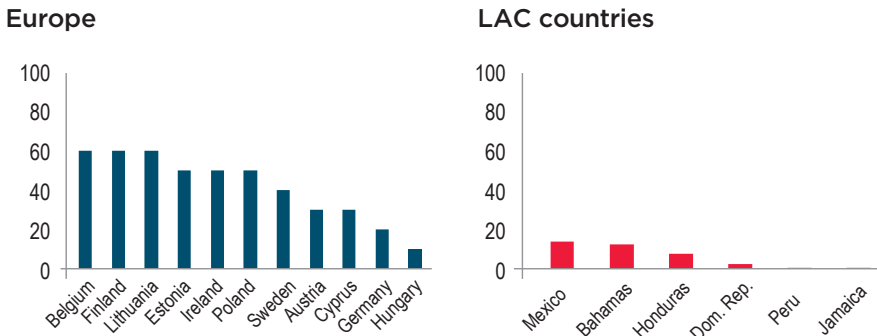
Figure 2.1 People looking for work in LAC by search method (percentage)



Source: Mazza (2011). Estimates based on household surveys.

Note: Formal job search methods include all types of searches that use public tools or mechanisms (see footnote 2 of chapter 2); these include: 1. answering newspaper, radio, and other ads; 2. searching online; and 3. registering with employment agencies to search for jobs in the public or private sector. Informal search methods, on the other hand, are all those that use personal contacts or personal visits to firms (asking friends, relatives, or employers; personally visiting firms; etc.).

Figure 2.2 Number of employers that use public employment services to post job vacancies (percentage)

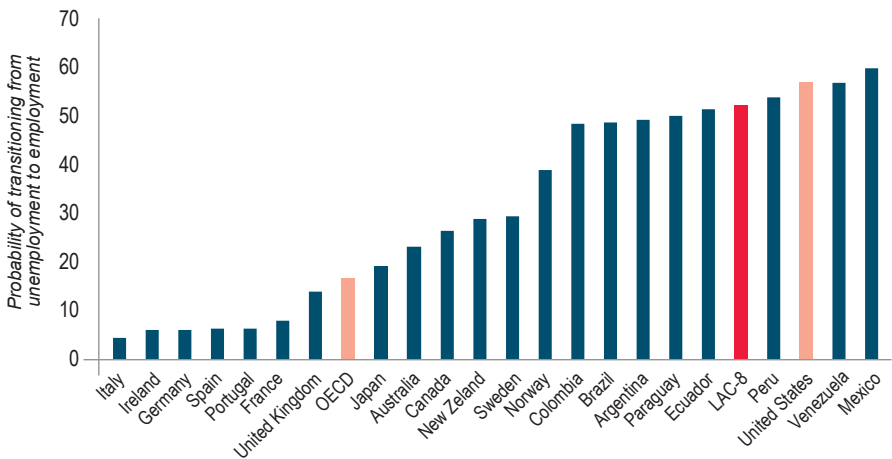


Source: IDB-WAPES-OECD (2015).

Heavy flows of workers to (informal) employment

Notwithstanding this potentially inefficient search, workers quickly find work. The job-finding rate (which indicates the number of people who find a job in a given period) is high (see Figure 2.3), and with only a few exceptions, very few workers remain unemployed for long periods of time (see Figure 2.4). The annual rate of transition out of unemployment is around 50%, a figure more than twice that of the OECD countries and similar to that of the United States. This explains why workers in LAC spend little time unemployed and why long-term unemployment (that is, the fraction of the unemployed who spend more than 12 months looking for work) is virtually nonexistent in certain countries in the region. On average, only 16% of unemployment is long term, while the figure in the OECD countries is 36% and in the United States 29%. In countries such as Chile, Honduras, and Uruguay, the number of unemployed who have been without work for more than a year is very small.

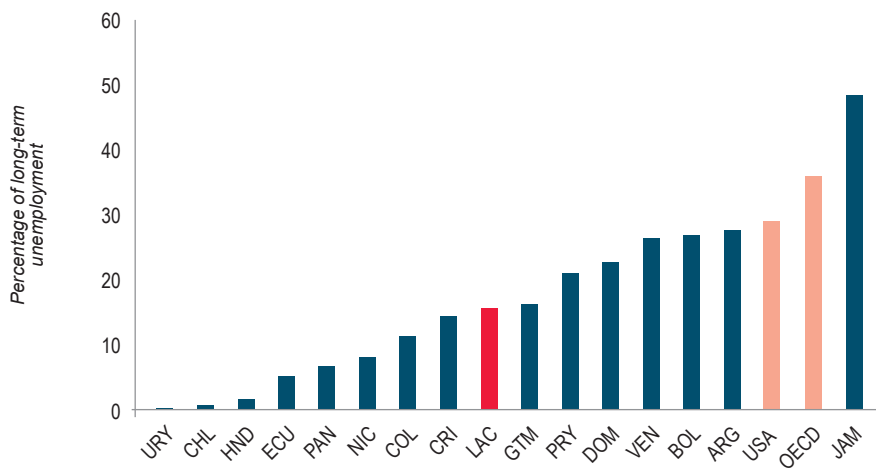
Figure 2.3 Probability of transitioning from unemployment to employment in the course of a year (percentage)



Source: Elsby (2008) and authors, based on panel data.

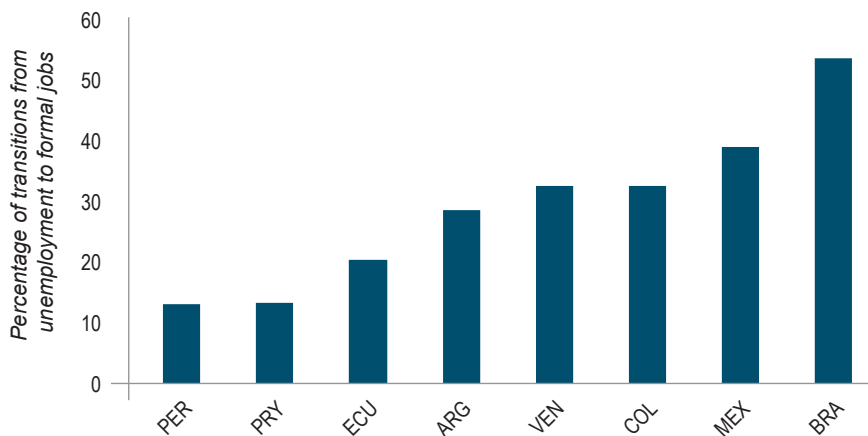
Note: For information about construction of the longitudinal data, see Table A.1 in the appendix of data sources.

Figure 2.4 Percentage of long-term unemployment (of at least 12 months), circa 2013



Source: IDB (2015b).

Figure 2.5 Percentage of unemployment-to-employment transitions that result in a formal job, population aged 15-64

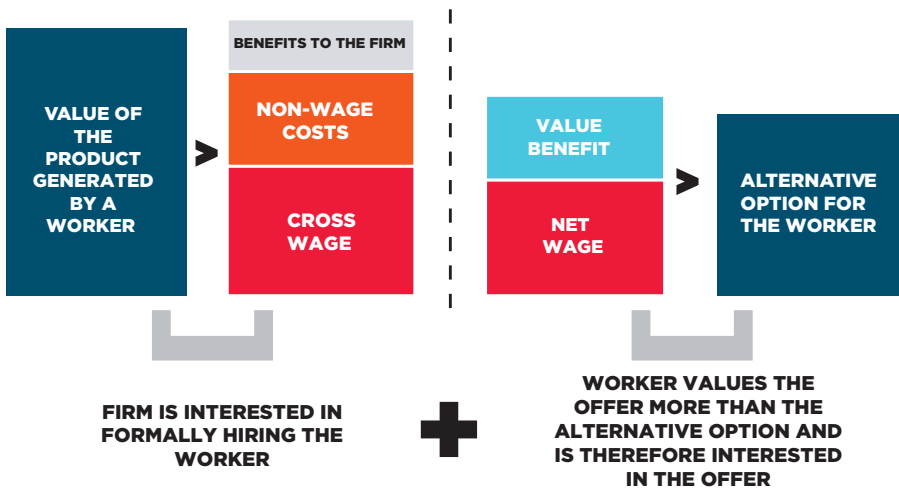


Source: Prepared by the authors, based on panel data.

Note: For information about construction of the longitudinal data, see Table A.1 in the appendix of data sources.

The vast majority of worker–employer matches resulting from this search lead to informal jobs (see Figure 2.5). Only 30% of the unemployed who obtain a job do so through a formal contract. This indicates that a significant portion of the new jobs created in the economy at a given time are informal and, thus, that the majority of search processes yield an informal job.

Diagram 2.1 Favorable conditions for creating formal jobs



Source: Prepared by the authors.

Necessary conditions for creating formal employment

Creating a formal job—that is, one with the benefits and protections established by law—requires the following conditions. A simple cost-benefit model indicates that firms will be interested in formally hiring a worker when they expect the value of the product produced by that worker to exceed his wages plus all the non-wage costs established by law (see Diagram 2.1). The difference between the value of the product and labor costs is the benefit that accrues to the firm from hiring a worker.

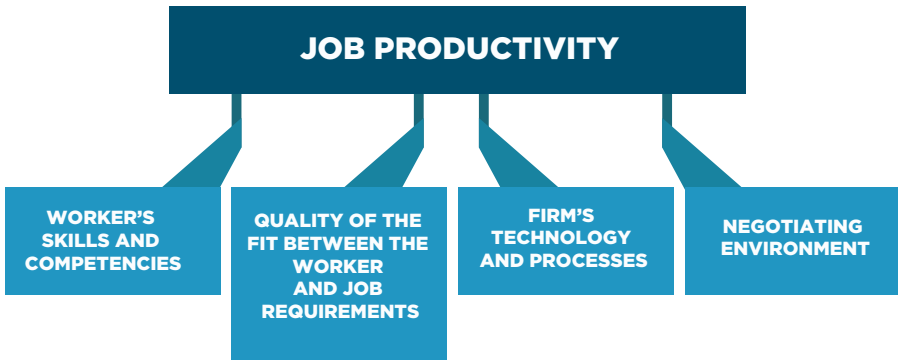
The worker, on the other hand, will accept a job offer if its value, consisting of wages and benefits, is higher than the alternative of continuing to look for work and waiting for a better offer (see Diagram 2.1). It is important to point

out that the non-wage costs for a firm do not necessarily translate one for one into benefits for the worker, as this will depend on the value the worker places on the benefits package established by law. For example, a young worker may place little value on the fact that the firm contributes to a pension plan in his name and prefer another offer whereby he receives at least part of the money in cash (Levy, 2008).

In this context it is essential to note that the search process affects the productivity of the employer–worker match. This productivity is obviously influenced by the characteristics of both the firm and the worker; however, it is also influenced by how suited the worker is to the firm. A great chef may be terrible at designing buildings. This is key to understanding why policies for improving labor market intermediation can be good policies for boosting productivity.

Due to these characteristics there are several scenarios in which a formal match does not materialize. The first is when the value of the match (productivity) is not high enough to offset the wage and non-wage costs. This suggests that, all costs being equal, more productive matches will have a greater likelihood of being formal. Furthermore, the quality or productivity of the match will depend on the quality of both the firm (especially the technology and capital with which it operates) and the worker (especially his skills). Factors external to the firm and the worker, such as a better negotiating environment or superior infrastructure, will also have an influence. Finally, as mentioned earlier, the occurrence of a formal match will depend on how good the match itself is—that is, how well the worker’s profile meets the needs of the firm and vice versa (see Diagram 2.2).

In Latin America and the Caribbean, this tension between productivity and labor costs is patent and poses one of the greatest challenges to creating formal employment. The basic cost of hiring a formal worker includes the minimum wage (which includes the employee’s contribution to the social security system), the social security cost to the employer, the cost of year-end bonuses and vacations, and the potential cost of dismissal. This package represents 38% of the gross domestic product (GDP) per worker, on average. In the higher-income countries, the basic cost ranges from 10% (Mexico) to 24% (Brazil), but in others, such as Nicaragua and Paraguay, it is as high as 70% of the GDP per worker, while in Honduras it is 100% (see Figure 2.6). Around 72% of these costs are for wages (minimum wage), while the additional 28% corresponds to non-wage costs from social security contributions and other levies on the employer.

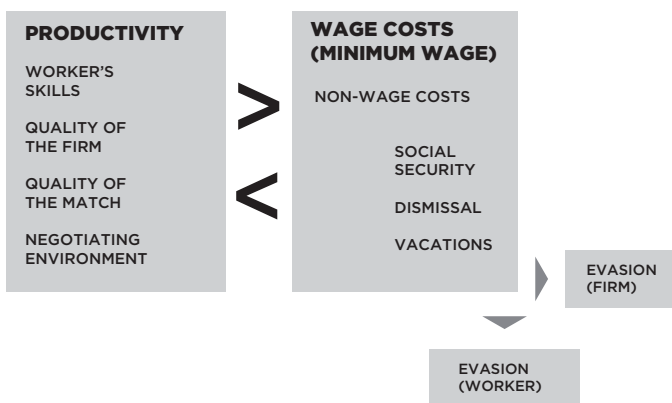
Diagram 2.2 Factors that determine job productivity

Source: Prepared by the authors.

It is important to underscore the dynamic nature of the decision to formally hire a worker. Here the determinants are not only the productivity and current costs of the match but also the future costs as well. For example, the higher the cost of ending the employment relationship, the greater the likelihood that firms will become more cautious and hire fewer formal workers. This is largely the case with young workers entering the labor market since, from the employers' standpoint, these beginners' lack of experience and the employers' limited information about them makes them particularly risky candidates. The higher the cost of dismissal, the less willing employers are to hire young people and others they consider high risk. This can prove very damaging, especially for the vast population of youth who are neither in education nor working in the region, which sees finding a well-paying, formal job as not within reach.

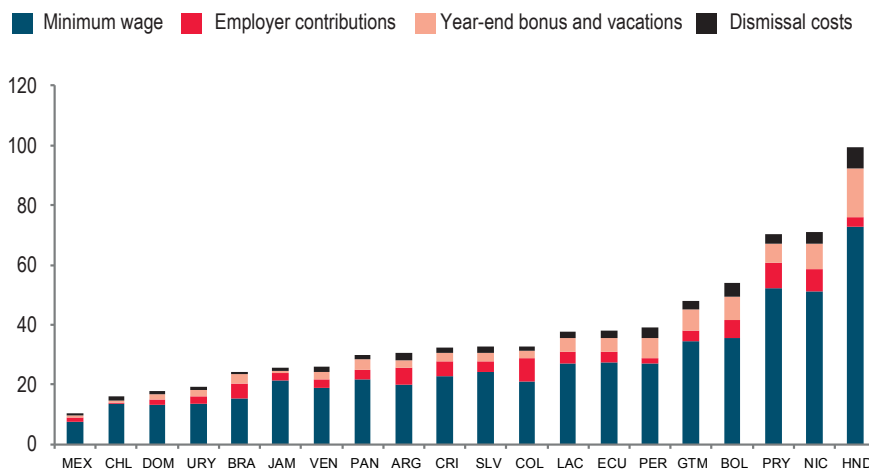
Countries with higher wage and non-wage costs (relative to their productivity) have a lower share of formal jobs (see Figure 2.7). Some 39% of the variance in formality rates can be explained by the variance in the costs relative to a country's productivity. According to this simple estimate, every 10% increase in the basic cost of hiring a formal, salaried worker is associated with a five-point decrease in the percentage of formal workers. Since formality depends on many other factors, the association between formality costs,

Diagram 2.3 Factors that influence the creation of formal employment



Source: Prepared by the authors.

Figure 2.6 Wage and non-wage costs in LAC, as a percentage of GDP per worker

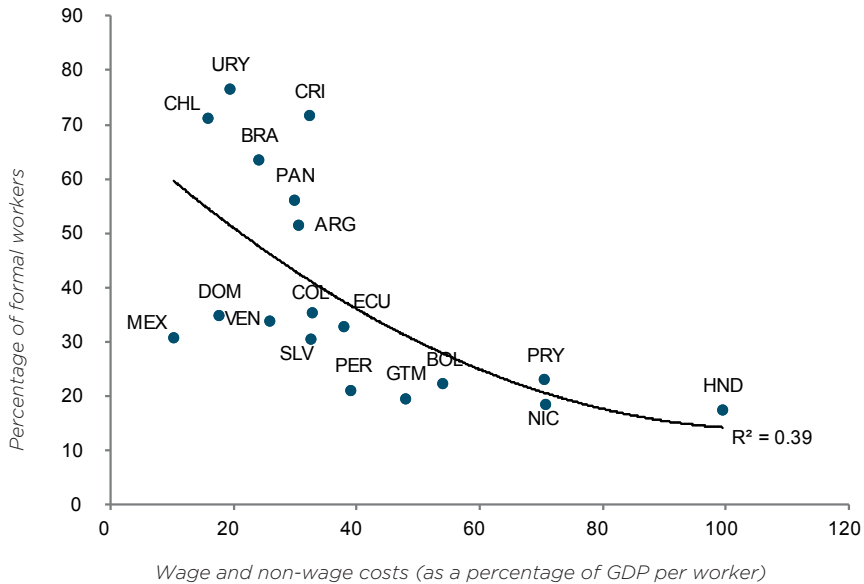


Source: IDB, based on available information on the legislation of each country as of December 2013.
 Note: Dismissal costs are the average annual sum that an employer must set aside to cover the cost of dismissing a worker with 5 years' tenure.

which particularly affect young people and the probability that a young person will be formally hired over an adult, is also considered (see Figure 2.8). The higher the costs associated with formality, the lower the rate of formal employment among young people versus adults. This ratio also explains why the most educated and productive workers in each country have the highest rates of formal employment (see Chapter 1), a stylized fact observed without exception throughout the region.

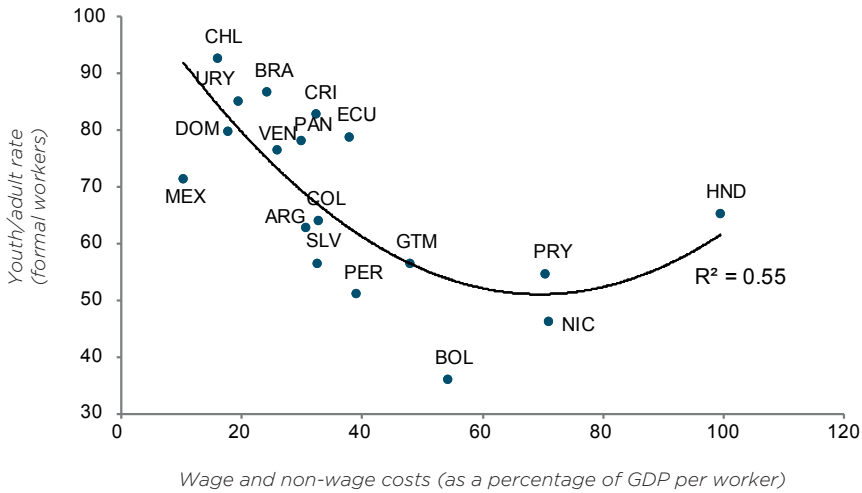
This association between labor costs and formality is also observed in the flow of workers who transition from unemployment to formal employment. In countries with panel data, the percentage of transitions from unemployment to formal jobs is inversely related to the relative cost of formality (see Figure 2.9).

Figure 2.7 Formal employment rate and wage and non-wage costs (as a percentage of GDP per worker) in LAC, 2013



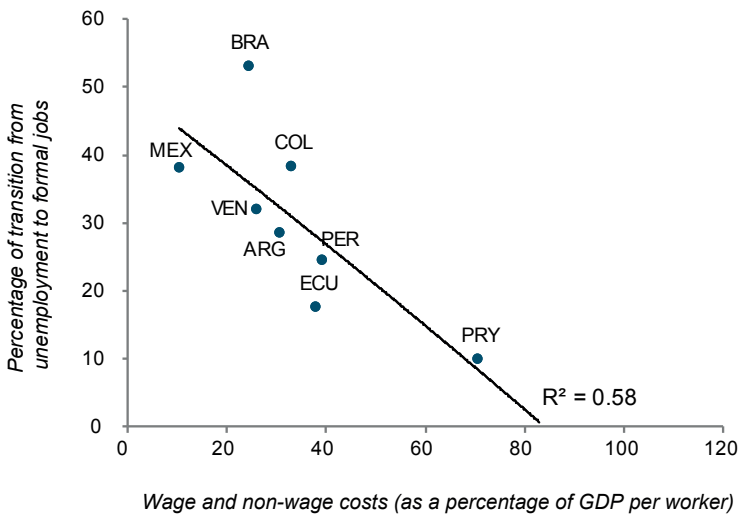
Source: Prepared by the authors, based on the available legislation of each country as of December 2013 and IDB (2015b).

Figure 2.8 Wage and non-wage costs (as a percentage of GDP per worker) and ratio of youths to adults (formal employment rate) in LAC, 2013



Source: Prepared by the authors, based on the available legislation of each country as of December 2013 and household surveys in LAC circa 2013.

Figure 2.9 Wage and non-wage costs and percentage of workers transitioning from unemployment to formal jobs in LAC, 2013

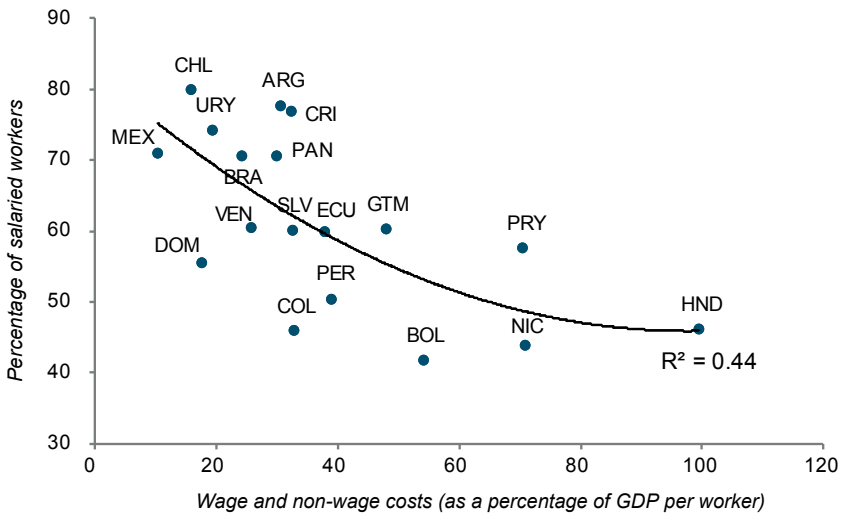


Source: Prepared by the authors, based on the available legislation of each country as of December 2013 and panel data.

Note: For details on the panels, see Table A.1 in the appendix of data sources.

Given the characteristics of the region, it is important to bear in mind that the concept of matching per se applies only to salaried employment. Due to the importance of non-salaried employment in LAC (some 20% to 60% of workers aged 15–64 and 30% of the newly employed are self-employed), it is essential to pay attention to this reality. Higher (wage and non-wage) hiring costs are also associated with lower rates of salaried employment and, hence, a high number of self-employed workers with less growth potential (see Box 2.2).

Figure 2.10 Wage and non-wage costs in LAC and percentage of salaried workers, 2013

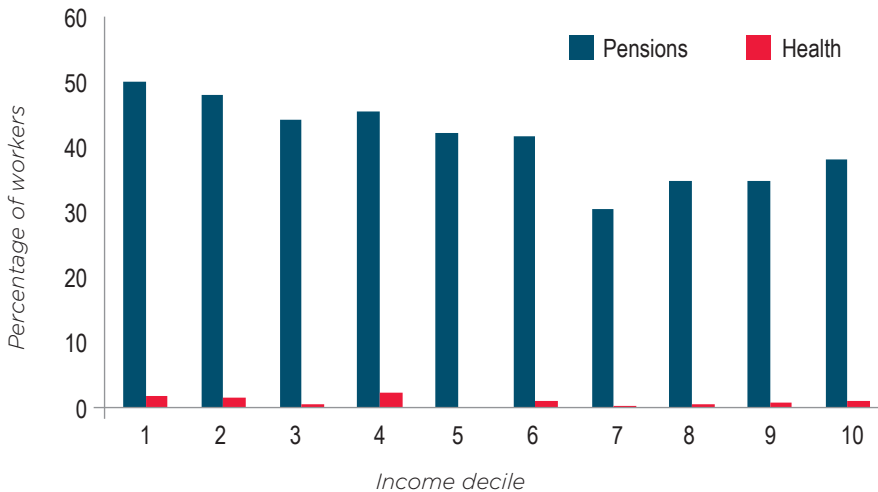


Source: Prepared by the authors, based on the available legislation of each country as of December 2013 and IDB (2015b).

There are cases where even though the productivity of the match is high enough to finance the costs associated with formality, the encounter between firms and workers does not result in a formal job. It may be that the worker receives a formal offer (salary plus benefits) that may not interest him because of the very low value of the benefits package associated with formality (Levy, 2008) or because he prefers to continue looking for work to see if he can get a better formal offer. Concerning the perceived value of the benefits established by law, it is important to consider the benefits that an informal worker receives, for which he pays little or nothing. While the studies that have pursued this line are few, the evidence shows that not all workers value the benefits associated with social security. A recent survey in El Salvador shows that the number of workers willing to contribute to a pension fund is

very low, while virtually all are willing to pay health insurance premiums (see Figure 2.11). These data suggest that workers place a higher value on contributions to health insurance than to pensions and that some prefer to stay out of the formal sector to avoid these costs.

Figure 2.11 Percentage of workers who would be unwilling to contribute to El Salvador's pension or health system (by income decile)



Source: Longitudinal Social Protection Survey 2013. Summary of final report (2014).

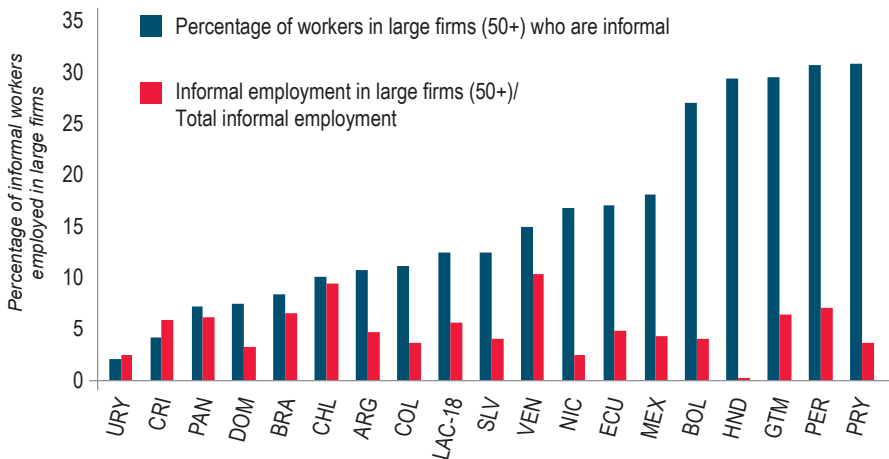
As mentioned in Chapter 1, there is evidence showing that, by offering monetary or in-kind transfers, some policies that subsidize informal workers give their beneficiaries fewer incentives to find a formal job.³

Furthermore, employers can draw up an informal contract, in violation of the law, with the objective of increasing utilities. Thus, there are two types of informal jobs or matches: those with low productivity that cannot cover the wage and non-wage costs of employment mandated by law and others with high productivity that can cover these costs but where the employer evades his responsibilities. A context marked by weak enforcement, like the one pre-

³ See Bosch and Campos-Vázquez (2014) for Mexico; Camacho, Conover, and Hoyos (2009) for Colombia; Amaranante, Arim, and Dean (2011) for Uruguay; Bosch, Maldonado, and Schady (2013) for Ecuador; and Box 5.6

vailing in LAC, fosters this situation—so much so that, on average, 12% of the workers employed in large firms (those with more than 50 employees) are informal (see Figure 2.12). In other words, more than one in every 10 people working in a large, formal firm does so without the benefits mandated by law. This means that around 6% of all informal employment in the region is in firms with more than 50 employees, who, presumably, are formal in many other dimensions.

Figure 2.12 Percentage of informal workers employed in large firms, 2013



Source: IDB (2015b).

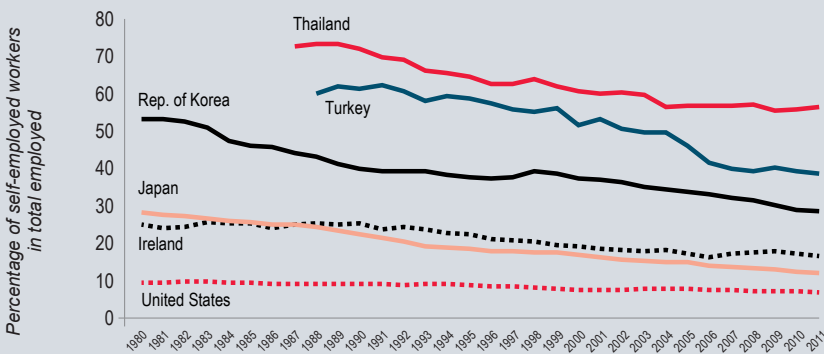
The discussion in the preceding paragraphs shows which factors affect the creation of formal and/or informal jobs to one degree or another. On the employer side, the circumstances that foster higher product prices, high productivity of the match, or higher sales relative to the trend in wage and non-wage costs stimulate greater formal job creation, while higher labor costs—wage and non-wage—relative to the value of production can reduce the creation of formal employment. Similarly, greater government enforcement of the law can motivate firms to formalize jobs, though at the potential cost of eliminating some informal, low-productivity positions that cease to be profitable when the firm must pay the benefits mandated by law.

Box 2.2. Self-employment and economic development

Opinions differ about whether people who choose self-employment—whether because they have a vocation for entrepreneurship or because they have been excluded—want to be salaried workers but have not found a better salaried alternative. In this conceptual framework self-employment can be considered an additional option for all people in which the worker makes the match with himself. The worker may or may not receive offers and, depending on the value of producing on his own (product value), will choose the type of job that is most advantageous to him. Workers with low productivity who produce goods and services will receive few offers to become salaried workers and must accept self-employment, even when the value of their product is low. In contrast, individuals who place little importance on social security benefits, either because they think little about their old age or because they have access to free health services, may prefer to be self-employed and thereby avoid the costs associated with these benefits.^a

Beyond the reason for self-employment, country growth processes are linked with a gradual decline in the number of self-employed workers. Countries that have experienced prolonged growth—such as Korea, Ireland, Japan, Thailand, and Turkey (see Figure 2.2.1)—have seen substantial reductions in the percentage of self-employment. In a way, the persistence of high self-employment rates in the region reflects the inability to make the transition.

Figure 2.2.1 Percentage of self-employed workers, 1980–2011



Source: World Bank (2015b).

^a In at least eight countries in the region, self-employed workers are not required to contribute to social security (Bosch, Melguizo, and Pagés, 2013). In the rest of the countries, even though they are, their level of contributions is very low, which de facto implies the existence of voluntary participation.

Inability to keep searching for a job due to lack of social insurance mechanisms

Another factor that may be influencing the high degree of informal job creation is that most workers cannot keep searching until they find a formal job. A critical result of the meager formal job creation in the countries is that social insurance mechanisms do not cover most workers. Consequently, when an employment relationship is severed, workers do not have the right to severance pay in most cases (although, according to the 2013 Longitudinal Social Protection Survey in El Salvador, there is some informal compensation) or unemployment insurance benefits (in countries where they exist). Thus, there are those who argue that informal work serves as “unemployment insurance,” as an inverse relationship is observed between unemployment and informality (see Chapter 4, Box 4.8). In short, unemployment insurance and severance pay are mechanisms that enable workers to spend more time unemployed while they search for a better offer. While this may lead to a lower rate of job creation, it can enable workers to find a job that is better suited to their skills and, therefore, more productive (Acemoglu and Shimer, 2000).

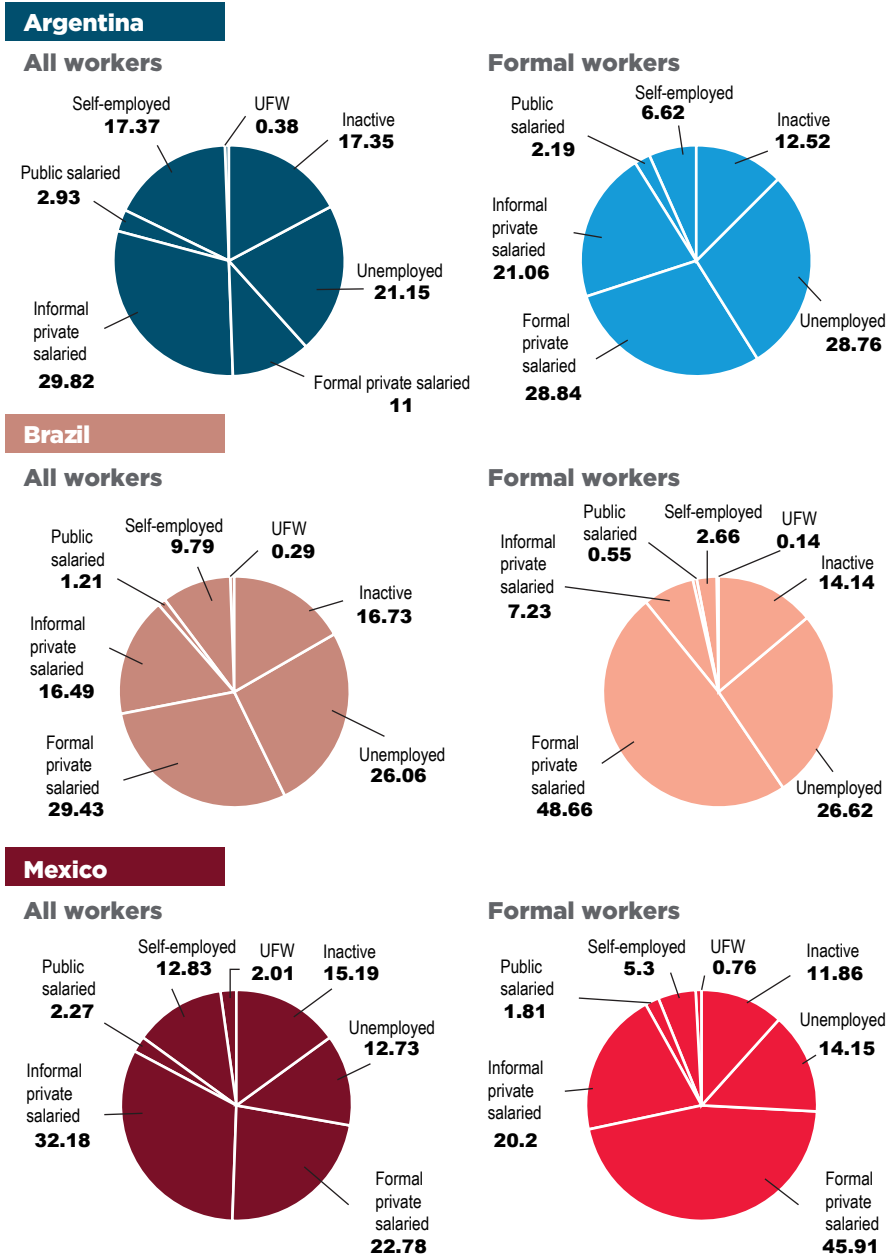
In LAC, losing a job significantly decreases the likelihood of obtaining formal employment. Only 11% to 30% of workers who experience an episode of unemployment transition from this situation to a formal job. The vast majority transition to informal jobs. It is hard even for formal workers to regain a formal job, although less so than for informal workers.⁴ Around 50% of formal workers who lose a job in Brazil and Mexico and 30% in Argentina return to formal employment one year later, versus 10% and 15% of informal workers, respectively (see Figure 2.13).

Losing a job and being unemployed have short- and, in some cases, long-term consequences for workers. If unemployment has no greater consequences than lost income while the situation lasts, the consequences will be limited. However, there is evidence suggesting that losing a job has short- and long-term consequences beyond the temporary lack of income (see Chapter 4, Box 4.9). In the short term, workers do not appear to recover their level of income. This is important considering the workers who change sector and are displaced (see Amarante, Arim, and Dean, 2014). In Argentina, for example, one year after dismissal the loss of income associated with the loss of a formal job is around 40% (see Figure 2.14). In the case of an informal job, the figure is close to 50%.⁵

⁴ It should be noted that the evidence is purely anecdotal (since it is hard to compare people who lose a job with people who keep one).

⁵ See previous note.

Figure 2.13 Status of workers one year after becoming unemployed (percentage)



Source: Prepared by the authors, based on panel data.

Note: For details about the panels, see Table A.1 in the appendix of data sources. UFW = unpaid family workers.

In short, it is clear that high labor costs (wage and non-wage) relative to job productivity, low job productivity, the low value accorded to social security, weak enforcement of social security laws, and the inability to remain unemployed while searching for a formal job are factors that contribute to both the high level of informality in the countries and the significant welfare losses associated with unemployment.

A substantial number of mechanisms can contribute to the achievement of greater formality, which is essential for promoting universal access to social insurance, obtaining sufficient savings for old age in the context of a rapidly aging population, and achieving greater insurance against unemployment. Promoting a high level of job productivity will help maintain appropriate levels of protection (paid for with non-wage costs). In pursuit of this objective, this strategy is superior to the one that proposes benefit cuts. Other potential mechanisms for achieving greater formality include increasing workers' knowledge and appreciation of the benefits of social insurance and improving enforcement and mechanisms that provide insurance benefits during episodes of unemployment. Chapter 4 revisits this topic and analyzes the region's often-nascent mechanisms for meeting these objectives.

Factors influencing the continuity or dissolution of the employment relationship: growing in the job

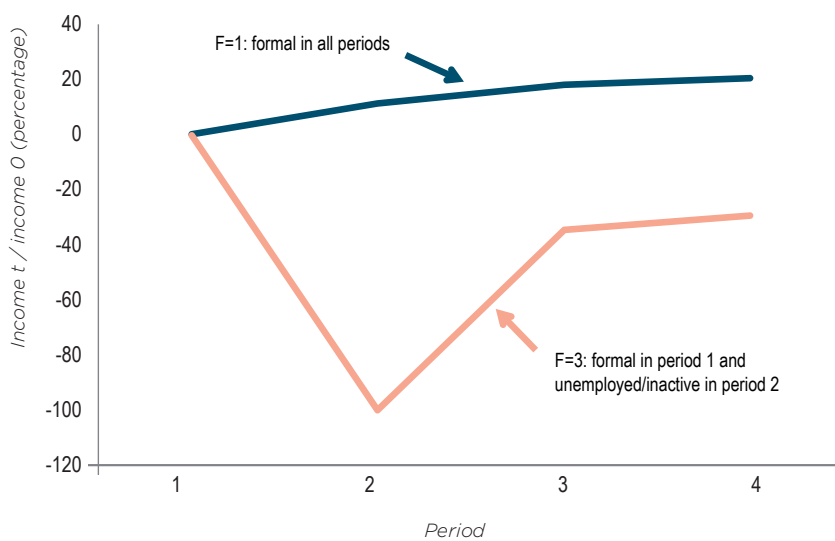
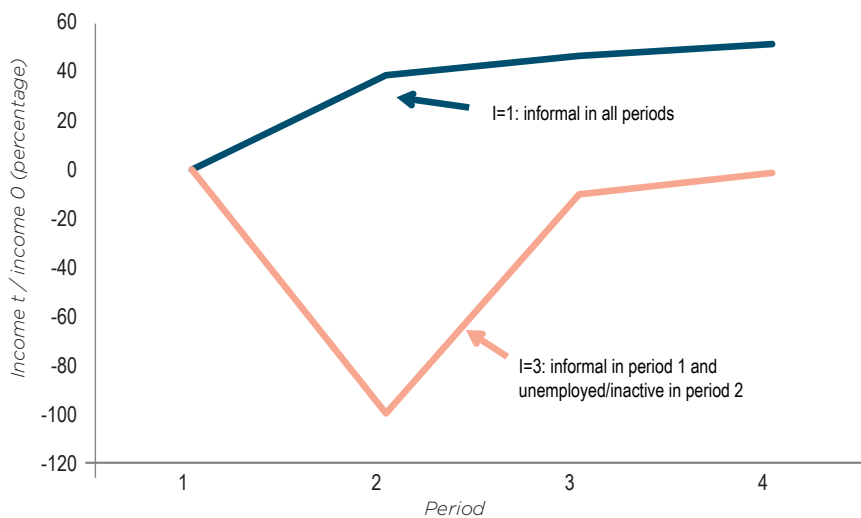
A high probability of separation

Chapter 1 discusses the high levels of labor turnover in the region, where figures are higher than those of other countries for which comparable data are available. These figures suggest that 30% of the workers of a firm in a given period will not be in the same job one year later. On average, 15% will be unemployed or inactive while another 15% will have a job in a different firm (see Figure 2.15).

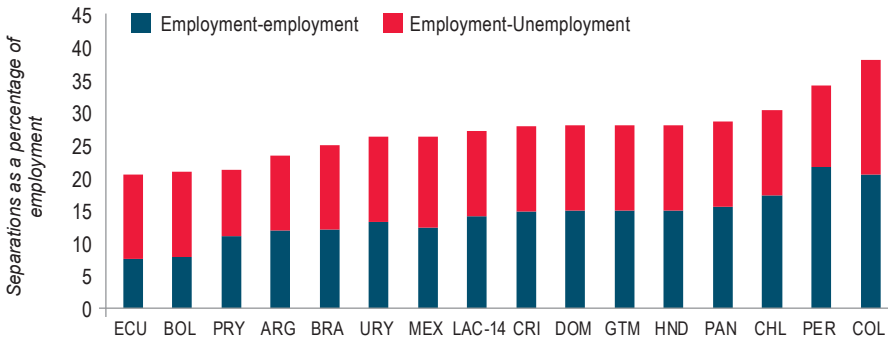
The degree to which employment relationships are severed may even be much higher since the dismissals that occur during the course of the same year are not observed. One estimate puts monthly separations in the region at 4% to 5% of total employment—more than double those seen in the United States, the OECD country with the highest labor turnover.⁶

⁶ This estimate takes the percentage of workers with one month or less in their job as hires for that month and assumes that in a given month, in a balanced economy, the hires and separations are equal.

Figure 2.14 Changes in personal income after losing a job, Argentina



Source: Prepared by the authors, based on panel data.
 Note: See appendix on methodology.

Figure 2.15 Percentage of workers separated from a firm within one year

Source: Prepared by the authors, based on panel data.

Note: The total probability of separation is calculated as the percentage of workers from the household panels who in one year, transition from employment to non-employment (unemployment or inactivity), plus the percentage of workers with less than one year in their firm who were in a job the previous year. For countries where panel data are lacking (Costa Rica, Chile, Dominican Republic, Guatemala, Honduras, Panama, and Uruguay) the average probability of transitioning from employment to non-employment in the region is assumed (13.3). For details about the panels, see Table A.1 in the appendix of data sources.

A substantial part of this labor turnover occurs because the workers are informal. Roughly 75% of these separations toward unemployment occur from informal jobs. This is seen in the panel data, which show that the probability of losing an informal job and becoming unemployed is two to six times higher than with losing a formal job, regardless of the worker's age or education level.

This high turnover entails high welfare costs, but is this a problem for the economies' performance? Is high turnover a sign that something is wrong, or is it part of the normal labor market operations, which, as indicated earlier, constantly reallocate workers in every country in the world? In LAC, is reallocation an engine of growth or something to be concerned about? To answer these questions, this section explores the factors responsible for the continuity or dissolution of the employment relationship once a hire is made.

Continuity in the job versus dissolution of the contract

As in the job creation stage, an employment relationship will last as long as both employer and employee consider its continuity more advantageous than its dissolution. Employment relationships end for a number of reasons. First, the firm may not have properly gauged the worker's skills when he was hired. Firms and workers are not all alike. Workers often have skills that are not discernable at the time they are hired. It may be that expectations about the worker's productivity are not met, which down the line may lead the employer to sever the employment relationship. The less information available at the outset, the greater the likelihood of surprises that could lead to the end of the relationship. As indicated in the first section of this chapter, the fact that searches by workers and firms are often conducted informally with little information about the candidates and vacancies can foster high turnover.

Other reasons why an employer would initiate a separation may include changes in demand or the firm's cost structure that make what was once a promising match no longer productive or technology upgrades that makes the worker obsolete. Workers who acquired their skills prior to entering the labor market or in a different technology context may be quickly replaced by younger workers more proficient in new technologies. The end of the relationship may also stem from problems associated with worker behavior, such as the lack of social-emotional skills (see Box 2.3), or the bankruptcy of the firm. Finally, the employment relationship may have originated to provide a product or construct a project for a specific period, in which case it was temporary from the outset.

From the worker's standpoint, a number of factors can lead to the end of the employment relationship. The worker may find a better job (in another firm or as a self-employed worker) or begin looking for a job (unemployment) to find a better alternative. Changes in family circumstances may also have an influence, as the worker may decide to devote himself to other-than-economic activities (e.g., caring for children or elderly relatives or pursuing an education).

In sum, employment relationships generally end when the value of continuing them is lower than the cost of severing them. In many respects, therefore, the employment relationship is a race between how productive the current match is (plus the cost of severing the relationship) and how productive it would be for both the firm and the worker to replace it with another.

Box 2.3. Social-emotional skills, a critical factor in the job search and job retention

A series of surveys conducted by the IDB among firms in the Bahamas, Honduras, Panama, Paraguay, and Uruguay reveals that problems with social-emotional skills in the workplace are responsible for a very high proportion of dismissals and high worker turnover. Some 40% to 70% of employers report problems with the social-emotional skills of their workers (attitude and behavior at work) as the main reason for dismissal; another 15% to 30% report absenteeism (also related to social-emotional skills) as a cause. Two other important reasons for dismissal stated by firm managers were low worker productivity (27% to 70%, depending on the country) and economic factors (20%).

Table 2.3.1 Main reasons for worker dismissal, 2012 (percentage of firms indicating the following reasons for dismissal as the first or second option)

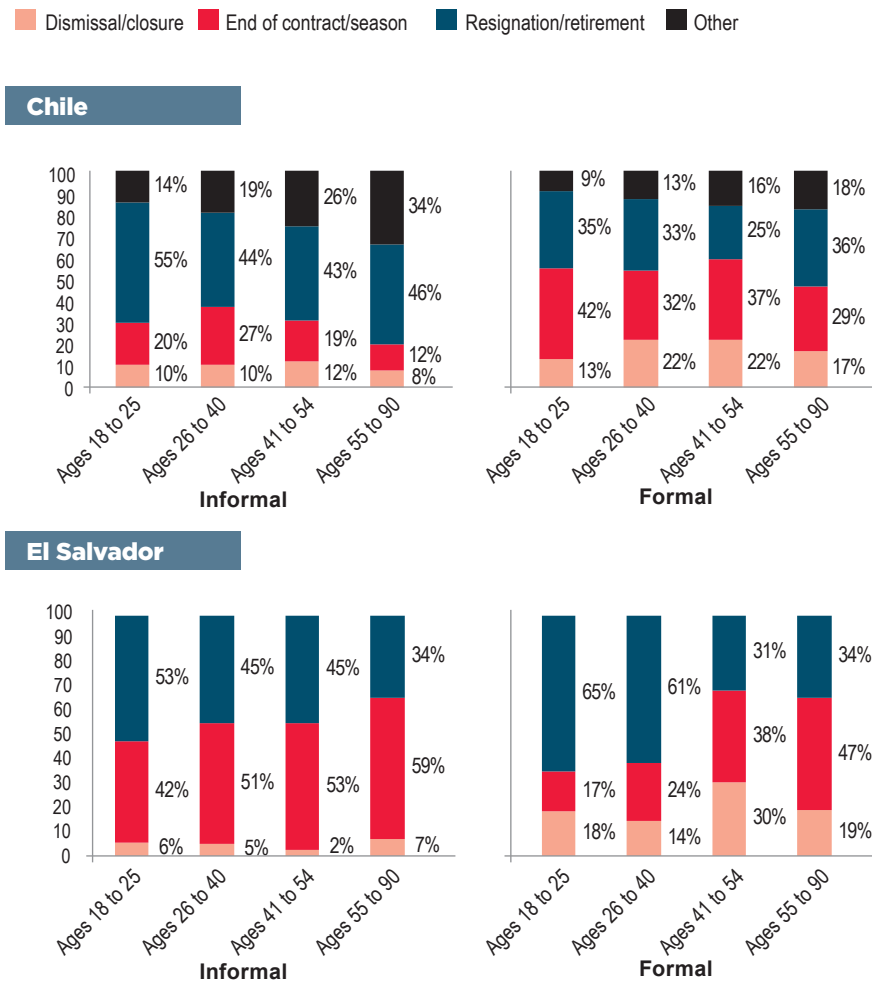
| Reasons for dismissal | Uruguay | Panama | Honduras | Bahamas | Paraguay |
|---|---------|--------|----------|---------|----------|
| Low productivity or poor performance | 56.8 | 71.0 | 59.5 | 27.5 | 65.6 |
| Problems with attitude or behavior in the workplace | 46.2 | 47.9 | 69.8 | 56.7 | 49.7 |
| Economic reasons of the firm | 10.3 | 3.0 | 29.8 | 18.4 | 8.1 |
| Absenteeism | 29.7 | 34.5 | 17.1 | 15.6 | 21.0 |
| Other | 14.7 | 14.7 | 5.2 | 34.6 | 22.0 |

Source: Wages and Productivity Survey conducted by the IDB among firms in the Bahamas, Honduras, Panama, Paraguay, and Uruguay.

Note: In the Bahamas the "Other" category also included the option "Limited technical skills." In Paraguay the "Other" category also included "Inadequate academic education" and "Lack of specific competencies." Since the survey allowed respondents to select more than one option among the reasons for dismissal, the columns do not add up to 100%.

Data from the social protection surveys reveal that workers initiate a rather substantial portion of the separations. Another significant portion occur simply when a contract or season comes to an end, while just 10% to 20% are the result of dismissal or firm closure (data from Chile and El Salvador, see Figure 2.16). This is consistent with other evidence. For example, 27% of workers in Colombia are looking for a new job. The vast majority of them (95%) report that they would like to change jobs to boost their income.

Figure 2.16 Types of separation in Chile and El Salvador (percentage)



Source: Under Secretariat of Social Security (2009) for the case of Chile; Longitudinal Social Protection Survey in El Salvador (2013) for El Salvador.

There is also evidence to suggest that LAC neither creates nor destroys (formal) jobs any faster than other countries do and that it is workers who are responsible for the high turnover. One reason jobs are more short-lived in the region is that firms are more exposed to unanticipated shocks or destroy more jobs when faced with such shocks. The available data from administrative records indicate that, on average, formal businesses in the region do not destroy (or create) more jobs than those in other parts of the world (see Box 2.4). But, if jobs are created and destroyed at the same rate, why is employment more short lived in LAC?

Box 2.4. Job creation and destruction according to administrative records

Labor turnover can be analyzed not only through household surveys but also through information from administrative records, which reflect job turnover in firms in the formal, or registered, sector. This is why household surveys—especially in developing countries where informality tends to be a generalized phenomenon—show only part of the turnover. In this type of context, higher gross job creation could be indicative of a formalization process without the existence of real worker movements behind it. A review of payrolls over the period for which these records are provided makes it possible to study changes in employment. Unfortunately, few countries in the region analyze and publish this type of information. For several years now Argentina's Employment and Business Dynamic Observatory has been processing and publishing data on employment dynamics and firms, using information from the social security system. However, this is not common practice in all the countries, particularly because of the enormous amount of information needed for the calculations and the difficulty involved in processing it.

The indicators used to analyze the labor dynamic through administrative data are generally job creation (the sum of changes in employment by firms that increase their personnel between moments $t-1$ and t , divided by the average total employment in $t-1$ and t) and job destruction (the negative sum of the changes in employment of firms that reduce their personnel between moments $t-1$ and t , divided by the average total employment in $t-1$ and t). By construction, job destruction is positive.

Although country comparisons are interesting, they are inherently difficult to calculate. Administrative records, generally from social security, must be available for an extended period. Various authors have published calcula-

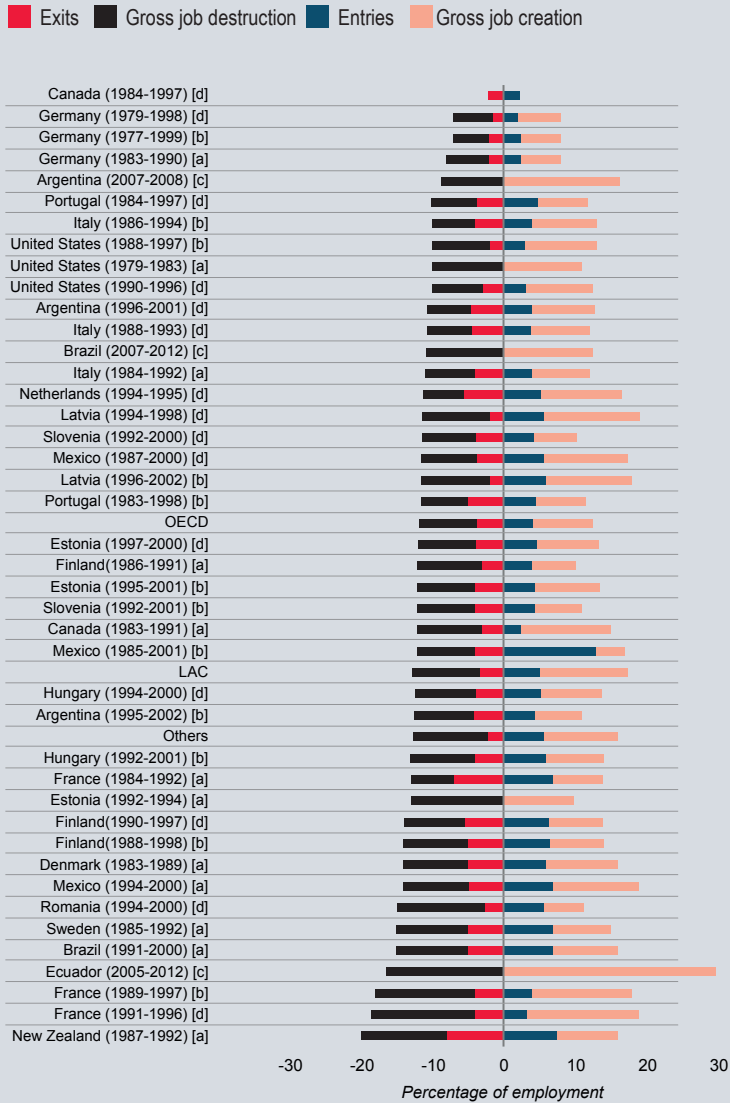
tions for specific periods in different countries in the world that make it possible to compare annual changes in the flow of workers (this information is systematized in Figure 2.4.1). As can be observed, different values appear for different periods in each country. Even though the data for certain countries are repeated, these individual calculations have been used to estimate the regional average since, in some cases, the change in the comparison period substantially affects the results obtained. Labor turnover is characteristic of both developed and developing countries. The ranges found in Latin America are consistent with those observed in the countries of the Organization for Economic Co-operation and Development (OECD).

An additional complication is that part of the job creation or destruction in Latin America may correspond to informal jobs that turn into formal jobs (creation) or jobs that were once formal but have become informal. Thus, job creation can, in reality, be the conversion of an existing, unregistered, informal job to a registered, formal job.

Gross job creation in Latin America, the product of new firms that create new positions and existing firms that expand their payrolls, is 14% on average. Firms entering the market account for 40% of the total, a percentage slightly above the average for the OECD countries, where gross job creation is 12.5% and new firms account for 33% of the total.

As for gross job destruction, also the product of existing firms that cut their payrolls and others that close, the average in Latin America is 11.4%, with the bulk of the destruction occurring in existing firms that remain in the market, as only 32% of the destruction is due to firms that exit the market or close. Values in the OECD countries are similar: average gross job destruction is 11.8% while the destruction in firms that close is 31%.

Although job creation and destruction in the region appear to be similar to those of other countries in the world, there is evidence that the movement of workers between jobs is more intense in Latin America (see Figure 2.4.2). According to administrative records, 3% to 4% of workers in the United States are hired and dismissed in a month. In countries such as Ecuador or Brazil, this figure is 5% to 6%, and in Mexico it is 6% to 7%. That is, the movement of (formal) workers between jobs in the short term in Brazil, Ecuador, and Mexico is 50% to 100% higher than in the United States.

Figure 2.4.1 Average annual gross job flows in various countries

Sources:

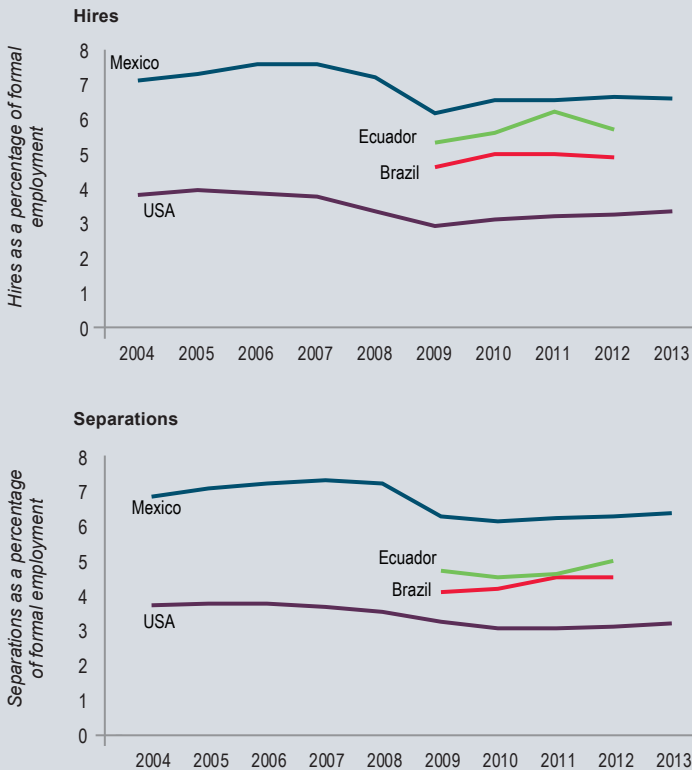
[a] IDB (2004).

[b] Haltiwanger, Scarpetta, and Schweiger (2008).

[c] Authors' estimates, based on data from BADE, OEDE, and MTSS (for Argentina); IESS (for Ecuador), and RAIS (for Brazil).

[d] Bartelsman, Haltiwanger, and Scarpetta (2009).

Figure 2.4.2 Monthly hires and separations in Brazil, Ecuador, the United States, and Mexico (as a percentage of formal employment)



Source: Prepared by the authors with information from the Mexican Social Security Institute Datacube, the Job Openings and Labor Turnover Survey of the United States, RAIS of Brazil, and the IESS of Ecuador.

Low levels of investment in the worker–employer match

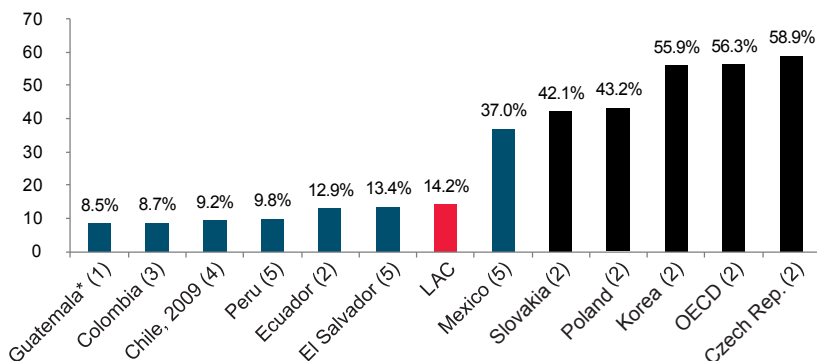
This equilibrium between a high degree of separation and a low level of job tenure occurs side by side with low levels of investment to boost the productivity of the employer–worker match. If, as indicated, separations occur when the value of continuing the relationship is lower than that of severing it, an important factor is how much is invested in maintaining and increasing the productivity of the relationship.

The reality is that investment in the training of active workers in the region is low. The percentage of workers who receive or take some training course or program is much lower than that observed in the OECD countries or countries outside LAC for which information is available. According to the social protection surveys, only around 9% of workers in Chile and Colombia had received some sort of training in their firm in the preceding years.⁷ In Ecuador, nearly 13% of workers had been trained in the past year. In Guatemala, 8.5% of young people aged 13–29 had received training in their firm in the past 6 months. At any given time, in countries such as Mexico, just 37% of workers had participated in some training course or program during their working life. These figures are 10% in Peru and 13% in El Salvador (see Figure 2.17). This is in contrast to the evidence from some high-income countries, where a high proportion of workers receive ongoing training, even in countries with incomes similar to those seen in the region.

As detailed in Chapter 5, lifelong training (also known as continuing education, which involves the acquisition, updating, and validation of workers' skills and capabilities) could play a key role in the region, given the cognitive deficits of current workers vis-à-vis new workers entering the labor market (see Chapter 4). Unfortunately, training for active workers takes place largely in formal enterprises and involves workers with some degree of education (see Figure 2.18). This pattern is repeated in the three countries analyzed (Chile, Ecuador, and El Salvador). The difference in the incidence of training between workers in formal jobs and those in informal jobs is striking. In Ecuador and El Salvador, hardly any informal workers receive training, in contrast to 20% and 30% of formal workers, respectively. Also troubling is the difference in the incidence of training between people with higher and lower levels of education. Early education tends to foster learning in maturity (Heckman and Masterov, 2007). Therefore, the cost of learning is usually lower for workers with a higher level of education, who have already learned how to learn. However, the lack of knowledge and skills among many workers, especially those with less education, means that training for this group entails a higher cost. This would explain why, in the absence of public policies to alter these patterns, firms tend to provide more training to workers with more education. This state of affairs leaves a large portion of the region's workers (especially those who need it most) with no opportunity for continuing education in the workplace.

⁷ The surveys cover different periods. In the case of Chile, they reflect the past three years; in the case of Colombia, the past two.

Figure 2.17 Percentage of workers who received training in a given period, 2012



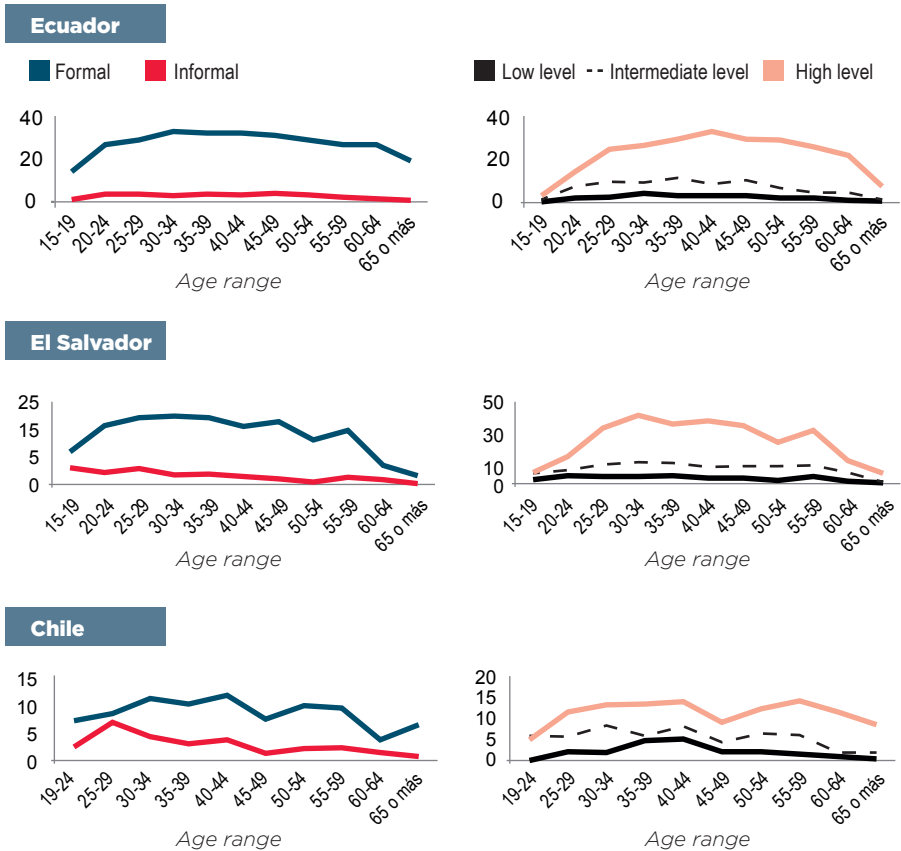
Source: Authors' calculations based on harmonized household surveys of Latin America and social protection surveys for Colombia, Chile, and El Salvador; OECD (2012b).

Note: (1) In the past six months; (2) in the past year; (3) in the past two years; (4) in the past three years; (5) throughout working life.

OECD average, based on the countries for which the PIAAC survey is available.

These data indicate that the region may be trapped in a situation where low levels of training and high labor turnover fuel each other and directly affect the capacity for human capital accumulation and the joint ability of workers and firms to be more productive. In this regard, the available studies show a close association between short-lived employment relationships (for example, temporary contracts) and a lower incidence of training (see Chapter 5, Box 5.1). In the OECD, workers with temporary contracts have a 20% to 40% lower incidence of on-the-job training than those with indefinite contracts (Cabrales, Dolado, and Mora, 2014). In Chile, Carpio et al. (2011) found that workers in temporary jobs in formal firms receive half the training that workers with indefinite contracts do. In Panama (see Figure 2.19), firms that make extensive use of temporary contracts tend to provide much less training. Although the evidence up to this point is anecdotal, it all suggests that less investment in training can result in lower productivity (see Box 5.5) and that low labor stability, in turn, discourages training and the accumulation of human capital in a firm, which in the long term can have a significant impact on productivity.

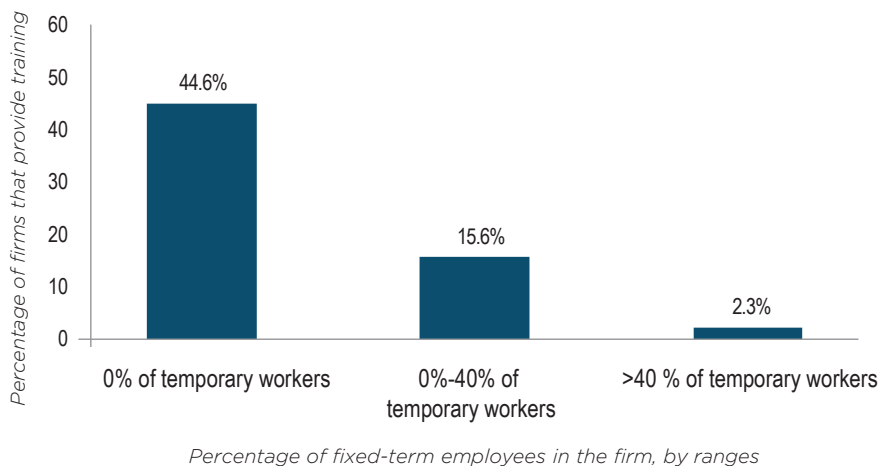
In sum, while, as in other labor markets worldwide, part of labor turnover is the result of unanticipated changes (shocks) in market conditions or technology, a substantial portion of the higher turnover seems to be fostered by greater worker mobility between jobs. The causes of this situation are

Figure 2.18 Percentage of trained workers by age, type of work, and educational level in Chile, Ecuador, and El Salvador

Source: Prepared by the authors based on household surveys for each country: ELPS in Chile (2009); ENEMDU in Ecuador (2013); and EHPM in El Salvador (2013).

hard to pin down, but it may be due to some matches whose productivity is initially low, little investment in human capital by firms (and the state, a topic revisited in Chapters 4 and 5), and a high level of surprises due to the limited information available at the time of the matches. Chapters 4 and 5 analyze labor intermediation and worker training systems in the region to explore this issue in greater depth. It is important to note that ensuring and maintaining matches is essential for consolidating lower levels of instability. Therefore, as in the case of formality, job productivity and its evolution relative to labor costs are basic variables for achieving greater labor stability.

Figure 2.19 Percentage of employers that provide training, by number of temporary workers, in Panama



Source: Prepared by the authors, based on the Survey of Human Resource Productivity and Training in Businesses (2011).

Reallocation, growth, and welfare

The preceding sections show that millions of workers rotate between jobs. Is this reallocation virtuous or not? The answer depends on the relationship between labor market dynamics, coverage of the risk to which workers are exposed, welfare, and productivity.

The constant reallocation of workers between jobs (high turnover) has a positive effect on productivity and economic growth if workers are quickly and effectively reemployed in jobs where they are more productive. Labor mobility is therefore positive when workers are offered a better job than the one they had and where their contribution is greater. This is also true for workers who voluntarily leave a firm for self-employment where they are more productive. It is likewise positive when workers who involuntarily lose a job quickly manage to find a new one where their productivity is higher than in the previous job.

However, as indicated earlier, high labor mobility may also be a reflection of problems in the labor market. Furthermore, reallocation can be very costly from the workers' standpoint, as they may endure long periods of unemployment without an income or with a lower income and lose skills that would enable them to find a good job.

Therefore, the effect of reallocation on workers' welfare has two components. On the one hand, reallocation is positive for welfare insofar as it produces productivity gains, economic growth, greater formality, and higher real wages. On the other hand, greater reallocation increases the likelihood of long periods of unemployment (or work in poor-quality, informal jobs) and can have major consequences for a worker's consumption and welfare, and possibly that of his or her family. The fewer the mechanisms for mitigating risk, the higher the risk.

In the United States, Aghion et al. (2014) note the existence of the two effects described above. Comparing regions in the United States, these authors show that higher job rotation is associated with a greater subjective perception of welfare in individuals when regions with similar unemployment levels are compared. If the unemployment levels differ, there is no clear association between job rotation and welfare, which indicates that the positive effects of turnover (higher growth and better wages) are diluted by the negative effects (greater likelihood of unemployment).

An additional dimension (specific to middle- and lower-middle-income countries like those of the region) that should be considered from the welfare standpoint is that the mobility observed often occurs without the protections of unemployment insurance or severance pay found in the developed countries. There are two reasons for this: first, there is no unemployment insurance in many LAC countries, and second, the mobility is associated with informal jobs (for a description of the mechanisms for unemployment protection and their coverage, see Chapter 4).

Furthermore, turnover itself leaves even formal workers unprotected. Both unemployment insurance, when there is any, and severance pay depend on job tenure. When workers with little tenure lose their job, they often become ineligible for unemployment insurance or receive very little severance pay. All this accentuates the lack of protection from turnover for the region's workers (for a more in-depth discussion of this issue, see Chapter 3).

This shows the importance of analyzing the point to which labor market behavior fosters economic growth and, at the same time, workers' welfare. It also demonstrates the urgency of promoting social protection mechanisms not only to mitigate the cost of unemployment but also to promote turnover that results in higher productivity and wages (see Box 2.5). As noted, gains in productivity occur only when workers are reallocated to a more productive job; if workers lack the economic support and information they need to

conduct an appropriate job search and end up in an informal job where productivity is low, the economy will experience no gains in productivity. There is a high social value to achieving good matches, while excessive dismissals may entail a high cost that may justify state intervention.

Furthermore, in this context it is important to point out that the greater the impact of gains in productivity on wages, the more effective they are in increasing workers' welfare. We know that gains in productivity are transferred to wages over the long term. That is why the wealthiest and most productive countries have higher average wages. Thus, the basic element for guaranteeing that wages can steadily rise is to ensure the greater productivity of matches; however, it is no less certain that the way in which gains in productivity are divided between employer and employee is important for calibrating welfare gains for workers, especially in the short and medium term. In this distribution, the respective bargaining power of workers and employers will determine the extent to which increases in productivity are reflected in higher wages (see Box 2.5). Mechanisms such as the minimum wage or collective bargaining are important for determining the distribution of profits (ILO, 2015 and 1985).

The evidence for the countries of the region for which longitudinal information is available indicates that a significant portion of the transitions between jobs is not conducive to (formal) jobs that pay higher wages or provide greater protection against risks. Using two variables, income and access to social benefits (formality), as proxies for job quality, it can be determined whether the shift from one job to another has resulted in greater welfare for the worker. Some 38% to 47% of the transitions between jobs in Argentina, Brazil, and Mexico unequivocally improve the conditions of workers (whether because of higher wages with the same benefits or an improvement in both dimensions); some 40% to 55% of transitions worsen them (see Figure 2.20); and some 6.6% to 12% show losses and gains. In other words, a very high proportion of job-to-job transitions entail losses to workers in the wages or benefits dimension, with no improvement.⁸

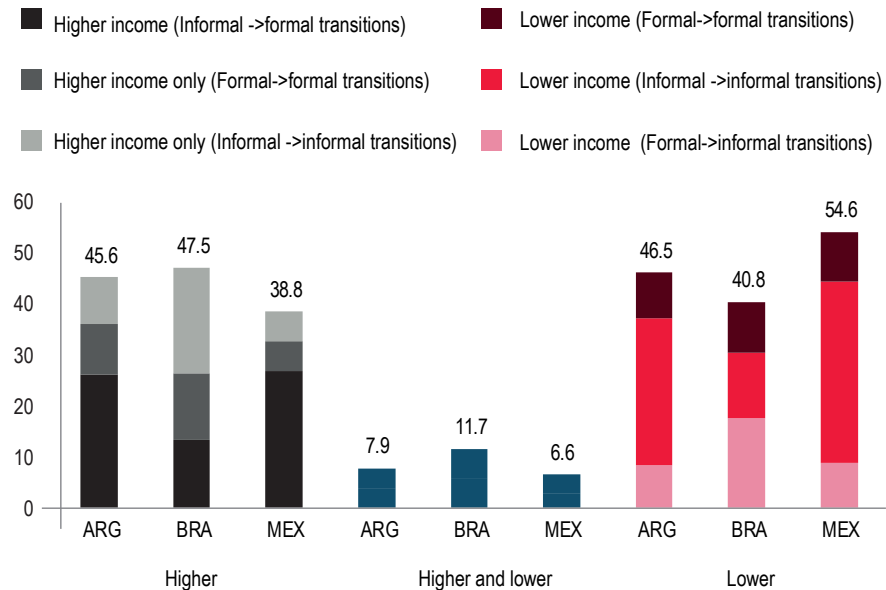
Moreover, although only partial information is available, workers do not appear to be reallocated from less-productive to more-productive units. One of the arguments for a mobile market is that mobility reflects the efficient reallocation of factors from less-productive to more-productive jobs. Taking the size of the firm as a proxy for productivity (Pagés, 2010), only about 20% of

⁸ Although there may be non-pecuniary aspects of the job that make the switch beneficial to the worker (distance to the workplace, hours, possibility of future promotion, etc.).

the transitions between jobs correspond to a shift from smaller to larger firms (see Figure 2.21). Many of the transitions occur between jobs of similar size or from larger to smaller units.

In the vast majority of cases, transitions from smaller to larger firms occur when a worker shifts from an informal to a formal job. In 60% of the cases in Argentina and Brazil and 70% in Mexico, transitioning from an informal to a formal job implies that the worker will end up working in a more productive unit. In contrast, more than 50% of the workers who move from a formal job to an informal one end up in a smaller unit, often as self-employed workers.

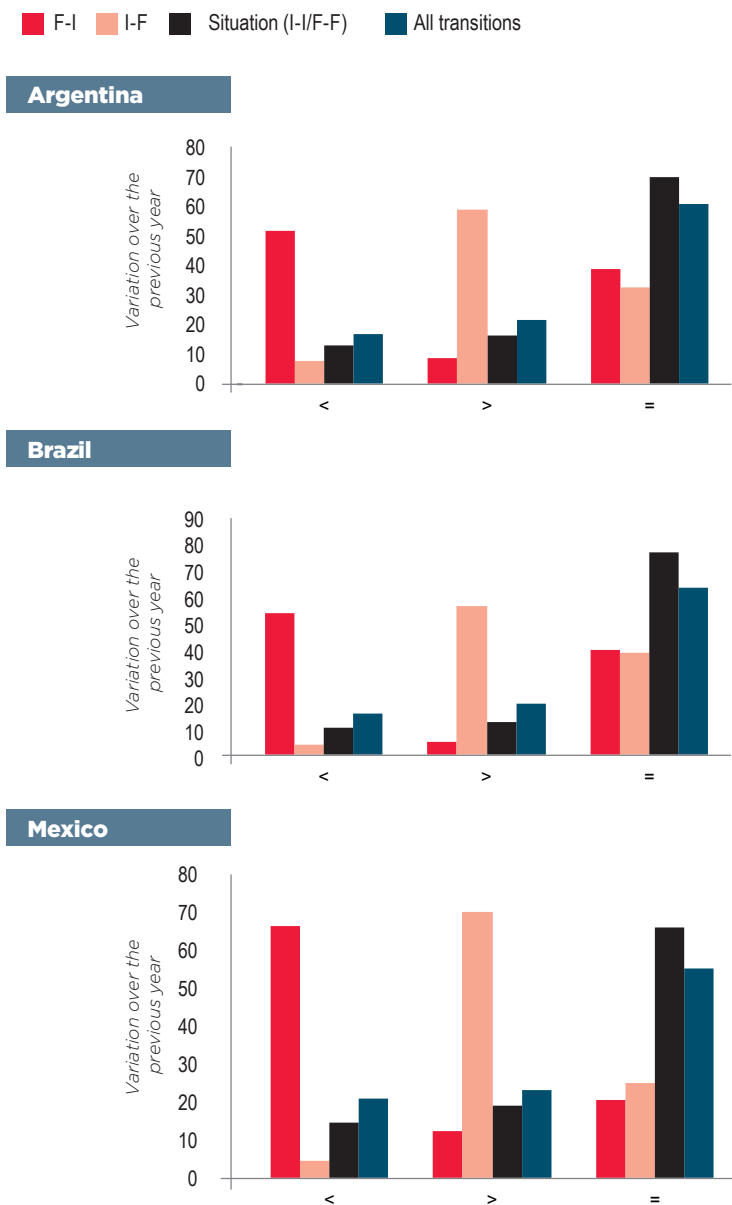
Figure 2.20 Percentage change in employment based on the quality of the worker's transition



Source: Prepared by the authors, based on the panels of Argentina (EPHC, 2003-13), Brazil (PME, 2002-13), and Mexico (ENOE, I Trim. 2005-III Trim. 2012).

Note: For details on the panels, see Table A.1 in the appendix of data sources.

Figure 2.21 Percentage of worker transitions to larger firms by type of transition



Source: Prepared by the authors, based on the panels of Argentina (EPHC, 2003–13), Brazil (PME, 2002–13), and Mexico (ENO, I Trim. 2005 to III Trim. 2012).

Note: For more details on the panels, see Table A.1 in the appendix of data sources.

F = formal; I = informal

Box 2.5. Wage setting

What affects wage levels? From a theoretical standpoint the wage should fall between the value of the productivity of the worker–employer match (above which the employer is not interested in hiring the individual) and the reserve value of the worker (below which the individual is not interested in working). In any case, the wage divides the value of the worker–employer match. This division is the product of a negotiation between the worker and the employer (or collective bargaining between unions and businesses) in the case of workers employed by others and of the benefits derived from individual activity in the case of self-employed workers.

Many labor market models use the equilibrium wage concept developed by late Nobel Prize-winner John Nash. In this equilibrium wage setting (in the context of a wage negotiation) is the product of what each party can obtain if an agreement is not reached, plus a proportion of the benefit derived from the employment relationship. Thus, both parties are aware that if no agreement is reached, the vacancy will not be filled; neither the worker nor the employer will get the benefit of a match, and each will have to bear the cost of a continued search. This means that the wage negotiation is linked to factors intrinsic not only to the match but to the economic situation (for example, how easily the worker can get another offer and the firm another candidate). In addition, these costs create incentives for the parties to reach an agreement. How much of the benefits of the relationship accrue to each party depends on its bargaining power. In the extreme case in which workers have no bargaining power, the wage is equal to what the worker would get without an agreement—that is, the value of looking for another job or working in the informal sector.

It should be noted that the higher the value of the match, the higher the wage. Thus, a more productive match, an increase in the price of the product, or higher sales will result in higher wages. Similarly, factors that can have a negative impact on job creation, such as higher non-wage or dismissal costs, can also have a negative impact on wages because they decrease the value of the match and, with it, the value of what there is to distribute between workers and firms. Furthermore, labor policies have also been adopted to influence wage setting, imposing wage floors (minimum wages) or affecting workers' bargaining power with firms.

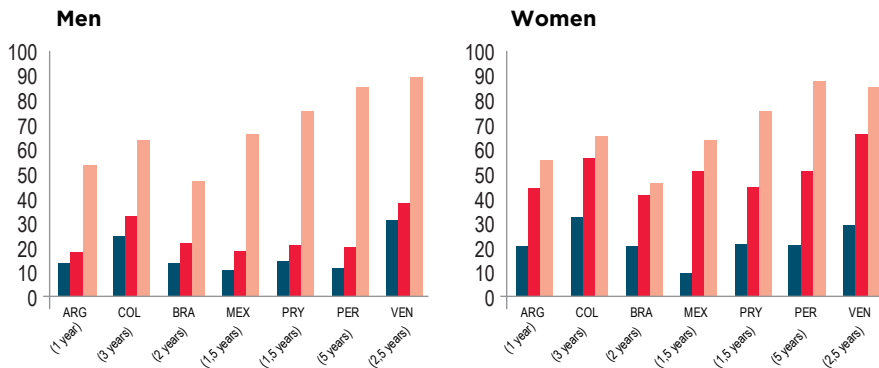
Ultimately, the main determinant of worker remuneration is the productivity of the match; however, labor regulations, non-wage costs, taxes, dismissal costs, and minimum wages can change this. Since these factors are relatively stable in the long term, the evolution of the productivity of the match(es) is the main determinant of wage growth in the long term.

Table 2.5.1 Factors affecting wage levels

| Factors that raise wages | Factors that decrease wages |
|---|------------------------------------|
| Increase in the productivity of the match | Taxes on the value of the match |
| Increase in worker bargaining power | Reduction in bargaining power |
| Low unemployment | High unemployment environment |
| Wage subsidies, minimum wages | |

Figure 2.22 Percentage of active workers aged 25–45 who have been unemployed or inactive or who have worked in the informal sector during the course of a panel

- Unemployed at least once
- Unemployed or inactive at least once
- In an informal job at least once



Source: Prepared by the authors, based on panel data.

Note: Country averages for unemployment, inactivity, or informality levels may vary because the figure restricts the sample to workers who were active for at least a period of the panel. For details on the panels, whose durations are indicated in parentheses, see Table A.1 in the appendix of data sources.

High turnover levels mean that the vast majority of the region's workers will, in a relatively short period, experience an episode of informality, unemployment, or inactivity. Longitudinal surveys that look at men and women in their prime (ages 25 to 45) who had had at least one job or were looking for one during the panel find that 20% to 40% of the men had been unemployed or inactive (for a year and a half to five years) at least once, and more than 50% had had at least one informal job. The panels show higher mobility for women: between 40% to 60% had experienced an episode of unemployment or inactivity, and more than 50% had had at least one informal job. In Peru, 80% of men and almost 90% of women in a five-year period were working in an informal job (see Figure 2.22).

Conclusions

This chapter presents arguments about the singularity of the labor market as not only the place where returns to work are allocated but the environment where much of the social contract is developed. Thus, the labor market plays a pivotal role in productivity and economic performance, as well as individual welfare.

The chapter also argues that while normal market economy is associated with high job and worker flows, in the Latin American experience these flows largely give rise to the creation of informal jobs. Although informality stems from a combination of many factors, it reflects the tension between the productivity of the employer–worker match and the cost of formality. In certain countries in the region, these two variables are out of balance.

In addition, the region is characterized by an equilibrium marked by a lack of ongoing investment in employer–worker matches. A cause, and at the same time an effect, of this situation is the fact that workers do not stay long in a job, and there is constant reallocation of workers among jobs. Therefore, while turnover is essential to value creation in market economies, the patterns observed in the region yield neither greater worker welfare nor higher productivity in the countries



Chapter 3.

From facts to policies

Summary

This chapter indicates where the main market failures lie. It argues that the context in which these failures develop calls for a labor policy conducive to creating more and better jobs. Given the existing deficits in the region, labor policy should pursue two major objectives: putting workers in formal jobs and promoting productive stability in the jobs. However, the reality in the region is that the possibility of successfully tackling the challenge of creating better jobs is slim because the labor force is sorely lacking in skills, the labor market is eminently informal, and institutions lack the basic mandates to make the labor force the centerpiece of a growth strategy. Building the necessary capacity to implement appropriate labor policies that result in greater job productivity could guarantee better working conditions for the workers of the region.

Introduction

In the preceding chapters it was argued that, despite the improvements of the past decade, the region's labor markets suffer from serious deficiencies that include high informality, high job instability, and very limited productivity growth. New solutions are therefore essential. Thus, as in the rest of the book, this chapter advocates the achievement of two major objectives that will facilitate the creation of more jobs characterized by greater protection and productivity. First, it is essential to put workers in formal jobs because it will enable them and their firms to fully enjoy the benefits of social security, the capacity for personal growth, and other added benefits of more formal economies. Second, it is also critical to promote productive job stability that lays the foundation for more lasting and productive employment relationships. Both objectives unquestionably require a strong labor policy designed to correct labor market failures that hinder achievement of these objectives in the region.

Labor markets around the world operate with high flows, but the magnitude and impact of these flows on welfare and productivity depend in good measure on how well the labor market works. They also depend on the nature and quality of the policies adopted to correct problems in the labor market. In addition to other factors, the labor market in Latin America and the Caribbean still operates with a high degree of informality, which poses additional problems.

Where does the labor market fail? What makes the region's situation different from other countries in the world? How do these failures and the regional context hinder achievement of the objectives of increased access to formal jobs and more productive job stability? Precisely because of their complexity and the various functions demanded of them (resource allocation, insurance against risk, preservation of the social compact), labor markets operate with many problems and deficiencies. At least four types of labor market failures merit attention and justify state intervention: lack of information, problems in the credit markets, impediments to structuring contracts that protect investments in training by workers and firms, and failures in the private unemployment insurance markets. These failures interact and are amplified in the specific context of the region, characterized by deficient basic education and training (Bassi et al., 2012), a high proportion of informal jobs, and, in many cases, institutions with little capacity and an insufficient mandate to design and execute policies and programs capable of solving these problems. All these elements combine to create an environment unfavorable to the cre-

ation of jobs that promote the growth of both individuals and countries in the region. In this context, comprehensive state intervention can achieve higher efficiency, equity, and welfare levels. The more contextual problems limiting the effectiveness of state interventions that are solved, the greater these gains will be.

Market failures that lead to fewer and more-inequitable opportunities for access to formal jobs

Information failures

These failures are the result of firms and workers operating on the basis of expectations and assumptions rather than real information. Thus, one of the prerequisites for the good operation of a market (where everyone who participates has the same information about the prices, quality, and quantity of what is offered) is generally absent.

Information failures or deficits reduce the efficiency of the economy and make the possibilities of finding good jobs more inequitable. Productivity falls because the more difficulty firms and workers have finding each other, the poorer the quality of the matches—that is, how well workers are suited to the needs and requirements of the jobs to create greater value. Problems recognizing whether a person is a good candidate for a job cause selection processes and contracts to be based on assumptions and expectations that may often foster discrimination and inequality of opportunity. For example, given the difficulty of ascertaining a candidate's productivity, the people in charge of the selection process may use criteria such as race, ethnicity, or age as productivity indicators, based on preconceived notions (Bertrand, Mullainathan, and Shafir, 2004). Information problems are exacerbated when young people and, in general, all new workers entering the labor market are involved. Another common strategy for inferring a worker's productivity is to contact former employers. Due to their lack of experience, the vast majority of youth in the region have problems getting their first job. This problem is sometimes solved by taking unpaid or poorly paid internships, which enable young people to gain the experience they need to enter the labor market. However, these mechanisms create other potential equity problems, as only individuals from high-income households can afford to work for a time without an income—a circumstance that, again, creates differences in access to the labor market from the outset, depending on the socioeconomic environment.

Information deficits also limit opportunities for people without the right relatives and acquaintances. Another fairly customary practice in estimating a candidate's productivity and reducing the risk of hiring someone who does not have the requisite characteristics and skills is to hire workers through relatives and acquaintances. Therefore, people without contacts or relatives among formal employers will have fewer opportunities for jobs in the formal sector.

To solve these problems, the majority of the countries have created information systems for connecting workers with vacancies. Known as labor intermediation systems (LISs), they are either public employment services that provide free or inexpensive assistance to all workers or private intermediaries that usually serve the higher-income niches of the market. Workers are not the only clients of these services. Since firms also suffer from information deficits, labor intermediation systems play an active role at both ends of the market, fostering gains in productivity and equity. Chapter 4 provides additional information about the available evidence on the impact and effectiveness of labor intermediation systems, as well as their functioning in the region.

Failures in the private unemployment insurance markets

The ability to actively look for a job depends on whether the worker has enough income to maintain consumption during the search period. In many cases, however, workers looking for a job face liquidity problems and must find work again somewhere as soon as possible to ensure an income.

Unemployment can entail high personal and social costs. A worker who loses a job may be faced, to one degree or another, with four potential costs: i) the loss of a source of income while unemployment lasts; ii) the loss of health benefits and pensions while unemployment lasts (in the case of formal job); iii) the erosion of personal satisfaction and self-esteem, as work is a determinant of personal identity in most societies; and iv) the potential lack of future income and/or benefits that a person can aspire to as a result of experiencing unemployment. These effects are particularly serious in the case of an economic crisis, especially in regard to points i), ii), and iv).¹ Moreover, in an economic crisis, the risk associated with unemployment is magnified, as the

¹ These exits from employment can have additional consequences. For example, they increase the risk of dying (Sullivan and von Wachter, 2009) and the incidence of suicide and suicide attempts (Browning and Heinesen, 2012). Similarly, they increase the use of antidepressants and hospitalization for mental health issues (Kuhn, Lalive, and Zweimüller, 2009). Furthermore, they have an impact on health, the family structure, and children's well-being (Nichols, Mitchell, and Lindner, 2013), and they also affect the mental health of spouses (Marcus, 2013).

possibility that more than one member of the household will be unemployed increases, reducing the prospects of diversifying risk within the family unit.

In principle, these costs could be covered by purchasing private unemployment insurance. As with other contingencies (theft, flood, disability, and death), an individual or family could obtain insurance, paying a monthly premium while the worker is employed and receiving a transfer or payment when unemployed. In practice, however, there is no market for voluntary private unemployment insurance for at least two reasons. First there is the problem of adverse selection: the people interested in obtaining insurance of this type would be those with a greater likelihood of becoming unemployed. Therefore, unless the insurance is compulsory, the market fails because there is no diversification of risk. Second, there is the problem of moral hazard: once subscribed to an insurance plan, people with insurance could manipulate their likelihood of becoming unemployed (for example, by not showing up for work or by asking the firm to dismiss them).

As a result, there has been little incentive for the market to offer unemployment insurance throughout the world. Thus, in many countries this risk has been covered by requiring firms to provide compensation for dismissal and/or by creating public unemployment insurance systems. When well-designed, mechanisms to protect the income of the unemployed increase productivity and welfare because they mitigate the losses associated with unemployment and foster better matches between firms and workers in the labor market (Acemoglu and Shimer, 2000). However, when poorly designed, they can operate ineffectively and reduce productivity, rather than increase it. Chapter 4 analyzes the way these instruments work in the region.

Market failures that hinder the promotion of productive job stability

Failures that affect the acquisition and production of skills

Maintaining high productivity relative to wage and non-wage labor costs is perhaps the most important factor in maintaining a formal employment relationship. In order to boost worker productivity, it is essential that they acquire new skills. However, skill acquisition is plagued with failures that, without the intervention of specific policies, can result in high turnover, low job productivity, and a high risk of dismissal.

Unwillingness to invest in human capital. In many cases, it is impossible to draw up a contract that will enable both firms and workers to benefit from investments in training while avoiding a situation in which, for example, a firm invests in training for its workers only to have them leave once the training is over. This is a particularly thorny issue in the case of training that develops crosscutting skills that will boost a worker's productivity in any job outside the firm that provides the training. This can increase the possibility that, once trained, workers will decide to move to another firm. Some of these general skills are the ability to understand written material, communicate, and do mathematical calculations and skills associated with the job or interpersonal relations (behavior). Specific skills, in contrast, boost worker productivity only in the firm in question. Thus, employers are more interested in investing in this type of training since its lower influence on worker turnover makes investing in it more profitable.

Imperfections in the capital market. Even if employers have no incentive to train workers, workers should have incentives to finance their training in crosscutting skills because they will profit from the returns. However, failures in the capital market often limit access to credit by those who wish to invest in human capital. Workers—and even employers—often lack the resources to finance training and encounter many obstacles to securing loans in exchange for the promise of higher future productivity. This is important, especially in smaller firms and among middle- and low-income workers who have greater liquidity constraints due to scarce resources. Since these workers and firms are those most in need of boosting their productivity (Pagés, 2010), lack of access to credit and resources for training can leave them trapped in a situation of low productivity.

Asymmetries and lack of information about training options. These failures affect the knowledge of workers, firms, and training providers about the benefits of training, the competencies that the market demands, and the quality and relevance of the training offered in the market. These constraints not only dampen the demand for training but also contribute to both a scarcity of supply and poor quality. This type of failure will especially affect less-skilled workers and micro and small enterprises since they have less information at their disposal and fewer possibilities for remedying these deficiencies.

These failures are illustrated in a recent IDB survey of a representative sample of firms in the Bahamas, Colombia, and Honduras. The firms were asked whether they provided training for their workers, and those that answered “no” were asked why not. Their answers indicate that in many cases firms in

the region have little interest in investing in training—perhaps because they are unaware of the need to boost their workers’ productivity. The second most-cited reason for the low demand for training is its high cost, followed by the fear of losing workers once they have been trained and the inability to find a suitable training provider (see Table 3.1).

Table 3.1 Main reasons firms give for not providing training (percentage)

| | Bahamas | Colombia | Honduras |
|--|---------|----------|----------|
| Received training and it wasn't useful; a waste of time | 6.7 | 10.0 | 8.3 |
| High cost | 16.4 | 26.6 | 30.3 |
| Doesn't know/ hasn't found training institutions | 5.8 | 5.8 | 25.5 |
| Once trained, personnel may leave the firm (lack of ownership) | 2.3 | 10.7 | 7.7 |
| The benefits of training cannot be measured | 3.9 | n.a. | 4.0 |
| Training is unnecessary; personnel are adequately trained | 72.8 | 34.5 | 62.4 |

Source: Flores-Lima, González, and Rosas (2014).

Note: Calculation of percentages based on the total firms that reported not providing training.

n.a. = no data available

To mitigate the problems associated with investing in skills, many countries have created job training systems that foster greater investment in skill building by firms, the state, and workers, as well as mechanisms for validating skills acquired in the workplace. Chapter 5 shows that when these mechanisms work properly, they can boost productivity and reduce instability, and it analyzes their effectiveness in the region.

Context matters

Market failures that justify public intervention to achieve greater efficiency, equity, and welfare occur in every country in the world. However, the regional context amplifies natural market failures and merits discussion.

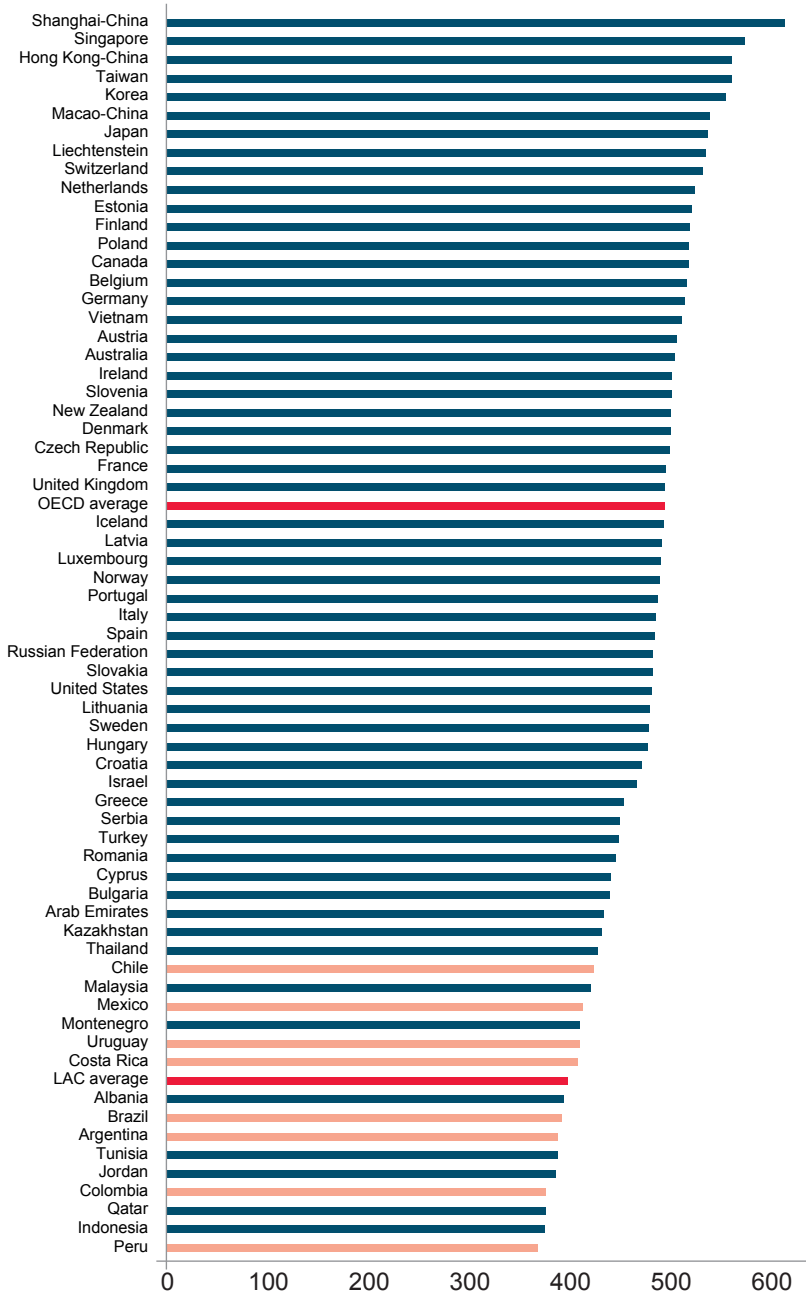
Deficient basic education

The foundations for creating jobs for growth are weak. The region's youth exit the educational system ill prepared, with serious deficiencies in their cognitive skills—so much so that, in comparison with the 65 countries that have implemented the Programme for International Student Assessment (PISA), the scores of the eight participating countries of the region rank in the lowest third in all subjects (Bos, Ganimian, and Vegas, 2014; see Figure 3.1). Some 48% of these young people cannot understand a basic text, while 62% cannot do simple calculations, with significant differences in performance between socioeconomic quintiles (OECD, 2010a). At the other extreme, very few students achieve the highest grade on these tests, which suggests that only a very small portion of new graduates will be in a position to compete in the global labor market.

One can assume that the skills of workers already in the labor market are not very different, or are even poorer, than those indicated by these figures. While there are still no measurements of the reservoir of skills among workers in Latin America, the evidence suggests that decades of deficient education have taken their toll on the quality of the region's labor force.

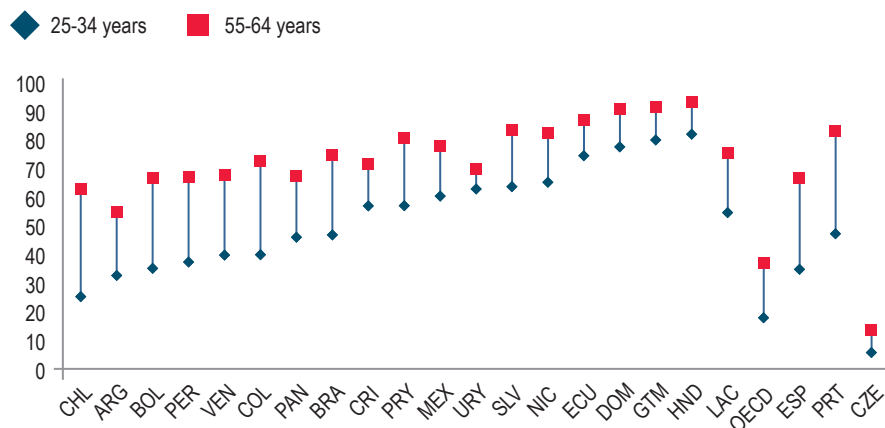
Human capital development in the region's labor force is still low, even when measured by years of schooling. On average, 55% of young adults aged 25 to 34 and 76% of adults aged 55 to 64 have less than a complete secondary education (2009–10), although there are major differences among the countries of the region. In contrast, the respective figures are 37% and 18% in the OECD countries (see Figure 3.2).

The purpose of this chapter is not to delve deeply into this fact (others have done so much more extensively and in greater detail—among them Bassi et al., 2012; Crespi, Fernández-Arias, and Stein, 2014) but, instead, to underscore that this lack of skills will interact with market failures. For example, in a world where graduating from school does not guarantee the acquisition of a series of skills that are important for the workplace, firms may be unwilling to formally hire young people without first ensuring their competence. Similarly, this lack of skills may dissuade many firms from training their workers, as the lack of initial skills can make training much more expensive. In the words of the employers, when beginning a training process, they have to “take many steps backward” because their workers lack some of the prerequisites necessary to profit from the training.

Figure 3.1 Average math scores, PISA 2012

Source: OECD (2012a).

Figure 3.2 Population in the 25-34 and 55-64 age groups with less than a complete secondary education (percentage)



Source: Prepared by the authors, based on household surveys of the countries of the region (2010) and OECD.

An eminently informal world

The low productivity of a tremendous number of workers, combined with high wage and non-wage costs is, as established in Chapter 2, one of the major impediments to formal job creation (especially for youth), causing more than half the labor force to be working without the protection of social security mechanisms.

There is no reason for this situation to remain permanent. Indeed, this book advocates the use of avenues that will substantially increase formality levels. However, the situation does have implications for understanding how market failures can be exacerbated in this context and the available policy options. Informality heightens the impact of market failures through various channels. First, it exacerbates information problems. Informality, almost by definition, implies operating at the margin of existing institutions. Thus, information about informal workers and firms is either nonexistent or very hard to obtain. This affects the intermediation and training activities that governments can implement. Moreover, the work history and experience of workers while they were employed in informal jobs may not be recorded anywhere or may not be available to or verifiable by employers when hiring or training decisions are made.

Second, the existence of generalized informality makes it harder to protect workers against unemployment. This is because workers do not pay into the system so that they qualify for unemployment insurance and because of the greater probability of moral hazards, as workers could find an informal job and continue collecting unemployment insurance. This hinders real protection against unemployment and reduces the effectiveness of insurance in the region (Espino and Sánchez, 2014).

Finally, informality complicates access to the capital markets to invest in training because, in practice, the income of informal workers and firms is unverifiable, limiting the capacity of both to invest in training.

Low levels of institutional capacity and unaligned institutional objectives

An additional obstacle confronting the region is the fact that the institutions charged with implementing public policies to correct market failures in the context in question lack the mandate or institutional capacity to do so. The ministries of labor, which are responsible for much of the execution of these policies, were conceived with the main objective of protecting the interests of workers and guaranteeing a decent job. Some ministries gradually took on the responsibility of administering their countries' pension plans (Rosen, 2014). Although both tasks are essential, expanding ministry responsibilities beyond the initial objectives has proven difficult.

At the same time, as the International Labour Organization has commented (ILO, 2013), while some ministries of labor are influential and visible and others have managed to improve their profile, as well as their budget allotments, ministry of labor activism in many countries has declined, and the ministries lack the capacity to do their job properly. An additional issue associated with the inability of the ministries of labor to formulate and implement public policies is their lack of funding and human resources to do so. Another is their lack of authority to assess the effectiveness of the policies and programs for which they are responsible.

Many of the problems discussed in this book require the institutions charged with policy implementation to shift from their traditional role of protecting workers to a more proactive role of preparing the labor force for the challenges of increasing the quantity and quality of investment in workers and contributing to the growth of productivity.

Public policies to achieve successful career paths

Due to the market failures discussed and the current context of the countries in the region, labor markets operate inefficiently, creating a high risk for both firms and workers, low levels of welfare, and low productivity growth.

Based on the vision of achieving successful career paths (explained in the introduction to this book) and the problems detected in the region (high informality and job instability), this book divides policies into two groups:

1. Policies to increase and equalize opportunities for access to formal jobs
2. Policies to promote productive job stability

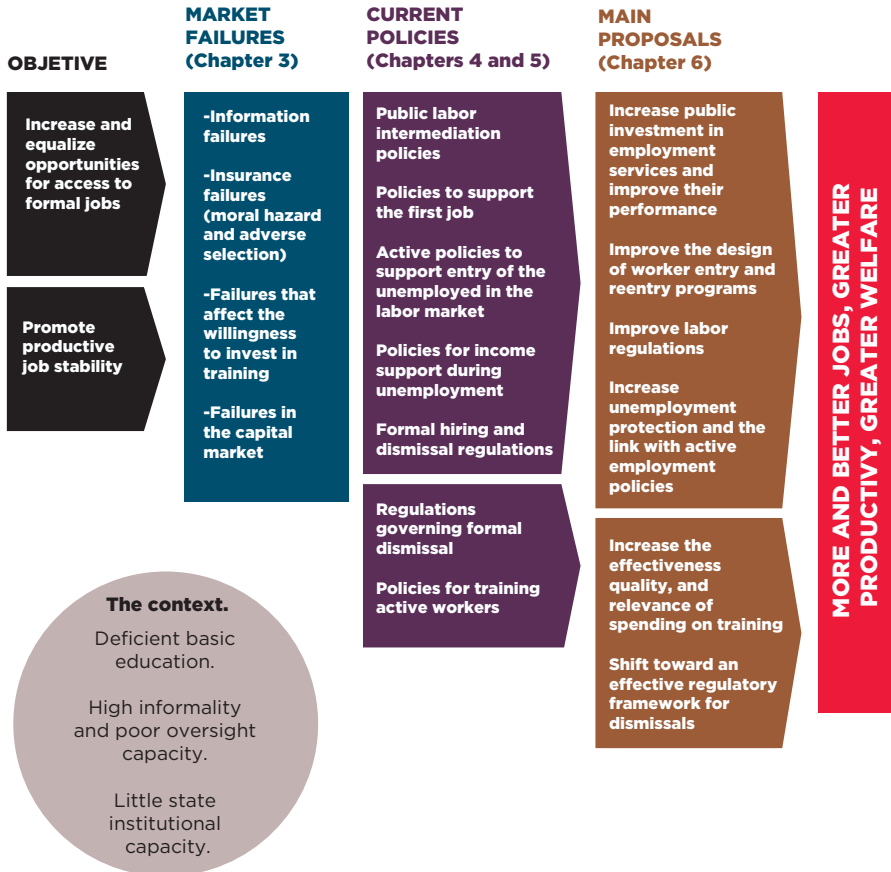
Labor market entry policies include all public initiatives in the labor market that facilitate the creation of formal employment and promote workers' ability to quickly and effectively find formal employment or new employment in a formal job after a period of unemployment or inactivity. These include policies to promote acquisition of the first job, policies to provide workers and firms with information that contributes to good matches, policies to support workers during periods of unemployment to help them re-enter the labor market, and policies to improve regulations governing hiring and dismissal that affect the decision to create a formal job. The most important market failures that such policies are intended to correct are: information failures, which are especially acute for youth and people without the appropriate contacts; failures associated with the private unemployment insurance markets; and failures in skill acquisition (see Diagram 3.1).

Policies to promote productive stability include two types of initiatives: restrictions on dismissals and policies for lifelong training.

These policies are discussed in Chapters 4 and 5. The premise of this book, however, is that public interventions are often poorly designed and executed; thus, instead of solving problems, they can create them or, occasionally, worsen the situation in the labor market.

The purpose of Chapters 4 and 5 is to offer the reader a review of existing labor policies in the region and, based on the available data, analyze the evidence of what works in the region and what doesn't, as well as the desir-

Diagram 3.1 A comprehensive approach to creating more and better jobs, increasing productivity, and achieving greater welfare.



able and undesirable impacts of these labor policies on the labor market. To accomplish this, Chapter 4 focuses on the first group of policies: “policies to increase and equalize opportunities for access to formal jobs”; and Chapter 5 on the second: “policies to promote productive job stability.”

Chapter 6, in turn, discusses a number of proposals that, in the authors’ view, are desirable for a comprehensive labor policy that promotes the growth of the peoples and countries of the region.



Chapter 4.

Policies to increase and equalize access to formal jobs

Summary

This chapter reviews current labor policies in the region that are designed to increase and equalize opportunities for creating quality jobs. These policies revolve around five elements: labor intermediation (policies to reduce information asymmetries and equalize opportunities for access to quality jobs); first-job policies (targeting youth, one of the groups with the greatest disadvantage in the labor market); support for adults reentering the labor market (policies to upgrade skills, especially among the most vulnerable people); income support during unemployment (policies to cushion the drop in consumption and facilitate a better job search and the reemployment of people who have lost their jobs); and hiring and dismissal regulations (to improve conditions for workers and protect them against the risks of poverty in old age, illness, and unemployment). This chapter also discusses the need for proper government enforcement to ensure regulatory compliance.

Introduction

A well-functioning labor market can contribute to economic growth by promoting quality jobs (jobs that are formal and sufficiently stable), reallocating working-age people to jobs that better match their skills, lifting the access barriers experienced by certain population groups, promoting continuing education, and building a more competitive economy with the resilience to adapt to individual and collective shocks.

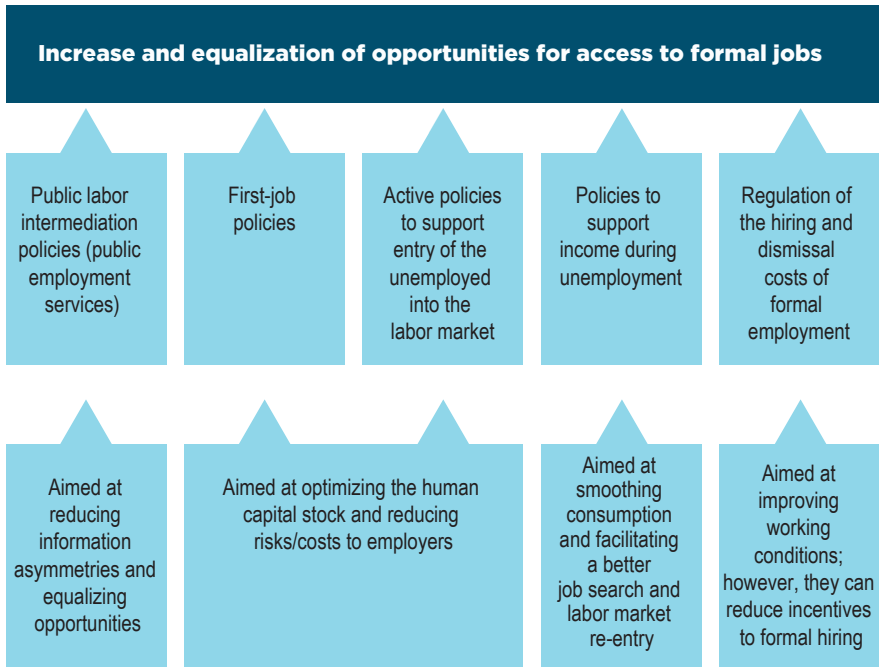
This combination of factors is hard to achieve. First, firms have trouble identifying good candidates to fill their vacancies. Second, the high labor costs associated with hiring and dismissal make firms wary of hiring personnel and thus create obstacles to higher formal employment. On the workers' end, many find it hard to productively enter the labor market due to information barriers and/or a lack of contacts in the world of work, a lack of access to credit markets to further their education or training, or a lack of the skills demanded by the labor market. In the economy, these problems translate into fewer people working and contributing to their country's income; thus, lower income per capita. They also result in decreased welfare levels and a lessened sense of belonging to society among many people who have had problems finding a job.

Labor policies play an important role in enabling people to embark (or re-embark) on a successful career path. In order to solve the problems described, the majority of the countries in the world have embraced policy measures focused on: i) achieving efficient and equitable labor market entry for young graduates of the educational system and adults looking for a new or better job; ii) cutting the recruitment costs of firms; and iii) ensuring that labor costs are compatible with employment generation. Moreover, in some countries, the policy response not only facilitates labor market entry for people actively seeking work, but it "activates" groups of people who have been inactive for extended periods. These groups include young people who are neither in education, nor working, nor looking for work, and mothers who have no access to day care for their children or face other obstacles to entering or reentering the labor force.

Labor policies in Latin America and the Caribbean (LAC) are designed to increase and equalize opportunities for access to formal jobs. This chapter reviews current labor policies in the region aimed at increasing quality job creation and equalizing opportunities for access to work. It begins with a review of active labor market policies (intermediation and training for labor

market entry), continues with policies to provide income support during unemployment, and concludes with a discussion on hiring and dismissal costs. The reason for including this combination of labor policies and programs is that, as noted in Chapters 2 and 3, all of them affect the creation of an employment relationship (see Diagram 4.1).

Diagram 4.1 Policies affecting the creation of formal employment



Source: Prepared by authors.

Labor intermediation policies

The purpose of labor intermediation policies is to reduce information asymmetries and equalize opportunities for access to quality jobs.

The new role of public employment services. The traditional role of labor intermediation policies (LIPs) is to connect people wishing to improve their employment situation (generally, the underemployed and unemployed) with vacancies in the productive sector (largely in private firms in the formal sector) by helping them with their job search, counseling, and assisting firms

with candidate selection. In the more developed countries, policies also include linkages to training programs, unemployment insurance, and social programs (Mazza, 2011). LIPs should also be understood as a system that includes public employment services (PES), private intermediation services (such as private job pools or temp agencies), and civil society organizations (CSO) that connect job seekers with employers (ILO, 2012b). Public employment services usually have nationwide coverage, although the offices that provide in-person assistance serve a specific geographic area (usually urban areas). There are also online services on which employers post vacancies, job seekers fill out their CV, and connections are based on the profile required. The importance of these services is growing, because Web-based employment services entail much lower service costs and reach remote areas that have no offices with in-person services. The region's private intermediation services range from large companies that operate on an international scale (for example, Manpower Inc. or Adecco) to small firms that operate locally and serve specific industries or types of organizations, such as churches, community organizations, and CSOs affiliated with international foundations (Mazza, 2011). Within the LIP system, this chapter examines public action in the delivery of public employment services. A new and significant PES role is connecting the various providers; however, who should finance public labor intermediation services is still under discussion, as is the question of whether the public sector should concentrate on the direct delivery of services or opt for subcontracting private providers and CSOs instead.

Labor intermediation services provided by PES are cost-effective. The empirical evidence, which comes mainly from developed countries, shows that labor intermediation is a cost-effective intervention for connecting workers with employers (Card, Kluve, and Weber, 2010). LIPs are also cost-effective when compared with other active labor market policies (ALMP) (Kluve, 2006). In this regard, LIPs are more effective in the following situations: i) periods and areas that generate more vacancies (Crépon et al., 2012; Flores Lima, Zamora, and Contreras, 2013b), and ii) when they have a greater focus on making connections and assisting firms, and they assign specialized personnel to work with these companies and find vacancies (Behncke, Frölich, and Lechner, 2007).¹

¹ Crépon et al. (2012) show that during recessions and in areas with fewer vacancies, a heavy focus on intermediation can have a displacement effect; that is, it can encourage firms to hire people who are served by LIPs at the expense of those who are not. The authors propose increasing unemployment insurance during recessions instead of promoting a greater search effort. However, LIPs still have a role to play in periods of sluggish economic activity, connecting and steering individuals to interventions specifically designed to mitigate the situation of low job creation during economic crises (Finn, 2011).

Specialized employment services are a very new phenomenon in the region and are utilized infrequently either by workers or by employers who need to fill vacancies. As Chapter 2 points out (see Figure 2.1), only 30% of workers searching for jobs do so through formal channels, which include public employment services. One of the reasons why the most common job search methods in the region are informal is that public employment services are still in the initial stages of development. Historically, LAC countries have invested very little in this type of service. Compared with the public expenditure on labor intermediation services in the countries comprising the Organization for Economic Cooperation and Development (OECD), the region's expenditure is very low: less than 0.04% of the gross domestic product (GDP) in each of the LAC countries (Cerutti et al., 2014) versus an average of 0.17% of the GDP in the OECD countries (OECD, 2011). Another reason why workers hardly use public employment services is that a substantial portion of the firms in the region are still not using these services. As observed in Chapter 2, Figure 2.2, LAC employers do not choose public employment services as their first option when searching for candidates to fill vacancies.

The region's public employment services generally lack the monitoring and management systems that would enable them to gauge their performance and generate information for evidence-based decision-making. Some services in the region, such as that of Brazil, collect a great deal of information about their service but do not yet have the indicators to monitor it and compare the performances of different agencies throughout the country. In LAC, the most advanced country in this respect is Mexico, which has a system of 71 performance indicators that enable it to compare the activities and results of the public employment service's labor intermediation at the state level.² Mexico has looked at the impact of its services. According to one study, unemployed Mexicans looking for work through PES find higher paying jobs than those who use other search methods, although this positive impact is seen only in men (Flores Lima, 2010).

² According to Mazza (2011), Mexico has a monitoring system in which 32 regional offices annually compete for the title of "best public employment service," which has led to and rewarded higher levels of service in the system. The system, implemented by the headquarters of Mexico's National Employment Service in the state of San Luis Potosí, has been recognized as one of the best services in operation (Kappaz and Cavallo, 2009).

First-job initiatives

The purpose of first-job initiatives is to strengthen the human capital of young people to increase their opportunities for access to the labor market and thereby reduce risks and/or costs to employers.

Young people are one of the groups at the greatest disadvantage in the labor market; they have no way to effectively transition from school to work, and they do not receive extensive, comprehensive support to increase their opportunities for labor market entry. Young people in the region share this vulnerability with their peers in other regions of the world. Their careers generally do not get off to a good start. As indicated in Chapter 1, this is reflected in the high rate of youth unemployment and the high proportion of young people who are neither in education nor working. Enabling these young people to successfully enter the labor market would represent a real opportunity for growth and social development.

Policies to help connect young people with their first job: a fragmented vision. Over the past three decades, the governments of the region have adopted a series of palliative policies to improve the youth employment situation, at least in the short term. Their implementation is usually piecemeal rather than a coherent youth employment policy aimed at correcting structural defects in the labor market while meeting short-term objectives at the same time.³ Neither are they linked with productive development policies that combine the development objectives of certain sectors or regions with lowering the barriers to young people getting these new jobs. Grouping these programs and policies more succinctly, based on the classification used by the International Labour Organization (ILO, 2015a), they can be divided into four types: i) on-the-job training programs for youth, which have generally followed the Chile Joven (Chile) or PROEMPLEO (Mexico) model; ii) training or apprenticeship contracts, which include contracts for apprentices; iii) employment subsidy programs, which include wage subsidy policies as well as policies that offer tax exemptions or contributions to social security; and iv) special employment arrangements for youth (for example, first-job laws). Table 4.1 describes the initiatives of this type in the region.

³ Moreover, these measures may have conflicting objectives. For example, employment subsidies can act as a disincentive, discouraging young people from looking for work, while support for self-employment can reduce formality.

Table 4.1 Initiatives to support workers' first jobs

| Type | Examples | General description |
|---|--|---|
| Training contracts | <ul style="list-style-type: none"> ● Apprenticeship Law (Law 10.997), Brazil (2000) ● Aprendizajes Program, Chile (2000) ● Training Contract in Law 4.951/13, Paraguay (2013) ● Types of on-the-job training for graduates and in enterprises in Law 19.133, Uruguay (2013) | <ul style="list-style-type: none"> ● Special contracts promote training for workers. They do not establish an employment relationship with the firm when workers are enrolled in a vocational training institute under an international fellowship program (IFP) or another training center. ● These contracts emphasize the educational nature of the youth's job duties. ● Some countries require firms to hire a minimum quota of apprentices (Brazil, Colombia, Paraguay), while others allow for voluntary apprenticeship contracts. ● Some recent initiatives offer wage subsidies for firms that hire apprentices (Paraguay, Uruguay). |
| On-the-job training programs | <p><i>Since the mid-1990s:</i></p> <ul style="list-style-type: none"> ● Training programs following the Joven model: classroom training and internships in firms (Argentina, Chile, Colombia, Dominican Republic, Peru, Uruguay) ● Training programs following the Scholarship Program for the Training of Unemployed Workers (PROBECAT): on-the-job training (Mexico, Honduras) <p>New initiatives:</p> <ul style="list-style-type: none"> ● Jóvenes con Más y Mejor Trabajo, Argentina (2008) ● Chile Califica, Chile (2002) ● Más Capaz (+Capaz), Chile (2014) | <ul style="list-style-type: none"> ● In general, these programs are managed by the ministries of labor. ● Programs target vulnerable youth with little or no work experience and limited job skills. ● They offer three to six months of technical training. The Joven model includes a classroom training phase provided by public and private training institutes as well as an internship phase in a firm, each for an average of three months. In the PROBECAT model, firms are responsible for training. ● Programs emphasize the role of the demand for skills in the productive sector. In the Joven model, training entities are usually responsible for establishing partnerships with firms to guarantee the implementation of internships. In the PROBECAT model, the program is responsible for linking beneficiary youth with firms. ● New initiatives focus on developing soft and life skills. They also introduce competencies associated with entrepreneurship. |
| Employment subsidy programs | <ul style="list-style-type: none"> ● National First-Job Incentive Program (PNPE), Brazil (2003) ● Primer Empleo, Mexico (2007) ● Law of Formalization and Job Creation (Law 1429), Colombia (2010) ● 40.000 Primeros Empleos, Colombia (2015) ● Youth Employment Subsidy, Chile (2009) ● Social Benefit Subsidy for Young Workers, Chile (2008) ● PROJOVEN, Panama (2015) | <ul style="list-style-type: none"> ● These promote youth employment through hiring subsidies. ● Normally, the subsidy is for firms (Brazil, Mexico, Panama), but in some cases, youth also receive them (Chile). ● Subsidies can cover part of the salary (Brazil, Chile, Panama), social security payments, or other contributions for which the firms are responsible (Chile, Colombia, Mexico). ● In some programs (Mexico's Primer Empleo and Colombia's 40.000 Primeros Empleos), the subsidy is delayed to encourage youth to remain on the job. |
| Special employment arrangements for youth | <p><i>Minimum wage regimes:</i></p> <ul style="list-style-type: none"> ● Chile, Costa Rica, Paraguay <p>Employment regimes:</p> <ul style="list-style-type: none"> ● Law 4.951/13 on youth employment, Paraguay (2013) ● Law 19.133 on the promotion of decent work among youth, Uruguay (2013) | <ul style="list-style-type: none"> ● In Paraguay and Uruguay, new legislation was enacted in 2013 to introduce special hiring practices for young workers. Specifically, formal first-job contracts were introduced. These target young people with little or no formal work experience and provide wage subsidies to encourage the hiring of young workers. ● Similar initiatives in the Dominican Republic, Nicaragua, and Peru failed due to the lack of prior consensus with social actors. |

Source: ILO (2015a).

The region still lacks apprenticeship programs like those found in many countries around the world. Effective programs of this type could foster broader, more robust labor market entry for youth in LAC. The major challenges involved in establishing this type of program in the regional context are the high levels of informality, the possibility that the programs will be used as instruments for obtaining cheap labor (ILO, 2012a), the need to guarantee enterprise involvement to ensure an adequate supply of formal vacancies for apprentices, and the obligation to ensure quality on-the-job training. In Europe and the United States, apprenticeship systems smooth the transition to the first job (Clark and Fahr, 2002; Reed et al., 2012; Lerman, 2013), but they are based on institutional systems still lacking in LAC; they are also a part of a continuing education system. As will be seen further on in Chapter 6, several countries in the region have embraced apprenticeship contracts and other similar initiatives. However, they tend to use them as employment subsidies rather than on-the-job training tools for placing workers in quality jobs.

Among these measures to support young people, short-term training programs have proven to be modestly (but persistently) effective in terms of the quality of the jobs found. The measures most frequently adopted by the countries of the region to tackle youth employment problems include programs in urban areas that offer short-term training and a mechanism for connecting young people with the labor market. These programs combine services to increase the human capital of the beneficiaries (for example, cognitive and socioemotional skills and work experience) and lower the cost of the job search for this population. They also offer tools for demand-based training; that is, they respond to the needs of the productive sector.

Current evidence regarding the impact of these programs in the region suggests that they yield positive (although modest) results, especially with respect to the quality of the employment found (in terms of formality and income). The achievements have proven to be greater in urban areas, where more opportunities for formal employment are created (González-Velosa, Ripani, and Rosas, 2012). One study on the long-term effects of this type of program (Ibarrarán, Ripani, and Rosas Shady, 2015) showed that the impact on the quality of the job found persisted, even six years after the intervention. These programs also tend to have “unexpected” impacts (see Box 4.1).

Some reasons for the successes, albeit modest, of on-the-job training programs for youth, and room for improvement. The encouraging findings regarding the impact of the programs implemented in the region may reveal that many of them have incorporated certain elements considered success-

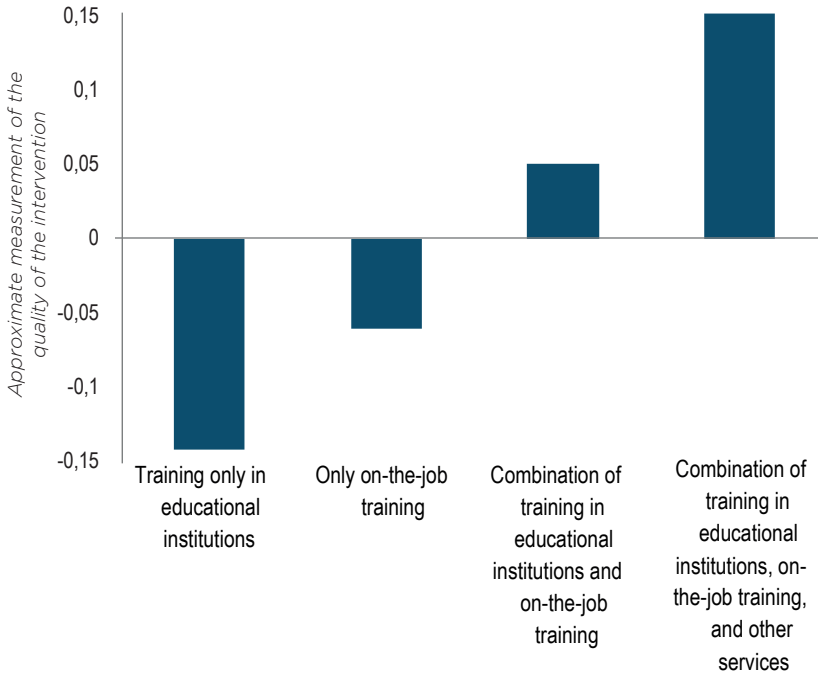
Box 4.1 “Unexpected” impacts of on-the-job training programs

The main objective of on-the-job training programs is to increase the probability of unemployed people finding a formal job and raising their productivity and income by acquiring the experience and skills valued in the labor market. Assessments of these programs' impacts have therefore concentrated on measuring their effect on job performance with variables such as labor market entry, tenure, wages, benefits, working hours, etc. It has been shown, however, that in addition to their impact on these variables, on-the-job training programs have positive externalities (for example, lower adolescent pregnancy rates; less drug, alcohol, and cigarette use; and less involvement in crime and violence).

Various estimates have quantified these impacts on both the region and in the rest of the world. A recent study in the United States found that on-the-job training and mentoring programs for at-risk youth had reduced the violent crime rate by 43% (Heller, 2014). The analysis also revealed that the impact of the intervention increased with the passage of time, so that 16 months out, it was seven times greater than it was right after the program ended. Likewise, assessments of the impact of disadvantaged youth participation in other programs with on-the-job training components in the United States, such as Jobstart, the Service and Conservation Corps, and the National Job Corps, indicate that they have contributed to a reduction in drug abuse, arrest and conviction rates, and the length of incarceration, respectively (Cave et al., 1993; Jastrzab et al., 1996; Schochet, Burhardt, and McConnell, 2008). Schochet, Burhardt, and McConnell (2008), for example, found that the National Job Corps (through which youth receive i) individualized vocational training, based on an assessment of their skills and interests, and ii) support for job placement) had helped lower detention and conviction rates and shorten detention periods for the participants.

In LAC, the Dominican Republic's Youth and Employment (Juventud y Empleo) on-the-job training program (which targets vulnerable youth and includes training in socioemotional skills) has reduced the probability of adolescent pregnancy by 20%, especially among adolescents who are not yet mothers (Novella and Ripani, 2015). This result is attributed to the fact that the program raises young women's job expectations and, therefore, the opportunity cost of having children.

Given these promising effects, it is important for on-the-job training programs to consider not only their impact on the job performance of their target populations, but these “unexpected” impacts, which are often the consequences of including modules that support the development of socioemotional skills.

Figure 4.1 Effects of combining on-the-job training with classroom training

Source: Fares and Puerto (2009).

Note: The vertical axis of the figure shows an approximate measurement of the quality of the intervention, because the program has an impact on employment outcomes and is cost-effective.

ful by specialized publications. Such elements include i) a demand-based approach; ii) the participation of private sector providers; iii) a solid labor intermediation component; iv) a heavy emphasis on on-the-job training; v) a concern for ensuring the quality of the training, both in the classroom and on the job (for example, through periodic accreditation of the training institutions or instructors from the firm and/or through the monitoring of program graduates' performances in the labor market; vi) the inclusion of modules for the development of socioemotional skills, such as self-esteem, perseverance, self-control, motivation, responsibility, and commitment; and vii) the integration of training programs for vulnerable groups in the continuing education system (González-Velosa, Ripani, and Rosas, 2012; Urzúa and Puentes, 2010). While the cost of these programs per beneficiary is low, and the cost-benefit ratio in many cases has been positive (Card et al., 2011), the returns are still relatively meager, indicating the need to further refine these programs to achieve better results. As Figure 4.1 shows, active labor market policies that emphasize intermediation (or some type of connection

with a private sector firm in the form of on-the-job training) are more effective in promoting labor market entry than those that emphasize only classroom training, which suggests that information failures are as important as skill gaps (Fares and Puerto, 2009).

Youth employment subsidy programs. Some countries in the region have opted to offer youth employment subsidies, which promote labor market entry for young people through hiring subsidies. The most common mechanism consists of giving this subsidy directly to the firm (through direct support that covers part of the young person's wages in the business or lowers the firm's contributions to the social security system). Other countries, in contrast, have opted to grant the subsidy to the young worker (see Box 4.2).

Box 4.2 Youth employment subsidies in Chile

Youth employment subsidies in Chile (Law 20.338 of 2009) are a benefit that the state provides to young workers (salaried and self-employed) in situations of vulnerability and to their employers. Young workers receive two-thirds of the benefit, and employers receive one-third. To be eligible for the benefit, workers must be 18 to 25 years of age, from a family in the poorest 40% of the population, and earn less than \$360,000 CLP. The purpose of this instrument is to reduce youth unemployment, supporting the most vulnerable individuals by promoting the formal hiring of young workers. According to a University of Chile study (2012), in its first two years of execution, 2009 and 2010, the program covered 4.6% and 4.8%, respectively, of the eligible population, based on the scoring criteria of the Social Protection Scorecard and age. Furthermore, the number of beneficiaries as a proportion of the total eligible youth (based on age and the score on the Social Protection Scorecard) who were formally employed in the income brackets was 21.2% in 2009 and 21.3% in 2010. Enterprise participation in the program was low: around 3.75%. The majority of the firms that took advantage of the subsidy were microenterprises (44%). The quasi-experimental impact evaluation conducted by the University of Chile indicates that this program had significant positive effects in terms of increasing the likelihood of young people (both men and women) getting a job and participating in the labor market. Among participating firms, the study showed a slight substitution effect favoring eligible young workers over other groups.

Source: Prepared by the University of Chile (2012).

First-job laws are another option adopted by the countries of the region to increase youth employment opportunities. Several countries in LAC have enacted such laws, which are policy instruments designed to encourage businesses to hire more young workers. In this sense, these programs are similar to youth employment subsidy programs, except that they take the form of laws. They include an incentive system, whereby, in general, the firm commits to hiring young workers and, in exchange, it receives some exemption or benefit that reduces its labor costs. The objective of this type of policy, which in the majority of cases is broadly applied in the legislative setting, is to reduce youth unemployment, facilitate the school-to-work transition, and help young people who have recently completed their formal education access the labor market more quickly and, specifically, find a good job (in a firm in the formal sector).⁴ One example of these laws in the region is Brazil's Apprenticeship Law, which grants tax exemptions to firms that hire and train youth, generally for their first work experience. According to Corseuil, Foguel, and Gonzaga (2014), this law increases the probability of having a comparatively better paying and more stable job, especially in the medium term (four to five years after participating in the program).

Seriously lacking in the region are policies to provide vocational counseling services. These services provide young people with information and guidance about options and returns in the labor market, enabling them to make better decisions about what occupation to choose. This type of policy can produce highly positive results at a minimum cost. Vocational decisions are often made with little information; this can lead to less-than-optimal choices, such as the selection of a career path or occupation with low returns or false expectations and costs associated with repeated studies or low graduation levels. The preliminary results of some studies suggest that interventions aimed at informing young people and their families about the returns of different educational options (for example, technical versus general education or what branch of technical education to choose) that offer vocational counseling and information about wages and employment rates in different occupations to promote better decision-making can be cost-effective (Jensen, 2010; Goux, Gurgand, and Maurin, 2013; Hastings, Neilson, and Zimmerman, 2015).

⁴ Current initiatives of this type in LAC have the following characteristics: i) they target young people aged 16 to 24 who have recently completed their academic education or vocational training, have no professional experience, and are looking for a job; ii) the state provides a tax or monetary benefit to the firm, which translates into tax exemptions, discounts on social security payments, or wage subsidies; and iii) first-employment contracts are short-term (a minimum of three months and a maximum of 12 months), and once ended, the employer can rehire the young worker under a conventional hiring modality, bringing the first job and its associated benefits to an end. The temporary nature of the jobs created by the law therefore becomes a challenge.

Training adults for entry or reentry in the labor market: beyond the first job

The objective of policies to help the unemployed, especially vulnerable groups, enter the labor market is to upgrade their skills to increase their employability and thereby lower the risks and/or costs to employers.

The mechanisms for helping the unemployed effectively return to work are inadequate. In most cases, workers who are separated from their firms, whether voluntarily or involuntarily, receive no institutional support for their job search and/or placement in a new job. The expenditure on active labor market policies (which include both labor intermediation services and training programs for labor market reentry) is low (see Figure 4.2), and the implementation of training programs for the unemployed in the region has room for improvement. Workers' inability to upgrade their skills so that they can find a new job leaves them unprotected against unemployment. While businesses and many national training institutes (NTI) in the region concentrate on training people who are already employed (with some exceptions),⁵ it is the ministries of labor who are generally responsible for offering short-term job training programs for people who are unemployed or searching for better work opportunities. The services provided by the ministries of labor frequently have little coverage and target a specific segment of the unemployed, such as youth. Some ministries of labor also provide training for other groups with specific vulnerabilities in the labor market.⁶

Programs to support the entry or reentry of vulnerable people into the labor market. In addition to youth, who have already been discussed in this chapter, there are other vulnerable groups in the labor market (for example, women who have not held a job for a long time, people with little education or low income—who, in some cases are the beneficiaries of social protection programs such as conditional cash transfers—older persons, people with disabilities, ex-convicts seeking to return to the world of work, and/or people who, because they live in

⁵ For example, the Salvadoran Vocational Training Institute (El Salvador) allocates 50% of its investment in training to the instruction of formal workers employed in firms and the other 50% to training more vulnerable people in the labor market who are not working in the formal sector. Another example of this type of institution is the recently created Bahamas National Training Agency, which allocates its resources to training young people disconnected from the world of work who have little or no work experience to help them improve their prospects for entering the labor market.

⁶ Chapter 5 describes the policies for lifelong learning, which include the support provided by national training institutes (NTI) for this type of policy. This section of the present chapter discusses only training policies for the labor market entry or reentry of adults.

areas with a high incidence of violence or because of their gender, race, ethnicity, or other personal characteristics, are victims of employment discrimination; see Box 4.3).

Figure 4.2 Public expenditures on active labor market policies, 2010 (as a percentage of GDP)



Source: Prepared by the authors, based on statistics from OECD (2015a) and Cerutti et al (2014).

Box 4.3 Ethnic, racial, and gender gaps in the Brazilian job market

Brazil has an unemployment rate very close to the regional average. Notwithstanding, due to gender and racial asymmetries, some segments of the population have unemployment rates similar to those of Guatemala (the LAC country with the lowest unemployment rate), while others have rates similar to those of the countries with the highest unemployment in the regional ranking.

The data for Brazil show that the unemployment rates for white women (4.5%) and Afro-descendants (7.1%) are 1.3 and 1.5 times higher than the rates for white and Afro-descendant men (3.4% and 4.3%, respectively), making the gender gap among Afro-descendants the widest. The situation is even worse when the characteristic of youth is added: young white and Afro-descendant women have unemployment rates of 13.7% and 16.5%, respectively. In the case of underemployment due to insufficient hours worked, the ethnic/racial gaps are slightly wider than the gender gaps. The eth-

nic/racial gap in real monthly income is similar. Finally, the labor turnover indicator (the percentage of current workers replaced per month) indicates that Afro-descendant men are at a significant disadvantage with respect to other segments of the labor force. These indicators are generally evidence of persistent ethnic/racial and gender gaps in the Brazilian job market, where women and Afro-descendants are commonly among the groups at the greatest disadvantage.

Table 4.3.1 Labor force aged 15-64 in six major Brazilian metropolitan areas, October 2014 (by sex and selected ethnic-racial groups)

| | Employment rate | Unemployment rate (from 17 to 24 years) | Long-term unemployment rate | Underemployment rate | Average actual performance (US dollars) | Average actual performance (secondary education) (US dollars) | Rotation rate |
|---------------------------|-----------------|---|-----------------------------|----------------------|---|---|---------------|
| White and Asian | 3.9 | 10.9 | 18.2 | 7.1 | 964.13 | 1,146.20 | 33 |
| Men | 3.4 | 8.4 | 18 | 5.2 | 1,097.40 | 1,326.52 | 34.1 |
| Women | 4.5 | 13.7 | 18.2 | 9.1 | 814.76 | 959.57 | 31.5 |
| African descendant | 5.6 | 13 | 19 | 15.1 | 570.97 | 668.49 | 43.6 |
| Men | 4.3 | 10.1 | 20.3 | 11.8 | 634.34 | 768.99 | 47.7 |
| Women | 7.1 | 16.5 | 18 | 19.1 | 470.40 | 561.40 | 34.8 |
| PEA TOTAL | 4.7 | 12 | 19.2 | 10.7 | 785.95 | 962.44 | 38.2 |

Main sources: IDB (2015b), the Monthly Employment Survey (PME) of the Brazilian Geography and Statistics Institute (IBGE), and the General Registry of Employed and Unemployed People (CAGED) of the Ministry of Labor and Employment (MTE)
 Notes: a) Open employment rate (as a percentage of total labor force); b) Open employment rate for the 17–24 age group (as a percentage of total labor force); c) Unemployed labor force that has been searching for a job for at least 12 months and has not worked during this period; d) Rate of underemployment due to insufficient hours worked—that is, employed labor force that was available to work more hours than it actually did (as a percentage of employed labor force); e) Average reals received per month. The real-to-U.S. dollar conversion used an exchange rate of 2.7; f) Turnover rate in jobs with a formal contract—that is, the percentage of existing workers replaced monthly; g) The six major metropolitan areas are Recife, Salvador, Belo Horizonte, Rio, San Pablo, and Porto Alegre; h) Afro-descendants = blacks and mestizos; i) Total labor force includes the categories of “indigenous” and “race unknown.”

Little is currently known about how to increase the ability of the poorest adults with low human and physical capital to enter the labor market and boost their earning capacity (Almeida, Behrman, and Robalino, 2012). Specialized publications focusing on the impact of training programs on the unemployed or vulnerable workers outside the region have indicated that such programs have a greater

impact on adults and women than on youth; however, such publications have also indicated that there are significant differences among regions (Dar and Tzannatos, 1999; Betcherman, Olivas, and Dar, 2004; Kluve, 2006; Card, Kluve, and Weber, 2015). As mentioned earlier, many governments in LAC have adopted specific labor intermediation or job training policies for vulnerable groups (with measures that tend to be more intensive), employment subsidy policies for hiring particular groups (many of them targeting youth), and policies to support employment creation for the self-employed. Concerning the evidence on the impact of subsidy assessments (Galasso, Ravallion, and Salvia, 2001; PD&R, 2004; Grosh et al., 2012; Centro de Microdatos, 2012), it indicates that subsidies can be effective in increasing the employment rate among beneficiaries, but for the effect to be permanent, the price of the target group's work must steadily increase. In addition, there is evidence that programs fostering self-employment may increase the probability of employment and labor market entry for highly vulnerable people who were unemployed or inactive prior to the intervention. Notwithstanding, up to now, the assessments suggest that this type of intervention is fairly ineffective in achieving greater profitability and/or income for people who are already owners of a microenterprise (de Mel, McKenzie, and Woodruff, 2012; Martínez, Puentes, and Ruiz-Tagle, 2013). It is important to continue investing in impact and cost-effectiveness assessments of interventions in this and other areas of labor policy (see Box 4.4). A promising but still emerging approach is to promote a new generation of conditional cash transfers that provide support mechanisms and promote the stable entry of their beneficiaries into the labor market (see Box 4.5).

Various countries in the region and around the world promote training programs in entrepreneurship as a means of entering the labor market. However, the current evidence suggests that these programs are still not a way to help put youth and women onto successful paths (Valerio, Parton, and Robb, 2014). There has been a growing trend among the governments of LAC and other parts of the world to offer entrepreneurship and microcredit programs that target specific groups such as women and youth. These programs are very much in demand, because they appear to provide an immediate employment solution. However, their effectiveness in terms of the duration of self-employment and its benefits has not yet been rigorously assessed.⁷ Self-employment can be an attractive alternative for women due to its flexibility, which enables them to balance household responsibilities with the time devoted to work. However, in the case of training for female microentrepreneurs in Peru, Karlan, and Valdivia (2010) found that these initiatives had little impact on results such as profits, benefits,

⁷ The term "microenterprise" is associated with the initiatives of people who, without the need for substantial resources, start projects that turn into businesses and generate employment, often of a local nature (Jaramillo, 2004).

Box 4.4 Why conduct impact evaluations?

Most social and employment programs are designed with the genuine intention of improving the living conditions of their beneficiaries. Unfortunately, however, this is easier said than done. That is why impact evaluations are necessary. These evaluations determine whether or not a program is working well and, in the broadest sense, help policymakers know why and how effective it is.

A core concept in impact evaluation is attribution or causality, because it makes it possible to determine whether a change in the indicator of interest is due to the intervention or to something else. Even if the expected results are being obtained, it is important to know whether or not this is due to the intervention. From a conceptual standpoint, the idea is to create a counterfactual—that is, to determine what would have happened without the program. The “with the program” scenario is compared to the “without the program” scenario, where all relevant dimensions for explaining the results (observable and unobservable) are equal.

An impact evaluation also makes it possible to identify aspects of the program that can be improved and can lead to a review of the diagnosis and project design to foster a more efficient use of the resources allocated to the programs.

or employment, although some improvement in business knowledge has been observed. For youth with no experience in the labor market, this type of program and support may pose a high risk, since many young people (especially the most vulnerable) have had no practical experience with financial management or business and, moreover, lack the seed capital needed to launch a business venture.⁸ According to Cho and Honorati (2013), these programs for youth have had a significant positive impact in the developing countries due to the increased business knowledge and skills they have fostered; however, they do not lead immediately to the creation or expansion of a microenterprise or higher profits. Thus, this type of program should only be promoted in the region if it is accompanied by a better climate for innovation and business ventures. Right now, there are many microenterprises in LAC, but their productivity is low (Lederman et al., 2014). This should be the premise to follow; otherwise, the situation in terms of quality employment may worsen with the promotion of unproductive jobs.

⁸ Young entrepreneurs can be divided into two groups: i) those who are “entrepreneurs by necessity” because they have not encountered options for formal employment or because they choose to continue their education, and ii) “entrepreneurs by vocation,” who take advantage of any opportunity to do business (Llisterri et al., 2006).

Box 4.5 Jamaica's Steps to Work program

Conditional Cash Transfer programs (CCTs) in LAC have been an important public policy tool for combating intergenerational poverty and developing the human capital of new generations. Studies to assess the impact of these programs have suggested that in the majority of the countries, the incidence of poverty would be 13% higher had they not been implemented. A more detailed analysis with household data, however, indicates that their beneficiaries remain poor and vulnerable, and their employment situation unstable. Therefore, to heighten the potentially positive impact of these programs in terms of breaking the cycle of poverty among vulnerable people in the long term, a new generation of CCTs must be designed that offers mechanisms to support and promote stable labor market entry for their beneficiaries.

Some countries in the region have ventured into the design of programs that provide services to supplement the cash transfers aimed at supporting transition to the labor markets; these services have largely involved both civil society organizations working in related areas and the private sector. Steps to Work (STW) is part of a comprehensive strategy of the Programme of Advancement through Health and Education (PATH), Jamaica's CCT. Through the STW, the Jamaican government has launched an initiative to help working-age people (ages 15–64) from PATH beneficiary households enter the labor market. STW operates primarily as a referral program. Candidates are referred to specialized service providers selected by the Ministry of Labor and Social Security (MLSS) that provide remedial and vocational education, training in job skills, workshops on how to search for a job, and microenterprise programs, for which the MLSS, in conjunction with the Business Development Corporation, has awarded start-up grants of up to JM\$100,000 to a total of 5,000 recipients. The program also includes a component to return young secondary school dropouts aged 15 to 17 (from PATH beneficiary households) to the educational system through summer camps that offer basic education, behavior modification, and vocational education courses. Data from the Planning Institute of Jamaica indicate that 82% of the 512 students who attended the camps have gone back to school. STW is currently developing a pilot training model that will enable PATH beneficiaries to enter the labor market through firms in different sectors and make it possible to measure results in terms of their employment levels.

Policies for income support during unemployment

The purpose of income support policies for the unemployed is to smooth consumption and facilitate a better job search and good reentry into the labor market.

Income from work is the most valuable asset of poor people and the middle class worldwide, and it must be protected. In LAC, 79% of household income is derived from work, a figure that ranges from 64% in Nicaragua to 90% in Paraguay (IDB, 2015b).⁹ There will always be people who lose their job. It is unavoidable, and as Chapter 2 notes, losing a job is one of the most traumatic experiences in a person's life as well as one of the greatest concerns of workers in the region. Unemployment leads to a short-term loss of income that may have long-term consequences. To mitigate this loss, policies are needed to smooth the consumption of workers and their families (Jacobson, Lalonde, and Sullivan, 1993; Gruber, 1997) and provide instruments that facilitate a more effective job search. At the macroeconomic level, income support for the unemployed is key to containing the drop in demand during crises (ILO, 2013).

Severance pay, unemployment insurance, and temporary employment programs can play key roles in getting the unemployed back to work. Having an income can enable workers to devote more time to looking for a “good job” instead of having to accept the first offer that comes along. It can even enable program beneficiaries to enroll in a training program, since the opportunity cost of working is covered by the income support programs.¹⁰ Some temporary employment programs in the region have therefore included a job training component in addition to a cash transfer, so that once the crisis is over, people have more tools at their disposal to find a new job. Although these programs are a good instrument for smoothing consumption, current evidence shows that they have not increased workers' probability of finding a new job or the wages in a new job. Severance pay, unemployment insurance, and temporary employment programs are mechanisms that are usually studied and reviewed separately; however, a good design for protection against unemployment requires that they be considered jointly and comprehensively (Blanchard and Tirole, 2008).

⁹ Just a decade ago, these percentages were even higher for the poorest quintiles of the population. However, with the creation of social welfare programs, especially conditional cash transfers, and the expansion of their coverage, this is no longer the case. Income from work in the region accounts, on average, for 64% of the total income of the 20% poorest households.

¹⁰ Alternatively, these programs can adversely affect the length of unemployment if beneficiaries wait until the subsidy runs out to begin their job search. The evidence in this regard will be analyzed in the next section.

While there are various instruments in the region for providing income to workers who lose their job, the majority of them target a small and select group: formal salaried workers. In fact, in several LAC countries, formal workers have a menu of options, including severance pay and unemployment insurance with and without individual savings accounts. There is no such mechanism for other workers. In recessions or periods of sluggish growth, some countries resort to temporary employment or public works programs, basically for people with very low qualifications or none at all. There are still workers who receive no financial support during unemployment (Table A4.1 in the annex to this chapter summarizes the instruments in each country).

Severance pay

Severance pay is the oldest form of social protection. In the developed countries, it was introduced in most cases before old-age pension and unemployment insurance schemes (Holzmann et al., 2011). Severance pay (SP) may be i) compulsory, generally provided for in the Labor Code; ii) instituted through collective agreements at the national or sector level; or iii) voluntary, if firms decide to issue these payments. How much severance pay workers receive depends on their years on the job and final salary, and it usually involves a consolidation period—that is, a minimum number of months worked is required for eligibility. It is customary to pay workers a proportion of their salary for each year of service (for example, one month's salary for each year of service). How severance pay is financed has a real impact on employer and employee incentives and even on their confidence in the instrument. There are four major types of financing: i) internal, without prior savings, using the firm's current account flows at the time of separation; ii) internal, using the firm's reserves, with the payment either partially or fully tax exempt; iii) external, through individual accounts managed by a financial institution (an insurance company, commercial bank, or specialized institution); and iv) external and centralized, generally administered by the government. In some countries, the state provides financial assistance, especially for large-scale restructuring operations that imply reductions in personnel with mass layoffs.

Severance pay is a useful mechanism for smoothing consumption during periods of unemployment (Maclsaac and Rama, 2001; Kugler, 2002). However, its purpose is not only to smooth consumption, but to serve as a mechanism for job protection (raising the cost to the firm for dismissing a worker) and human resource management (as a way of retaining workers with specific skills through a lower current salary with the promise of higher compensation at the end of the employment relationship; Holzmann et al., 2011). The literature

therefore suggests exploring the implications of severance pay in a wider context. Here it indicates that as states improve their management and administrative capacities, countries could consider creating unemployment insurance while simultaneously reviewing their current legislation on severance pay.¹¹

Severance pay is the most common instrument in LAC for protecting workers' income against unemployment. Compulsory systems predominate in the region, but collective agreements are found in three countries: Argentina, Chile, and the Dominican Republic (Holzmann et al., 2011). Furthermore, the prevailing method of financing is internal without prior savings—that is, payment with the firm's current account flows at the time of separation.

Financing severance pay with current account flows can be a challenge for smaller employers, even in good times, and poses a threat that workers will not be paid in the event of insolvency in firms of any size. In countries with weak legal frameworks, employers—even solvent ones—often fail to comply with the law, making these potentially generous benefits irrelevant. Only Colombia and Chile have created special guarantee funds to mitigate the risks of insolvency and illiquidity (Holzmann et al., 2011).

In practice, many workers who are eligible in principle do not receive severance pay, which reduces its effectiveness as an instrument for protecting income during unemployment. Even though the benefits are compulsory, many workers do not receive them. In Argentina, only 32.4% of workers with the right to severance pay receive it (González-Rozada, Ronconi, and Ruffo, 2011). In Mexico, a mere 20% of workers receive the funds immediately, while 39% receive nothing. Moreover, there is a high cost to securing the payment: 30% of the severance pay ends up going to legal fees. The expected value of severance pay is, on average, 35% of the amount mandated by law (de Buen, Bosch, and Kaplan, 2012). In Peru, only 50% of eligible workers receive severance pay on dismissal (Maclsaac and Rama, 2000).

Unemployment benefits

There are at least three types of unemployment benefits: individual unemployment savings accounts, unemployment insurance, and social assistance for unemployment or an unemployment subsidy. These instruments basically differ in their source of financing and in their eligibility criteria.

¹¹ In this context, Article 22 of C168, Employment Promotion and Protection against Unemployment Convention (ILO, 1988), provides for changes in severance pay when the worker is covered by unemployment insurance, and vice versa.

Unemployment insurance savings accounts

Unemployment Insurance Savings Accounts (UISA) are a mechanism whereby the employer and employee contribute to a specific account whose balance belongs to the employee, to be used in periods of unemployment—generally, regardless of whether the separation was voluntary or involuntary. There are several types of UISA programs: i) the pure type, in which withdrawals are limited strictly to the balance in the UISA—this type is identical to a prefinanced program of severance pay; ii) a UISA with a debt option in which people can request a loan that exceeds their balance in the UISA (within present limits); and iii) the UISA Fund with a solidarity pillar, from which people whose savings have run out receive payments from the Solidarity Fund (for a description of the Chilean system, introduced in 2002 and reformed in 2009, see Huneus, Leiva, and Micco, 2012). The two latter programs combine self-insurance with public insurance.

Some countries in the region have created UISAs. These instruments were introduced at different times. They first appeared in the 1970s in Argentina and Panama (in the former, they were only for construction workers). In the 1990s, they arrived in Brazil, Colombia, Peru, and Venezuela, and at the beginning of the 21st century, in Chile and Ecuador (Ferrer and Riddell, 2011). UISA operations are simple and transparent. Employers regularly deposit a legally established fraction of each worker's earnings in an individual savings account. In Chile, workers must also make regular contributions to their account. On separation—the reason for the separation is not considered in most countries—workers can withdraw from the account as they see fit (some programs allow access to the funds before separation for reasons of health, education, or housing). In Brazil, workers may access their accounts only in cases of involuntary separation, and employers must pay the worker an additional 40% of the balance in the account. In all the countries, positive balances are added to the old-age pensions.

Unemployment insurance

Unemployment insurance (UI), in contrast, has an insurance component. Both employee and employer contribute to a general fund, and based on certain eligibility criteria (notably a minimum of contributions in the period prior to unemployment), the employee has the right to a certain benefit for a certain length of time. The benefits are not linked directly to the contributions; thus, UI is an instrument with defined benefits, while a UISA is a mechanism with

a defined contribution. Both are contributory, and eligibility in the countries of the region is based on formal employment.

There are several differences between unemployment insurance and severance pay:

i) First, while unemployment insurance tends to be administered by the public sector, severance pay is a transfer handled by the private sector, but by public mandate. There are very few registries that can be used to verify whether or not this operation actually takes place, making it very hard to estimate its coverage.

ii) Second, while most types of unemployment insurance are prefinanced with the combined contributions of firms, workers, and governments, severance pay is not. This means that if the severance pay must be disbursed at a difficult time for the business, it often is not, and firms leave it to the courts to resolve the issue.

iii) In the event of unemployment, the unemployment insurance benefit is usually paid monthly for a given period; severance pay, in contrast, is a one-time payment.

Some LAC countries have traditional unemployment insurance to cushion the loss of income due to unemployment. These mechanisms are found in the higher-income economies of the region, which include Argentina, Bahamas, Barbados, Brazil, Chile, and Uruguay as well as Colombia and Venezuela. With the exception of Chile, these programs are executed separately from UISAs or severance pay, which means that in certain countries, such as Brazil, workers who are involuntarily unemployed can receive benefits from three different systems. The contributions vary, but fluctuate around 1.5% of the paycheck (for example, in Argentina, payment is made only by employers; in Barbados, employers and employees contribute the same amount; and in Chile, in addition to their contributions to the UISAs, employers pay 0.8% toward a UI system called the Solidarity Fund).

UISA benefits in LAC tend to be of relatively short duration compared with those in the majority of OECD countries. In the region, program coverage ranges from up to 13 weeks in the Bahamas to up to 12 months in Argentina (when the worker has made payments for more than 36 months), with six months being the most common maximum coverage (Barbados, Colombia, and Uruguay). In Argentina and Uruguay, workers over the age of 45 and

50, respectively, may receive benefits for longer periods if they have made sufficient contributions prior to unemployment.

The minimum contribution density for UI eligibility varies from country to country; but in every case, the design of UI systems is tailored to the situation observed in reality: high turnover, with short periods of formal employment (see Chapter 2). For example, Argentina and Brazil require six months of contributions in the previous 36 months, while Uruguay requires six contributions in the previous 12 months (see Table 4.2).

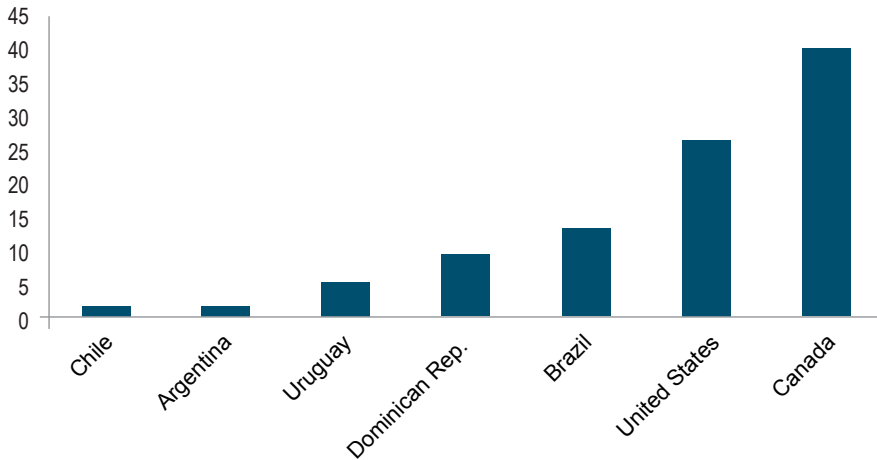
The reality in the region is that during unemployment, very few workers receive unemployment insurance benefits. As noted in Chapter 2, many of the newly unemployed (around two-thirds) have held informal jobs and therefore have no right to severance pay or unemployment insurance benefits—if they exist in the country. Even where unemployment insurance does exist, the coverage is very low (see Figure 4.3). In Brazil, the country with the highest coverage in the region, just 13% of the unemployed are receiving unemployment insurance benefits, compared with 26% in the United States and 40% in Canada. There are those who argue that informal jobs serve as “unemployment insurance,” since there is an inverse relationship in the region between unemployment rates and informality; this can be seen at the static level, but it does not appear to hold true at the dynamic level (see Box 4.6). Unemployment insurance in the region meets one of its most important objectives: smoothing the consumption of workers who lose their job. However, it may have a negative impact on the length of unemployment, the probability of remaining unemployed, and the wage upon reemployment. A series of studies financed by the Inter-American Development Bank explored these aspects in Argentina (González-Rozada, Ronconi, and Ruffo, 2011), Chile (Huneus, Leiva, and Micco, 2012), Colombia (Medina, Núñez, and Tamayo, 2013), and Uruguay (Amarante, Arim, and Dean, 2013). Gerard and Gonzaga (2013) also conducted a similar study for Brazil. In short, it has been observed that instruments to support income during unemployment produce positive results in terms of smoothing consumption but do not improve the conditions of reemployment. Moreover, the design of these instruments (length of benefits, mode of payment, etc.) can have undesirable effects on the length of unemployment and the likelihood of finding a formal job.

Table 4.2 Minimum contributions to be eligible for unemployment insurance

| | |
|------------------|--|
| Argentina | <ol style="list-style-type: none"> 1. The minimum contribution is six months during the three years prior to unemployment; for temporary workers, it is 90 days of contributions in the 12 months prior to unemployment. The law allows extended benefits to unemployed workers with a higher density of contributions. |
| Bahamas | <ol style="list-style-type: none"> 1. Complete a total of at least 52 weeks of paid contributions. 2. Have 13 weeks of contributions credited or paid in the 26 weeks prior to the start of unemployment. 3. Have seven weeks of contributions credited or paid in the 13 weeks prior to the start of unemployment. |
| Barbados | <ol style="list-style-type: none"> 1. Complete a total of at least 52 weeks of contributions. 2. Have at least seven weeks of contributions paid or credited in the next-to-last quarter prior to the start of unemployment. 3. Have at least 20 weeks of contributions paid or credited in the three consecutive quarters ending in the next-to-last quarter prior to the start of unemployment. |
| Brazil | <ol style="list-style-type: none"> 1. Must have worked at least six of the past 36 months. |
| Chile | <ol style="list-style-type: none"> 1. Have 12 payments registered in the Unemployment Solidarity Fund (FCS) in the 24 months prior to dismissal. 2. Of these payments, the last three must be continuous and with the same employer. 3. Monthly visits to the Municipal Labor Intermediation Office (OMIL) while receiving the benefit. |
| Colombia | <ol style="list-style-type: none"> 1. Be registered with the Family Welfare Funds in the three years prior to the start of unemployment (at least 24 months for self-employed workers) and must have contributed continuously or discontinuously for 12 months. |
| Ecuador | <ol style="list-style-type: none"> 1. Complete at least 24 months of contributions. 2. Complete at least two months of unemployment. |
| Uruguay | <ol style="list-style-type: none"> 1. Complete at least six months of work in the 12 months prior to unemployment. 2. Workers that have made discontinuous payments must have worked for at least six months and earned at least 15,588 Uruguayan pesos in the six months prior to unemployment. |
| Venezuela | <ol style="list-style-type: none"> 1. Complete at least 12 months of contributions in the 24 months prior to unemployment. |

Sources: Social Security Administration (2013) and AFC Chile (2015)

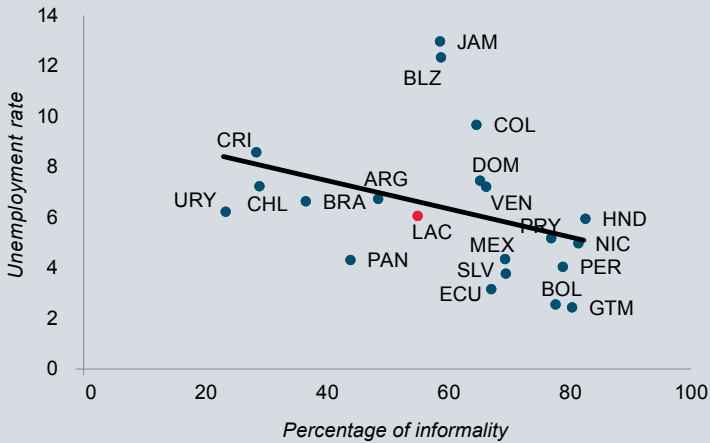
Figure 4.3 Percentage of workers who receive unemployment insurance benefits out of the total number of unemployed in selected countries, 2013



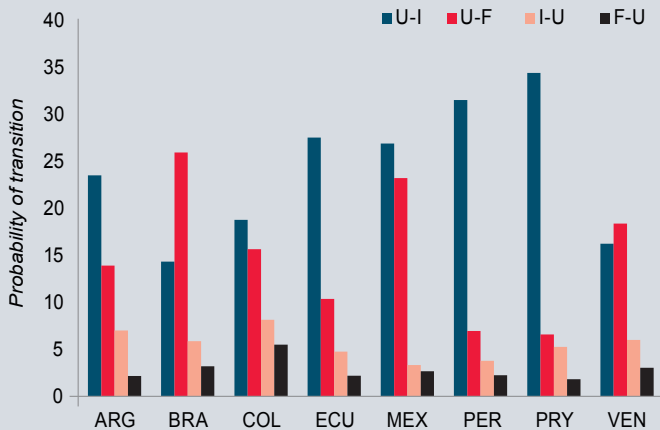
Source: Prepared by authors, based on household surveys and ILO (2015b).

Box 4.6. Informality as unemployment insurance

It is often argued that informality serves as protection against unemployment, but this is not necessarily true. A comparison of unemployment and informality rates in the countries of the region reveals a clearly inverse relationship between the two rates (see Figure 4.6.1). Countries such as Chile, Costa Rica, and Uruguay have informality rates under 20% but unemployment rates that are relatively higher than the regional average (7%), while countries such as Bolivia, Honduras, and Paraguay have informality rates over 60% with unemployment rates lower than the regional average. This supports the idea that informal employment serves as “unemployment insurance.” Income from work is a major component of household income in LAC (79%). When faced with the loss of a job, liquidity constraints, and the absence of unemployment protection policies, workers are forced to accept informal jobs.

Figure 4.6.1 Unemployment and informality

Source: IDB (2015b)

Figure 4.6.2 Transitions from and to unemployment and informality

Source: Prepared by authors, based on panel data.

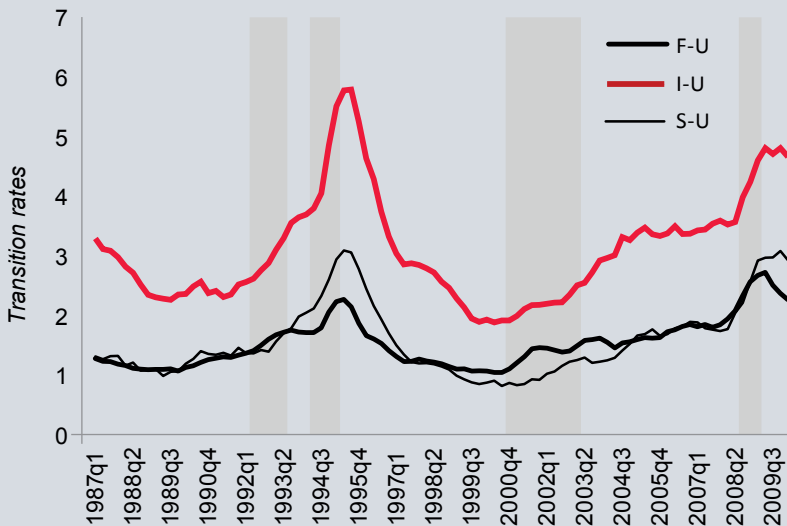
Notes: U = unemployment, I = informal employment, F = formal employment. Transitions: Argentina, semi-annually; Paraguay, quarterly; Peru, annually. For information on the construction of longitudinal data, see Table A.1 in the appendix on data sources.

However, this picture does not tell the whole story. In countries with panel data—that is, data that follow the same people at different points in time—these data paint a very different picture. On the one hand, an informal worker is twice as likely to become unemployed than a formal worker. This has been observed, for example, in the case of Argentina (2.3 times), Paraguay (2 times), and Peru (1.9 times). On the other hand, unemployed people looking

for work are more likely to find an informal job than a formal one (see Figure 4.6.2): Argentina (2.6 times), Paraguay (9 times), and Peru (3.2 times).

Bosch and Maloney (2008) took it a step further, studying the flows between unemployment and informality throughout the economic cycle. Using extensive series of panel data from Brazil and Mexico, they arrived at three stylized facts. First, the unemployment rate is countercyclical, because informal worker separations increase during recessions. Second, the proportion of formal employment is countercyclical, which is due more to the difficulty of finding formal jobs after periods of inactivity, unemployment, and other informal employment during recessions than to an increase in separations from formal jobs. Third, flows from formality to informality are not countercyclical but pro-cyclical. Figure 4.6.3 shows the transitions to informality and the economic cycle in Mexico for the period of 1987 to 2009. We can observe that the transitions from informal employment to unemployment are higher at all times than those between formal employment and unemployment, but the difference is more marked in periods of recession (gray areas).

Figure 4.6.3 Transitions to informality and the economic cycle in Mexico, 1987–2009 (percentage)



Source: Prepared by authors, based on data from Bosch and Maloney (2008).

Notes: Gray areas indicate official recession periods in Mexico: F = formal salaried workers, I = informal salaried workers, S = self-employed workers, U = unemployed. The lines show the transitions from F, I, and S to U.

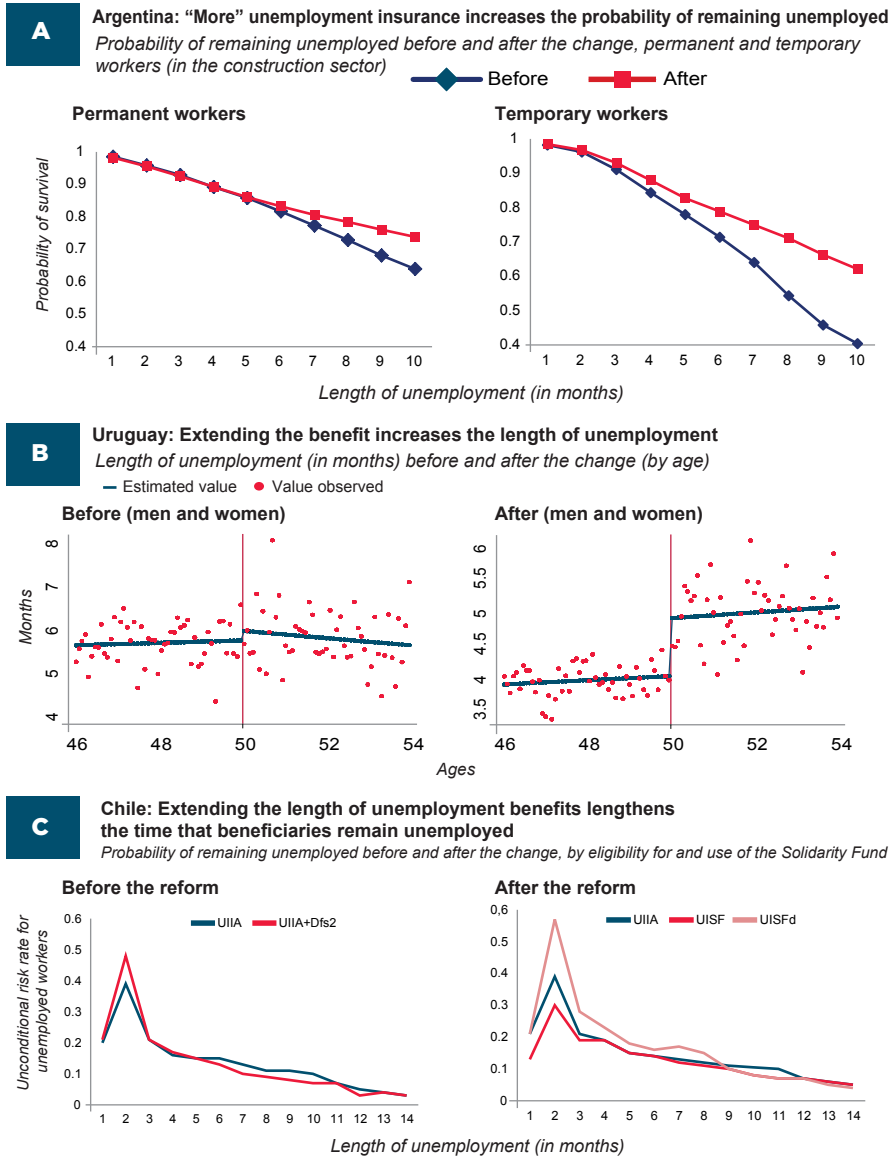
Raising the benefit level (higher replacement rate) and extending the benefit increases the persistence of unemployment. This is what González-Rozada, Ronconi, and Ruffo (2011) found in the case of Argentina when they analyzed the 2006 unemployment insurance reform, which raised the benefit for all workers (permanent and temporary; see Figure 4.4.a) and extended the length of the benefit for workers aged 45 and over. Amarante, Arim, and Dean (2013) obtained similar findings in Uruguay when they examined the reform of 2009, which extended the benefit for workers aged 50 and over (by four weeks; see Figure 4.4.b). In the case of Chile, the 2009 reform increased the real benefit and relaxed the eligibility criteria for benefits from the Solidarity Fund (which acts as unemployment insurance *per se*). Huneus, Leiva, and Micco (2012) also described longer unemployment among people who opt to receive benefits from the Solidarity Fund (see Figure 4.4.c).

However, this longer unemployment does not translate into a search leading to a better job. Huneus, Leiva, and Micco (2012) found no evidence that the increased benefit resulted in a better job, as measured by a higher reemployment wage.¹² Amarante, Arim, and Dean (2013) found that the reemployment wage did not increase with the extension of the benefit for people over 50, that job loss generally has an impact on wages that may be long-term, and that unemployment insurance cannot make up for this (see Box 4.7).

In contrast, a decreasing benefits schedule (as opposed to a constant schedule) can have a positive impact on the length of unemployment without affecting the reemployment wage. With the reform of 2009, Uruguay shifted from a constant payment schedule of 50% of the pre-dismissal wage for six months to a decreasing schedule starting at 66% and ending at 44%, without changing the full amount of the benefit received over the six-month period. Amarante, Arim, and Dean (2013) found a small but significant reduction (approximately one week) in the length of unemployment that, moreover, did not lower the quality of reemployment, measured in terms of wages.

¹² In Chile, the risk rates prior to the reform (see Figure 4.4.c) were similar for the two groups of workers: those who had an unemployment insurance savings account (UISA) and those who had an individual account and had met the minimum contribution density to be eligible for the insurance with the Solidarity Fund after the reform (who had slightly higher rates). It was observed after the reform that the unemployed who were eligible for the Solidarity Fund but did not take advantage of it had higher rates during the initial months of unemployment than those who took advantage of it. However, when the unemployment insurance benefits ran out, all the groups were similar.

Figure 4.4 The effect of unemployment insurance design on the length of unemployment



A. Source: González-Rozada, Ronconi, and Ruffo (2011).

B. Source: Amarante, Arim, and Dean (2013).

C. Source: Huneus, Leiva, and Micco (2012).

Notes: UIIA = Unemployment insurance with individual account; UIFS = Unemployment insurance that combines social insurance with the establishment of a Common/Solidarity Fund; UIFd = Individuals who are eligible for the Solidarity Fund but do not use it; UIIA+Dfs2 = Individuals who have the contribution density required for access to the UIFS.

An increase in the amount of the benefit is not equivalent to an increase in the length of the benefit. Although both changes increase the length of unemployment without improving the quality of reemployment, when they are considered together, it is seen that a higher benefit in a shorter period may be a better option. González-Rozada, Ronconi, and Ruffo (2011) found that in Argentina, a 10% increase in benefits resulted in a smaller reduction in the reemployment rate than a one-month extension of the benefit—changes that would be equivalent in terms of cost to the government.

Box 4.7 Wage loss and unemployment insurance: the case of Uruguay

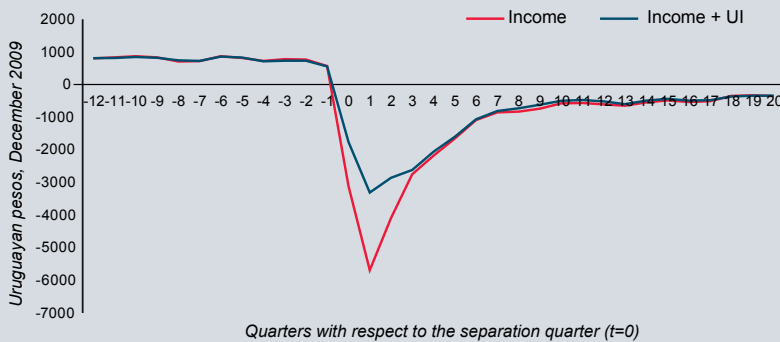
Losing a job obviously implies losing the wages received from it. However, the evidence shows that this loss can be significant and long-term. There are several reasons for this (Fallick, 1996; Kletzer, 1998; *inter alia*) and evidence to validate such reasons (Carneiro and Portugal, 2006; Appelqvist, 2007; Kaplan, Martínez, and Robertson, 2005a; Galiani and Sturzenegger, 2008). One of the reasons derives from the theory of human capital, since, in addition to their jobs, workers lose the specific experience associated with the employer and economic sector in which they were employed. In addition, workers with more years of experience in a job may experience greater losses, because they have more specific knowledge about the position and may have received raises based on that knowledge. Another explanation derives from the job-search and job-matching models, which indicate that workers may incur a wage loss if they end up accepting a lower-quality job than the one they previously had, where quality is measured by the fit of the candidate's characteristics with the job profile.

New evidence for Uruguay shows that income losses associated with unemployment persist and are higher for workers who switch to a different industry. However, workers with access to unemployment insurance are less affected by this phenomenon. Amarante, Arim, and Dean (2011) used administrative data from Uruguay's Banco de Previsión Social (Social Welfare Bank) and evaluation techniques based on Jacobson, Lalonde, and Sullivan (1993) to analyze wage losses associated with the loss of formal employment among workers with more than three years in the same job over a 13-year period (1997–2010). The authors compared the wages of workers who had lost their job at a given point in time (“displaced” workers) with those of workers who remained in the same job throughout the period (“nondisplaced” workers). Although in this sample the displaced workers had higher wages than the non-

displaced workers, after being unemployed, the affected workers never reached the same level of income as those who had kept their job, even after 20 periods. One period after the loss of the job, the reduction in displaced workers' earnings represented 39% of the wages of those who remained employed. However, for workers with unemployment insurance, this loss fell to 13.5%. Figure 4.7.1 shows the income trends for displaced workers with and without access to unemployment insurance compared with those for the group that did not lose their jobs.

Source: Amarante, Arim, and Dean (2014).

Figure 4.7.1 Income disparities between the employed and the unemployed, both with and without unemployment insurance benefits, in Uruguay



Source: Amarante, Arim, and Dean (2014)
 Note: UI = Unemployment insurance.

Unemployment insurance can create a moral hazard if workers slack off, thinking that, if dismissed, they will receive unemployment insurance benefits. For example, unemployment insurance may increase labor turnover, something that may be happening in Brazil right now (see Box 4.8).

The effects discussed in the preceding paragraphs may be the result of the moral hazard and adverse selection typical of insurance schemes. With an improvement in their situation, unemployed workers put less effort into the job search, which results in longer unemployment and new jobs with no pay increase (Lalive, van Ours, and Zweimüller, 2006; Caliendo, Tatsiramos, and Uhlendorff, 2009; Filges et al., 2013, inter alia, for the developed countries).

This is seen in the cases of Argentina, Chile, and Uruguay (Amarante, Arim, and Dean, 2011; González Rozada, Ronconi, and Ruffo, 2011; Huneus, Leiva, and Micco, 2012). The case of Chile, in turn, can be used to explore the hypothesis of adverse selection in the framework of the 2009 reform, which eased access to the Solidarity Fund. Huneus, Leiva, and Micco (2012) examined three scenarios: people who were eligible to use the Solidarity Fund and did so, people who were eligible to use it but chose not to (and made use only of the individual account component), and people who were eligible only for individual accounts. The authors found that the reform had lengthened the unemployment of people who were eligible for the Solidarity Fund and took advantage of its benefits, and shortened it for those who, despite their eligibility, opted not to. The lack of linkage with active labor market policies may explain the undesirable effects observed in the region, such as moral hazard and adverse selection. Integrated systems that offer income support in periods of unemployment but are linked to active labor market policies may be successful in increasing the incentives to put greater effort into searching for the next job.

Box 4.8 System for protecting the unemployed in Brazil and its impact on the labor market

Gerard and Gonzaga (2013) studied the impact of Brazil's system for protecting the unemployed on the length of employment. The figure below shows the percentage of employees who separated from a firm, by workers' tenure. The results show that employment decisions are influenced by the incentives created by the system for protecting the unemployed; heavier requirements for dismissal after three months on the job lead to more worker separations prior to reaching this threshold.

Furthermore, a worker has the right to collect unemployment insurance benefits after six months on the job. The figure also shows a spike in the turnover rate just after workers become eligible for unemployment insurance. That is, the possibility of collecting unemployment insurance benefits appears to act as an incentive for labor turnover.

Figure 4.8.1 Employees separated from a firm, by tenure (percentage)

Employees hired in 1995



Source: Gerard and Gonzaga (2013).

Finally, once the worker accrues one year of tenure, dismissal requires a signature from the Ministry of Labor or the union. The separation rate is clearly much higher in the months before the worker completes one year on the job than in the subsequent months.

The important public policy lesson here is that employers and employees will respond to the incentives created by the design of the system for protecting the unemployed. Attempting to protect the jobs of workers with longer tenure, for example, could create incentives to ensure that the jobs do not last long enough to activate the protection mechanism. Therefore, some protection measures may prove counterproductive.

Social assistance during unemployment or unemployment subsidies

Finally, social assistance during unemployment, or unemployment subsidies, tends to be non-contributory and is designed to reduce the risk of poverty among the unemployed. In some countries, it is the non-contributory alternative to unemployment insurance; in others, it is also connected with the contributory system, giving access to this benefit to people who are still out of work and whose unemployment insurance benefits have run out. This is the case in several OECD countries (Ozkan, 2014; Immervoll, 2009) and certain countries in the region, such as Argentina (see Box 4.9).

Temporary employment programs

The instruments described above, which provide income to workers who have lost their jobs, are available, in the best of cases, to formal salaried workers. There are no such instruments to protect informal salaried workers or the self-employed against unemployment or other occupational risks. In this context, a common policy response to high unemployment in LAC has been the creation of temporary employment programs (TEPs) or public works programs (this has been true not only in the region but in Asian and Eastern European countries as well). Some examples of TEPs in the region are Chile's Temporary Employment Program and Bolivia's National Emergency Employment Plan (PLANE). Argentina, Colombia, and Mexico also have programs. During the most recent crisis, due to its limited regional effects, Peru and Mexico in particular used TEPs as tools for smoothing the consumption of workers and their families.

TEPs tend to target informal workers whose unemployment status is very hard to document or verify. Thus, this type of program does not have strict eligibility criteria and is generally based on "self-targeting" through the offer of a cash transfer below the minimum wage (for example, the *Construyendo Perú* program paid two-thirds of the minimum wage). This induces beneficiaries to voluntarily exit the program if a more "regular" job opportunity comes along.

In most cases, temporary employment programs are used to guarantee a minimum income for poor, unskilled workers for brief periods of three to six months in exchange for work for as long as the benefit lasts. The beneficiaries generally work in labor-intensive projects such as the repair and maintenance of roads, buildings, and public spaces. TEPs try to keep administrative costs low to maximize the percentage per peso invested that reaches the beneficiaries. The nature of the projects often requires local government and civil society involvement.

Box 4.9. Training and Employment Insurance in Argentina

Argentina's Training and Employment Insurance (ScyE) is an integrated, non-contributory unemployment benefits system to assist different targeted groups in their active search for a job by upgrading their job competencies and placing them in quality jobs. ScyE targets unemployed workers over 18 years of age who are actively searching for a job and who receive no other benefits and/or subsidies. Candidates under 25 years of age must have completed their secondary education. In addition, people aged 40 and over who have exhausted their (contributory) unemployment insurance benefits and are still unemployed can apply for admission to the ScyE program.

ScyE offers a two-year, non-remunerative monetary benefit of Arg\$225 for the first 18 months and Arg\$200 for the last six months. This sum may be supplemented with other benefits, such as an award on finishing school (Arg\$600) or professional training (Arg\$900), an employment incentive (public or private, of Arg\$2,700) or on-the-job training (of Arg\$2,000 per month), and seed capital of up to Arg\$15,000 for those who present a business plan.

In order to keep their benefits, participants must i) visit the Municipal Employment Office at least twice a month to report their progress in their job search and update their work history, ii) participate in as many activities as possible, and iii) accept appropriate job offers proposed by the employment offices.

Source: Ministry of Labor, Employment, and Social Security of Argentina

Note: The exchange rate is Arg\$1 = U.S. \$0.11 (Banco de la Nación Argentina).

TEPs are effective in cushioning the drop in their beneficiaries' income—that is, in smoothing consumption. The evidence indicates that these programs are effective in maintaining income. This is true of the Plan Trabajar in Argentina (Gasparini, Haimovich, and Olivieri, 2009) and the PLANE program in Bolivia (Hernani Limarino, Villegas, and Yáñez, 2011). However, TEPs have proven unsuccessful in increasing workers' employability at the end of the intervention. Adverse effects associated with the stigma of participating in these programs have even been documented; thus, TEPs work better as mechanisms for smoothing consumption than for securing employment (Kluve, 2006; Gasparini, Haimovich, and Olivieri, 2009; del Ninno, Subbarao, and Milazzo, 2009; Hernani-Limarino, Villegas, and Yáñez, 2011).

Although TEPs are meant to cushion the drop in income during crises, the time it takes to design and implement them means that the programs may arrive too late, when the economic crisis that led up to them is over (as in the case of Peru's A Trabajar Urbano program). In addition, the lack of preestablished mechanisms for their execution can lead to high administrative costs (in Construyendo Perú, they accounted for 20% of the total cost). Furthermore, despite their temporary nature, some programs become permanent.

TEPs can create incentives to informality. If the program does not require a minimum of hours worked (with the necessary enforcement to verify compliance), there is the possibility of workers receiving an unemployment benefit and working "under the table" in the informal sector, as occurred with the Trabajar program in Argentina (Gasparini, Haimovich, and Olivieri, 2009).

Finally, even though programs in some cases have training components, there is no evidence that they increase human capital or improve career paths. Hernani-Limarino, Villegas, and Yáñez (2011), for example, found that in Bolivia, PLANE did not have a medium or long-term impact on its beneficiaries' career paths. It neither increased the probability of finding a job nor raised the level of the wages obtained.

Hiring and dismissal regulations in the formal sector

Labor regulations seek to improve working conditions and protect workers against the risks of poverty in old age, illness, unemployment, etc. They can sometimes reduce the incentives to formal hiring. In order to fulfill their purpose, these measures must be accompanied by proper enforcement.

The countries of the region have ambitious labor laws to meet their objective of protecting workers. LAC began regulating the labor market early on, between 1930 and 1940. This was motivated by the need to protect workers from cyclical fluctuations and the excessive power of employers and to protect workers in some way against job loss or income insecurity. From 1980 to 1990, labor reforms focused on increasing protection for workers (benefits and guarantees).

For this reason, the cost of formally hiring a worker is higher in LAC countries than in OECD countries. Using the legal minimum wage as the point of reference, the

annual labor cost, which is the sum of the minimum wage (which includes the employee's social security contribution) and the employer's social security contribution, accounts for one-third of the GDP per worker in LAC countries versus one-fifth in OECD countries. Moreover, the range in LAC is wider, since this percentage varies from 9% in Mexico to 76% in Honduras, versus a minimum of 13% in Luxembourg and a maximum of 29% in France (see Figure 4.5).

In some cases, wage and non-wage costs exceed job productivity. As observed in Chapter 2 (Figure 2.7), there is a clear inverse relationship between formality and high labor costs with respect to productivity. This is true in countries such as Chile, Costa Rica, and Uruguay, which have formality rates of more than 70% and labor costs equivalent to less than 35% of GDP per worker. High labor costs, coupled with weak state enforcement capacity, encourage informal hiring, with wages below the legal minimum (see Box 4.10).

Box 4.10. Non-compliance with minimum wage requirements in the region

A high percentage of workers receive wages below the current minimum wage set by the state. The purpose of the minimum wage is to provide an income that meets the basic needs of workers and their families. However, a high minimum wage that would theoretically cover these needs can lead to job destruction and non-compliance, especially where state enforcement is weak, as occurs in the region (ILO, 2014). On average, 38% of salaried workers in LAC are paid a salary below the minimum wage, a percentage that ranges from a high of 75% in Honduras to a low of 12% in Venezuela.

These data expose the weaknesses of state enforcement but do not show whether the minimum wage level is high or low with respect to the job productivity of unskilled workers, who are largely those who receive the minimum wage. Neither do they indicate the relationship between the minimum wage and the basic needs of workers and their families. One way to find out is to compare the minimum wage with the average wage. It can be seen, for example, that in Honduras it may be high, since the current minimum wage is 1.5 times higher than the average wage. At the regional level, the ratio is less than 1 (0.68) but higher than the figure observed in the OECD countries (0.40).

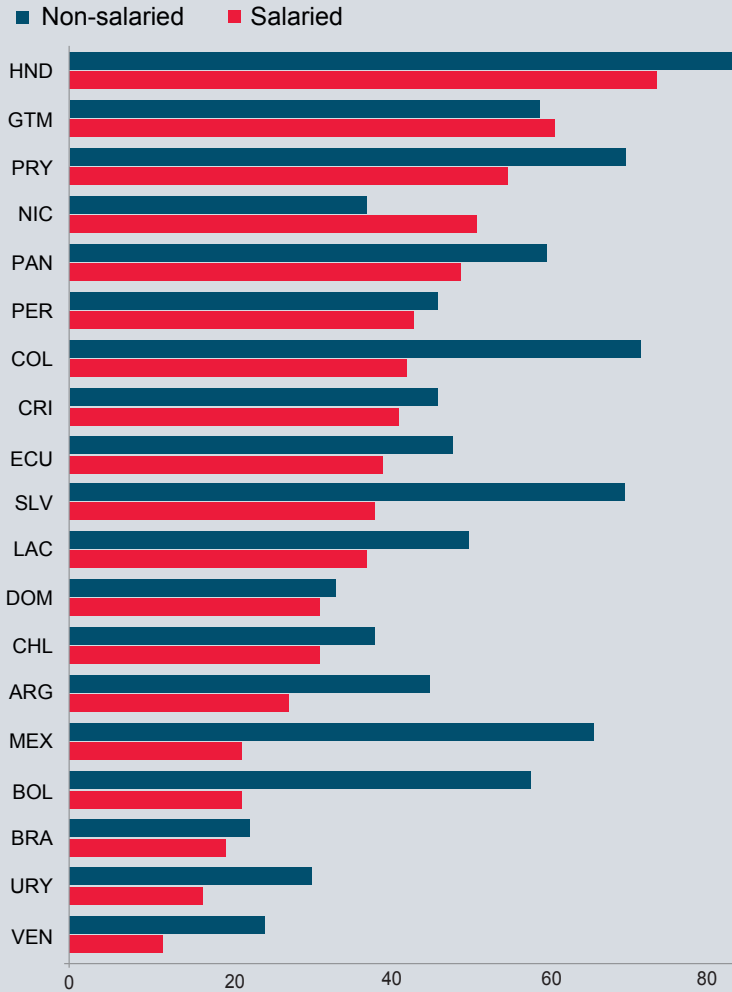
Figure 4.5 Wage and social security costs in LAC and OECD countries

Wage and social security costs as a percentage of GDP per worker

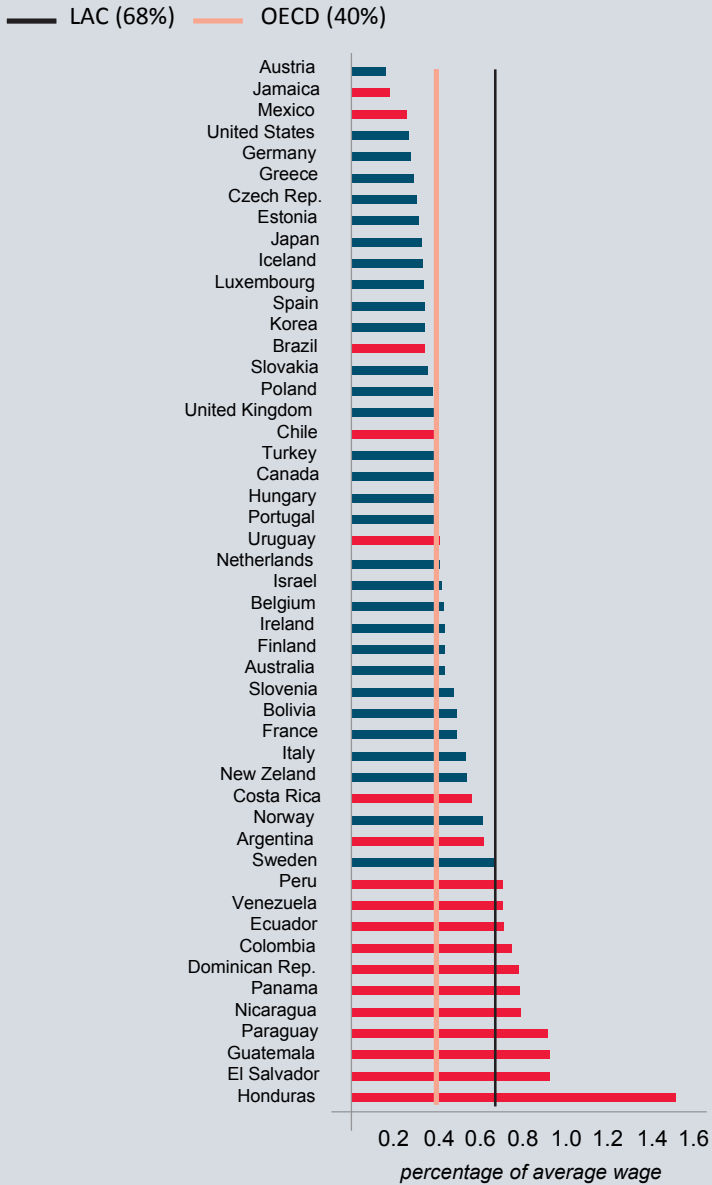


Source: Prepared by authors, based on the legislation of each country as of December 2013 and OECD (2015).

Figure 4.10.1 Salaried and non-salaried workers who earn less than the hourly minimum wage (percentage)



Source: IDB (2015b).

Figure 4.10.2 Ratio between the minimum wage and average wage

Source: IDB (2015b) for LAC and OECD (2015).

Labor regulations that support fathers and mothers at different points in their children's lives enable people who decide to have children to enter the labor market in greater numbers. Regulations of this type favor longer time in a job and prevent dismissal without just cause. They are generally considered positive for meeting these objectives. Paid maternity leave is the measure most widely adopted in the region for protecting women during pregnancy and their babies' early days of life. As noted in Chapter 1, increasing women's participation is important for reducing the existing gender gaps and for the countries' development and growth in general (Tsani et al., 2013; United Nations, 2014). Thus, a better understanding of the barriers to women's participation in the labor markets and the design policies for reducing these gaps is imperative. LAC countries have begun investing more in policies and programs that support working mothers (see Box 4.11), both to guarantee paid maternity leave and to increase the provision of day care. The countries of the region have not made as much progress as the OECD countries when it comes to paternity leave. Longer and more widespread paternity leave would balance gender inequalities, reduce the disincentives to hiring women, and promote a new and fairer division of roles in the home.

Although regulations to support working mothers generally meet their objective of protecting formal employment for women, their impact on the decision to hire a woman instead of a man should be monitored. While the main objective of these policies is clearly to promote and increase women's participation in the labor market, disconnecting it as much as possible from a woman's decision to become a mother, and many studies indicate that they have had just that effect (see Box 4.11), other studies have found that some of these policies can reduce women's employment and/or the wages they are paid.

Regulations to reduce involuntary dismissals promote lower labor turnover but can create barriers to formal hiring. As noted in Chapter 5, labor regulations reduce labor turnover and increase investment in workers. However, from the employer's standpoint, they constitute potential future costs, which are taken into consideration in decisions about formal hiring.

Therefore, in a labor market characterized by high dismissal costs, a series of secondary adverse impacts on formal hiring can be generated that are worth exploring. In countries where dismissal costs are high, firms become very reluctant to hire workers formally because it is considered risky. The heavy restrictions on dismissal, whether administrative or involving a monetary transfer from employer to worker, are a cost associated with formal hiring that employers assume at the time of the hire. Thus, even though their

Box 4.11 Policies to support working mothers

Although the majority of countries in LAC have job protection strategies designed to balance the domestic and labor market activities of pregnant women and mothers, the high informality and inactivity in this population group rates (53% and 41.3%, respectively) mean that these policies benefit only a small proportion of women. The most important protection measures in the region are currently the safeguard against dismissal without just cause, protection against discrimination, the right to paid leave during the day to nurse their babies, and paid maternity leave. For example, with the exception of Suriname, every country in LAC has at least one law on the books governing maternity leave. Moreover, in theory, these policies cover the entire normal salary of these workers (except in El Salvador, Guyana, and Paraguay, where mothers receive less than 100% of their normal salary during maternity leave). Furthermore, the length of this leave varies significantly throughout the region. At one extreme is Jamaica, which provides only eight weeks of paid maternity leave, and at the other is Chile, which provides 25 weeks.



Finally, it should be noted that in 96% of the countries in the region, the resources for maternity leave are provided by mixed systems that include the social security system and employers. While these measures are important for promoting the women's employment, they benefit only 47% of women in formal jobs.

Another very common policy in LAC is the provision of day care. While the main objective of these policies is to increase children's well-being and interrupt the intergenerational transmission of poverty, they can help free up time for parents (especially mothers, due to the prevailing role of women in domestic production) that could be offered in the labor market. The evidence on the impact of day care centers on women's participation in the labor market is inconclusive. Theoretical or empirical studies in the region have found that the existence of day care centers increases women's participation in the labor market (Berlinski, Galiani, and Ewan, 2011; Haan and Wrohlich, 2011; Attanasio et al., 2013). However, there is also evidence to the contrary. In Chile, where women's participation is particularly low in comparison with that of other countries in the region and the OECD countries, Encina and Martínez (2009) show that a substantial increase in public day care centers neither increases nor decreases mothers' participation in the labor market and the wages they receive. In fact, Prada, Rucci, and Urzúa (2015) found just the opposite. In addition to the existence of day care centers, factors such as the parents' trust in the child care providers (El-Attar, 2013), the geographic proximity of the day care center to the home or workplace, and the fit between the day care center's business hours and the work schedule (Contreras, Sepúlveda, and Cabrera, 2010; Contreras, Puentes, and Bravo, 2012) also influence women's participation in the labor market.

potential impact is felt only when the employment relationship is severed, employers include this calculation when hiring, either formally or not. The higher these costs, the more reluctant employers will be to hire formally, for fear they will have to pay a large sum of money or get caught up in an endless sea of red tape in cases when a worker proves not to be as productive as anticipated or expectations about the demand for the product are not met. This guarded behavior especially affects workers whose productivity is more uncertain (youth, women who have been out of the labor market for an extended period, less-skilled workers, etc.). The evidence indicates that the level of employment among these groups is lower than that of adult males and skilled workers (Addison and Teixeira, 2003; Montenegro and Pagés-Serra, 2004; Kahn, 2007). It is therefore important to strike a balance between protection and formality incentives.

The importance of enforcement

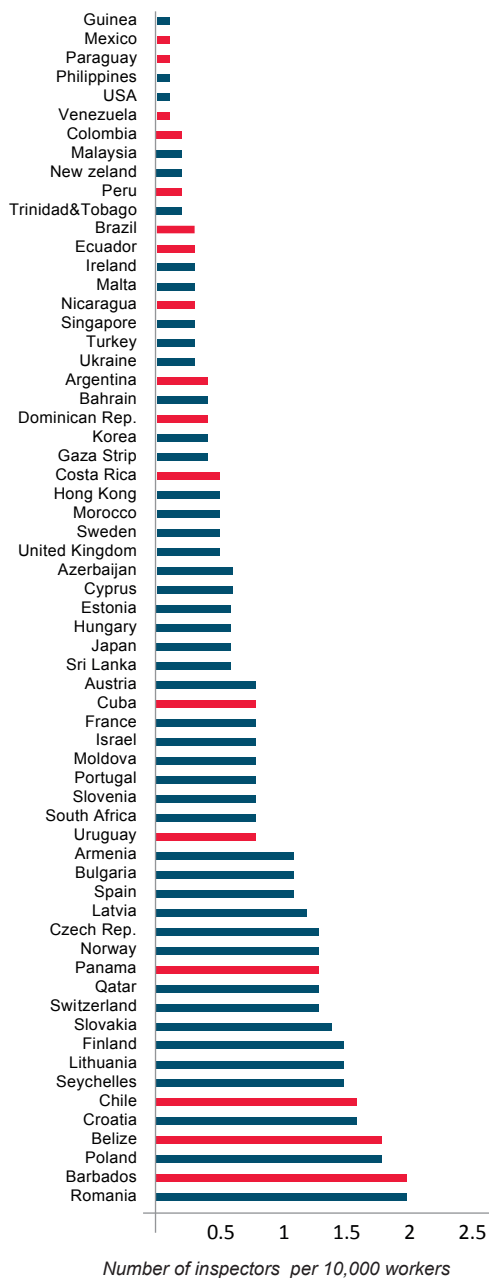
Bringing more workers and firms into the formal sector will require not only economic measures such as those described, but administrative measures as well. In addition to enacting legislation, the state must decide how much emphasis to place on enforcing compliance. This emphasis will depend on the intention of enforcing the law as broadly as possible and on the available financial, human, and material resources to do so.

As Chapter 2 points out, one of the potential reasons for the high informality in the region is non-compliance with the law. That is, even though the jobs are productive enough, firms decide not to formalize employment relationships to save themselves the cost of social insurance. In addition, due to weak enforcement, there may be collusion between workers and firms to hire informally, with part of the formality costs translating into higher (informal) wages.

LAC countries generally have fewer resources for enforcing labor laws than other regions of the world. The countries of the region have less than 0.4 inspectors per 10,000 workers, on average, while the OECD countries have 0.7, and the world average is 0.6 (see Figure 4.6). Some countries, such as Colombia, Mexico, and Paraguay, have fewer than 0.2 inspectors per 10,000 workers. Barbados is the country with the highest proportion in the region: two inspectors per 10,000 workers.

The intensity of labor law enforcement is associated with the degree of formalization. Although this does not represent a causal relationship, it suggests

Figure 4.6 Number of inspectors per worker in LAC countries compared with other countries

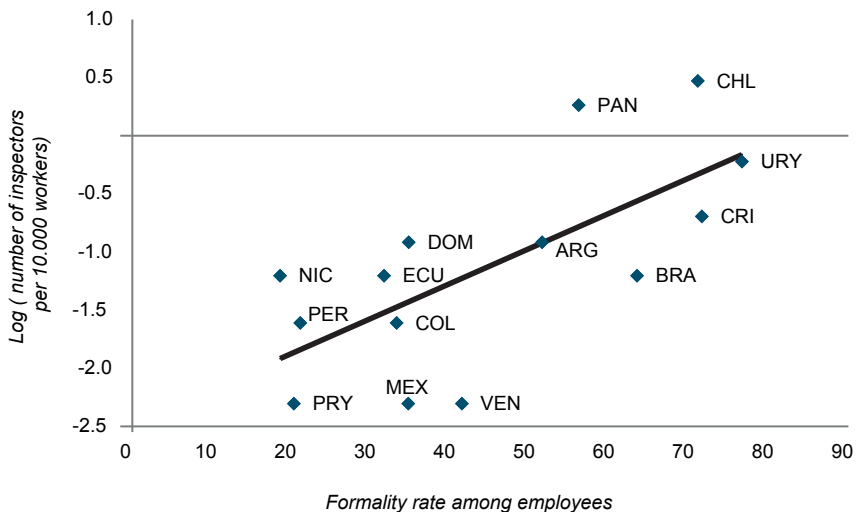


Source: ILO (2015c), based on the latest available data for each country.

that greater enforcement can yield greater formalization. This is the view of Bosch, Melguizo, and Pagés (2013), who gathered evidence from impact evaluations in Brazil that very convincingly showed the power of enforcement in boosting formal employment. It should also be recalled that enforcement can increase the de facto cost of formality and induce employers and workers to not enter into formal contracts.

Greater integration of information sources fosters the growth of formal employment. In addition to inspection, one of the tools used by the developed countries to facilitate monitoring of the informal economy is the consolidation of administrative databases (that is, beneficiary records of all social programs, tax registries of people who pay personal income taxes, etc.). Several countries in the region, among them Argentina and Brazil, have begun making substantial efforts to link databases in order to identify opportunities to improve labor and social security administration. However, much remains to be done to consolidate administrative databases through the use of unique identification codes. Investing in this type of instrument could yield real gains in terms of tax revenues and workers' welfare.

Figure 4.7 Number of inspectors per 10,000 workers and the formal employment rate



Source: Prepared by authors, based on data from ILO (2015c) (number of inspectors) and IDB (2015b) (formality).

Conclusions

A variety of instruments can promote formal job creation, as well as the allocation and reallocation of people of working age to jobs more suited to their skills, by overcoming the access barriers of certain population groups and offering training incentives that can increase the probability of finding and keeping a quality job. This chapter examined the degree of development and effectiveness of instruments in the region that have the following functions: i) reducing information asymmetries and equalizing opportunities for access to formal jobs (labor intermediation policies); ii) improving the stock of human capital, reducing risks/costs to employers (first-job policies) in the case of younger people, and active policies to support labor market entry for the unemployed, in the case of the general population; iii) smoothing consumption to facilitate a better job search and labor market reentry (policies for income support during unemployment); and iv) increasing the incentives to formal hiring (labor regulations and enforcement).

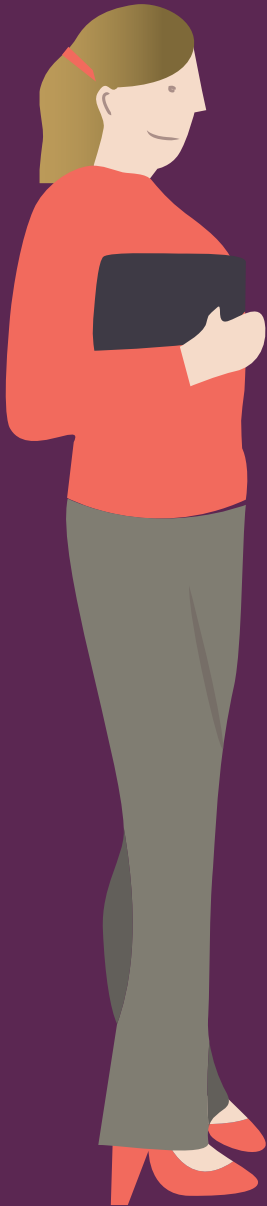
To summarize, this chapter's main messages are:

- i) The region still does not invest enough in supporting formal job creation (public labor intermediation and job training for inactive and unemployed people) and lacks good information on effectiveness (and cost-effectiveness) in the investment of resources for this purpose to know whether they are being allocated properly. However, this matter should be investigated further through evaluations that provide policymakers with information for making potential improvements in the design and implementation of these policies.
- ii) The region's capacity to smooth the income of the unemployed and encourage the search for formal employment is seriously constrained by informality; any income-smoothing mechanism that depends on firms paying (either before dismissal, in the case of unemployment insurance, or after, in the case of severance pay) does not work for informal workers, who are the majority in the region.
- iii) The region's labor regulations are very important in terms of social security and workers' benefits, which increase welfare. They can, however, affect the jobs available in an economy—not so much the number of jobs, but their composition (for example, more jobs for unskilled workers or more informal jobs). That is why caution should be taken in determining the degree of labor regulation, bearing in mind the economic and social situation of each country. Moreover, economic and human resources should be guaranteed for proper enforcement.

A pending task in LAC countries is to increase and equalize opportunities for access to formal jobs for the vast majority of working people. The first guideline in designing public policies is that these instruments should be conceived as an integrated system, so that virtual interactions and undesirable effects among them can, and if possible ex ante, be observed and detected. Chapter 5 will continue analyzing the available instruments in the region; this time, however, it will examine policies to boost productive job stability. Finally, in addition to promoting this integrated approach, Chapter 6 will propose specific measures to increase the scope and effectiveness of labor policy instruments to promote better career paths.

Table A4.1 Income support instruments in the region

| Country | Severance pay | Unemployment insurance | Unemployment insurance individual savings accounts (UISA) | Temporary employment programs |
|---------------------|---------------|------------------------|---|-------------------------------|
| Argentina | ✓ | ✓ | | ✓ |
| Bahamas | | ✓ | | |
| Barbados | ✓ | ✓ | | ✓ |
| Belize | | | | |
| Bolivia | ✓ | | | ✓ |
| Brazil | ✓ | ✓ | ✓ | |
| Chile | ✓ | ✓ | ✓ | ✓ |
| Colombia | ✓ | | ✓ | |
| Costa Rica | ✓ | | | ✓ |
| Dominican Republic | ✓ | | ✓ | |
| Ecuador | | | | ✓ |
| El Salvador | ✓ | | | |
| Guatemala | | | | |
| Guyana | | | | |
| Haiti | ✓ | | | ✓ |
| Honduras | | | | |
| Jamaica | ✓ | | | ✓ |
| Mexico | ✓ | | | ✓ |
| Nicaragua | ✓ | | ✓ | ✓ |
| Panama | | | | ✓ |
| Paraguay | ✓ | | ✓ | ✓ |
| Peru | ✓ | | | |
| Suriname | | | | |
| Trinidad and Tobago | ✓ | | | ✓ |
| Uruguay | ✓ | ✓ | | ✓ |
| Venezuela, R.B. | ✓ | ✓ | | |



Chapter 5.

Policies to increase productive job stability

Summary

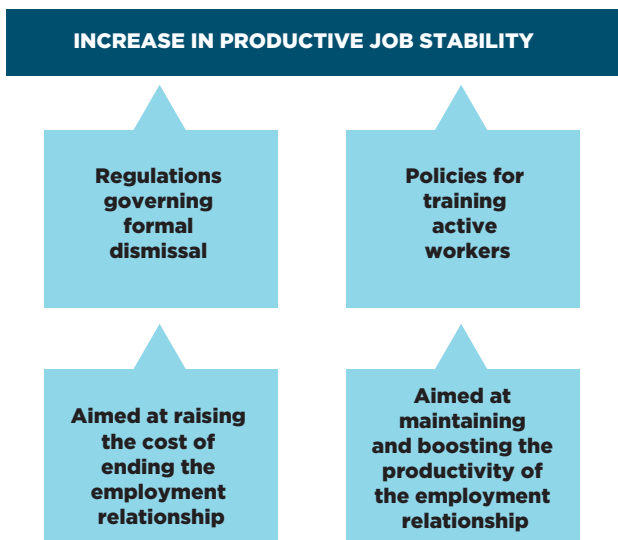
Labor mobility can be a source of growth if it permits the reallocation of workers to more productive jobs. However, high job instability undermines worker welfare and can adversely affect productivity. Jobs for growth recognizes two major groups of policies and instruments for reducing the incidence of dismissals, which will be explained in this chapter: labor regulations that reduce dismissals by raising monetary and administrative costs, and policies to promote continuing education for workers to augment their human capital through the acquisition, updating, and certification of their competencies and skills.

Introduction

High job instability undermines worker welfare and can adversely affect productivity. It is not surprising, therefore, that labor policy in many countries focuses on decreasing it.

This book recognizes two major groups of policies and instruments for reducing the incidence of dismissals: 1) labor regulations that discourage dismissal by raising monetary and non-monetary costs for employers who dismiss workers and targeted policies to promote lifelong learning, including the acquisition, updating, and certification of worker capacities and skills. Although the latter are not usually considered mechanisms for promoting stability, the evidence suggests that one of the major reasons for dismissal is the lack of skills for good job performance (Fazio and Pinder, 2014; see also Chapter 2, Box 2.3). There is also a strong correlation between the educational level and human capital of workers and lower labor turnover (see Chapter 1, Box 1.2). Consequently, policies and instruments aimed at promoting lifelong learning for individuals and the continuous adaptation of their skills to the ever-changing needs of the labor market also reduce the incidence of dismissals and result not only in higher productivity, but greater job stability.

Diagram 5.1 Policies affecting job destruction



Source: Prepared by the authors.

Regulations governing formal dismissal

The purpose of dismissal regulations is to increase the cost of ending the employment relationship.

Dismissal regulations reduce the incentives for firms to end the employment relationship and protects workers, thus promoting lower turnover and providing workers with an income during unemployment. As discussed in Chapter 4, laws to regulate dismissal were conceived with the dual purpose of providing workers with an income during unemployment and serving as a mechanism for job protection (by raising the dismissal costs to the firm) or human resources management (by retaining workers with specific skills through a lower present wage, with the promise of higher compensation at the end of the employment relationship) (Holzmann et al., 2011).

Labor law, in many countries, imposes constraints on dismissal with the goal of preventing it. These constraints may consist of high monetary costs and/or administrative red tape when hiring or dismissing an individual. From the worker's standpoint, these constraints may be justified by the high cost of losing a job for people whose subsistence and welfare on depend remaining employed. This is especially true if the cost of dismissal is not pecuniary, but affects, for example, the worker's identity and self-esteem, creating a cost for which no monetary transfer can compensate (Blanchard and Tirole, 2008; and Espino and Sánchez, 2014).

The evidence indicates that high dismissal costs do, in fact, reduce labor turnover and, with it, the probability of dismissal and its associated costs. According to the evidence, the stricter the dismissal legislation, the lower the labor turnover (Lazear, 1990; Dertouzos and Karoly, 1993; Micco and Pagés, 2006; Haltiwanger, Scarpetta, and Schweiger, 2008).¹ From the standpoint of the state, dismissal expenses are a cost-effective way to protect workers since they require no transfer or effort on the part of the government, except to ensure that, in the occasional case of dismissal, the worker receives the respective payments. As recommended in Chapter 6, dismissal should involve an expense to the firm to ensure that its social costs are internalized in the firm's decision (Blanchard and Tirole, 2008; Espino and Sánchez, 2014).

¹ The evidence in this regard is mixed, since in the case where high dismissal costs impede the substitution of indefinite contracts with temporary contracts, regulation can ultimately result in higher labor turnover associated with temporary contracts. See Boeri (1991), for example.

Labor regulations can encourage greater training for and investment in workers. There is substantial evidence indicating that the higher the cost of dismissal, the more training firms offer their workers (Pierre and Scarpetta, 2013; Addison and Teixeira, 2003), which can have a positive impact on employee productivity.

Regulating dismissals can also have undesirable effects, however. As mentioned in the preceding chapter, a labor market with high dismissal costs can produce a series of undesirable secondary effects. From the standpoint of maintaining an existing employment relationship, the undesirable effect of reducing formal hiring is compounded by other undesired outcomes that affect the quality/productivity of that job, its stability, and, hence, the probability of its destruction. These factors include the following:

1. Productivity may fall. While a significant amount of productivity growth is the result of human capital accumulation in firms, some of that growth—and no small portion, either—occurs because of the constant reallocation of workers to better jobs (Pagés, 2010; Davis and Haltiwanger, 1999), as well as a better combination of factors of production. When the value that a worker creates for a firm permanently falls—for example, because the firm loses its market share—that same worker can be employed more productively in another firm whose market share is increasing. In that context, preventing worker reallocation can reduce the overall productivity of the economy (Dolado and Jimeno, 2004; Martin and Scarpetta, 2011). In the United States and several European countries, it has been observed that stricter regulation and/or higher dismissal costs change the capital-to-labor ratio and reduce productivity (Author, Kerr and Kugler, 2007; Cingano et al., 2010, 2015).

2. Employers may opt more often for temporary contracts. Another consequence in a labor market with very high dismissal costs is that employers may end up hiring personnel through temporary contracts that entail lower dismissal costs. According to the available evidence, in countries where dismissal is more regulated, the percentage of workers with temporary contracts that afford little protection against unemployment is high. The use of fixed-term contracts can lead to a highly unequal situation, since one group of workers will enjoy significant protection against unemployment and the other, very little. Moreover, this situation also has important negative consequences for the labor market: excessive turnover of temporary workers and inferior reemployment, in terms of productivity growth (see Box 5.1).

3. Certain volatile industries may suffer to an excessive degree. The demand in some industries is more unstable than in others. For example,

in information technologies, mobile communications, and related goods and services, new products are emerging daily to replace those that have dominated the market. These industries cannot survive in countries with very high dismissal costs, or they do so by employing workers under temporary contracts (Micco and Pagés, 2006; Haltiwanger, Scarpetta, and Schweiger, 2008).

Box 5.1 Negative consequences of temporary contracts

Temporary contracts were originally used for economic activities that did not occur on a regular basis. Two situations justify such contracts: i) seasonal or fixed-term productive activities (a specific project or service, odd jobs, temporary replacement of absent workers); and ii) probationary contracts (for training purposes, to launch a new activity, etc.), designed to solve the problem of imperfect information among employers and employees during hiring.

Temporary training (or probationary) contracts that facilitate the match between the job and the worker, as well as contracts related to specific training provided to the worker, are desirable and associated with higher productivity. On the flip side, temporary contracts used to reduce monetary and non-monetary dismissal costs can negatively impact both the job and productivity.

On one hand, temporary contracts with lower dismissal costs result in higher job creation and destruction rates, leading to higher turnover in the labor market. On the other hand, a temporary contract whose only purpose is to replace an indefinite contract because it entails lower dismissal costs can reduce productivity because it diminishes employer and employee incentives to invest in the employment relationship and thereby boost productivity over time. Temporary contracts of this nature will give firms and workers fewer incentives to invest in accumulating specific human capital. Dolado and Jimeno (2004) present evidence of this in Spain, noting that, in 2004, the country had a temporary hiring rate of 30.6% of salaried workers, almost 20 percentage points higher than the average for the European Union. Concluding that excessive job instability has negative implications for equity and economic efficiency, they underscore the fact that the groups most affected by it—youth, women, and low-skilled workers—suffer from high unemployment with no social protection, due to the brevity of their contributory periods. With data from the 1990s, Dolado, Felgueroso, and Jimeno (1999) find that the

probability of receiving specific on-the-job training in Spain was 22% lower for workers with temporary contracts than for those with indefinite contracts.

Carpio et al. (2011) examine the effect of temporary contracts on human capital accumulation in Chile. Using panel data from the Social Protection Survey, they find that workers with temporary contracts have a lower probability of receiving employer-financed training and that this deficit is not offset by other types of training. They likewise find that the probability of moving from a temporary contract to an indefinite one is very low; thus, the adverse effect on human capital accumulation is replicated with each temporary contract, with major implications for the productivity of workers and the country as a whole.

Finally, various studies examine the role of employment protection law in Europe during the recent international crisis and its impact on the labor market, which can be summarized in two major results:

- The stricter the laws governing the dismissal of workers with permanent contracts, the higher the turnover rate among workers with temporary contracts. While this does not affect aggregate employment, it does have an adverse effect on aggregate production (Cahuc, Charlot, and Malherbet, 2012).
- The greater the difference between the dismissal costs of temporary and permanent contracts and the easier it is to hire workers on a temporary basis, the greater the increase in unemployment during an international economic crisis such as that of 2009 (Bentolila et al., 2010) and the greater the volatility of the labor market (Costain, Jimeno, and Thomas, 2010). This last phenomenon is due in part to the fact that, when hiring, employers will opt to use temporary contracts for less productive matches—that is, for jobs that are already at the edge of dismissal at hiring time and are the first to disappear when a recession hits.

Therefore, while regulating dismissal can yield benefits in terms of greater welfare and investment in training, it can also generate significant costs in terms of less employment, especially for the most vulnerable groups; greater use of temporary contracts; and costs that are too high for high employment-creation firms, especially in developing countries. Thus, protection is not just a matter of rights, and countries should attempt to strike a fair balance, which is no easy task. This topic will be revisited in the last chapter.

Regulations governing dismissal and temporary hiring in LAC. In contexts marked by informality, such as those of Latin America and the Caribbean, labor regulations can have undesirable effects on employment, formality, labor mobility (the reallocation of resources), and, ultimately, on income per capita and economic growth. Various studies of the region present evidence in this regard.

Changes in non-wage costs affect labor mobility and the reallocation of resources. Roman (2011) examines a labor reform in Bolivia that increased dismissal and hiring costs. To do so, he uses a dynamic and stochastic general equilibrium model with two sectors, formal and informal, and finds that the reform reduced both formal and informal labor mobility within and between sectors, increasing the time necessary for GDP to recover during a recession or respond during an expansion. Saavedra and Maruyama (2000) examine the regulatory flexibility adopted in Peru in the 1990s, and, when estimating the demand functions of formal enterprises, observe an increase in the level of employment and the speed with which employment adjusts to its optimal level.

The labor rigidities associated with regulations and non-wage costs can increase informal employment, especially among workers with lower skills or limited education. Mondragón et al. (2010) and Torres and Álvarez (2011) examined labor reforms in Colombia in the 1990s. The two studies found that less labor regulation increases the size of the formal sector, and that this effect is especially important for low-skilled workers.

Promoting labor flexibility through temporary contracts can reduce job tenure and increase labor turnover. Saavedra and Maruyama (2000) and Saavedra and Torero (2004) found evidence of this in the case of Peru. Both studies find that temporary contracts were responsible for the increase in employment in Peru, translating into an average reduction in job tenure and higher labor turnover. These results were observed among formal and informal workers, but the impact was greater for informal, young, and low-skilled workers.

At the macroeconomic level, labor regulations can adversely affect income and economic growth. Loayza, Oviedo, and Servén (2005) conducted an aggregate study of 75 countries (including 15 from Latin America) to measure the impact of regulation on economic growth and the relative size of the informal sector. They observed that a higher regulatory burden (especially in the labor and goods markets) reduces growth and promotes informality, but that these effects can be mitigated to the degree that the countries' overall institutional framework improves.

The countries of the region place great value on protecting workers. As indicated in Chapter 1, in more than half of them, severance pay and unemployment subsidies are mentioned in the constitution. Three out of 18 constitutions in Latin America even have specific provisions that enable workers dismissed without just cause to demand reinstatement or rehiring by their firm, effectively nullifying the dismissal. In contrast, no non-Latin American member of the Organization for Economic Cooperation and Development (OECD) has a constitution containing provisions on reinstatement/rehiring or a minimum wage, even countries that provide for substantial severance pay.

The regulations to curb worker dismissal in the region date back to the mid-20th century and have been subject to few modifications since then. They are divided into two types: individual dismissal regulations and collective dismissal regulations. The first group covers the dismissal of workers for economic or personal reasons or redundancy, with or without just cause, and include monetary and non-monetary costs that affect hiring and dismissal decisions. The monetary cost of dismissal includes severance pay and advance notice. As their name indicates, collective dismissal regulations are special regulations that are applied when an employer dismisses a certain number of workers at the same time. Dismissal regulations also include another important group: those governing the use of temporary contracts. These regulations specify the maximum length of employment, the maximum number of times a contract can be renewed, and the valid circumstances or reasons that pertain to a temporary contract, whose expiration is subject neither to individual nor collective dismissal regulations.

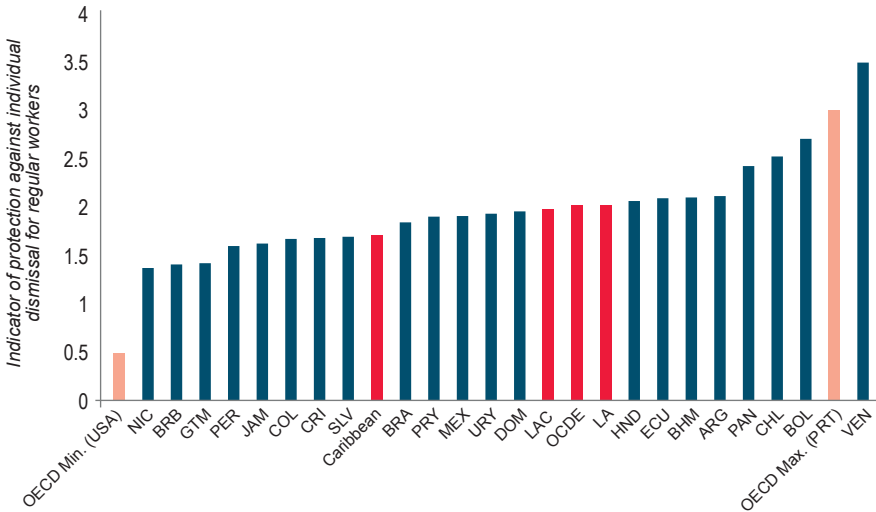
This chapter presents new information for comparing the region's dismissal and temporary hiring regulations with those of the OECD countries. It lists the "employment protection indicators" according to the OECD methodology (OECD, 2013b), which groups 21 characteristics into three major dimensions: individual dismissals, collective dismissals, and temporary contracts (see Box 5.2). Like any methodology that aggregates varied information, the methodology considered here is subject to limitations.² In any case, if compared with equivalent indicators (such as, for example, the labor market efficiency pillar of the World Economic Forum's Global Competitiveness Index), similar results are observed (see Box 5.3).

If the *de jure* regulations of LAC and the OECD are compared using the OECD methodology, the LAC regulations on dismissal without just cause do

² For an explanation of the methodology, its interpretation for Latin America and the Caribbean, and country estimates, see Alaimo et al. (2015).

not appear to be as strict. However, a proper comparison should also include other factors, such as the economies' level of human capital, the capacity of firms to create value, and the state's ability to enforce the law. The relationship between regulations, productivity, and institutions is an aspect that should be explored in future analyses of this topic.

Figure 5.1 Protection against individual dismissal of regular workers



Source: OECD-IDB (2015) for LAC, and OECD (2013b) for the OECD countries.

Note: Indicator that takes values ranging from 0 to 6, where 0 represents the least strict regulation and 6, the strictest. LAC = average for countries in Latin America and the Caribbean; LA = average for countries in Latin America, excluding the Caribbean (Bahamas, Jamaica, and Barbados).

On average, the regulations associated with individual dismissal are virtually as strict in Latin America and the Caribbean as in the OECD countries, although there are significant differences between countries, especially in Latin America and the Caribbean. This finding comes from a comparison of employment protection indicators. According to the regulations in force at the end of 2013, it is slightly more difficult to dismiss an individual worker in the OECD than in Latin America and a little more difficult than in the Caribbean, although wide differences were observed between the OECD countries, with the least difficulty in the United States, well below Nicaragua, and the greatest difficulty in Portugal, exceeded only by Venezuela (Figure 5.1) Additional regulations on collective dismissals, in turn, are generally stricter in the OECD countries than in LAC and nonexistent in seven countries (Figure 5.2). While the regulations governing temporary hiring are stricter in Latin America than in the OECD countries and far stricter than in the Caribbean (Figure 5.3), the use of temporary contracts has increased in the region in recent de-

Box 5.2 How labor protection indicators are built

The employment protection legislation (EPL) indicators were developed by the Organization for Economic Co-operation and Development (OECD) to measure the degree of stringency of employment protection legislation. The EPL indicators measure the strictness of employment protection legislation across countries by analyzing the procedures and costs involved in dismissing individuals or groups of workers and the procedures involved in hiring workers on fixed-term or temporary work agency contracts (TWA). For each country, EPL is described using 21 basic items, which can be classified under three main areas:

1) Individual dismissal of workers with regular contracts (EPR): this area refers to the rules affecting permanent employees dismissed on personal grounds or for economic redundancy, but without just cause, and covers items 1 to 9.

2) Additional restrictions on collective dismissals (EPC): most countries impose additional delays, costs, or notification procedures when an employer dismisses a large number of workers at one time. The indicator measuring these costs are included in items 18 to 21.

EPR and EPC indicators are then combined into a synthetic indicator that combines restrictions on individual and collective dismissal (EPRC).

3) Regulation of temporary contracts (EPT): this component includes regulation of fixed-term and temporary work agency contracts with respect to the types of work for which these contracts are allowed and their duration, the rules governing the establishment and operation of temporary work agencies (TWA), and the equal principle treatment for agency workers. They are described in items 10 to 17.

The sources used to calculate the indicators refer to national or regional legislation. Collective agreements and court rulings have recently been added as sources to compute the index. These 21 items are quantified by converting each of them into a cardinal unit that is then converted into a score measured on a scale 0 to 6, with 0 representing the least strict regulation and 6 the strictest. Items are then aggregated using weights to obtain four indicators, as described in tables 5.2.1 and 5.2.2.

Table 5.2.1. Degree of job protection: individual and collective dismissal of regular workers (weights and summary indicator)

| Level 1 Scale 0 - 6 | Level 2 Scale 0 - 6 | Level 3 Scale 0 - 6 | Level 4 Scale 0 - 6 | Weights | |
|---|--|---|---|--|--|
| Individual and collective dismissals - regular workers (EPRC) | Individual dismissals - regular workers (EPR) (Weight: 5/7) | Procedural inconveniences (1/3) | 1. Notification procedures | (1/2) | |
| | | | 2. Delay to start a notice | (1/2) | |
| | | Notice and severance pay for no-fault individual dismissals (1/3) | Difficulty of dismissal (1/3) | 3. Notice period after | 9 months (1/7) 4 years (1/7) 20 years (1/7) |
| | | | | 4. Severance pay after | 9 months (4/21) 4 years (4/21) 20 years (4/21) |
| | | | | 5. Definition of unfair dismissal | (1/5) |
| | | | | 6. Trial period | (1/5) |
| | | | | 7. Compensation | (1/5) |
| | | | | 8. Reinstatement | (1/5) |
| | | | | 9. Maximum time for claim | (1/5) |
| | | | | Additional provisions for collective dismissals (EPC) (Weight 2/7) | |
| 19. Additional notification requirements | (1/4) | | | | |
| 20. Additional delays involved | (1/4) | | | | |
| | | 21. Other special costs to employers | (1/4) | | |

Table 5.2.2. Degree of job protection: temporary and TWA contracts (weights and summary indicator)

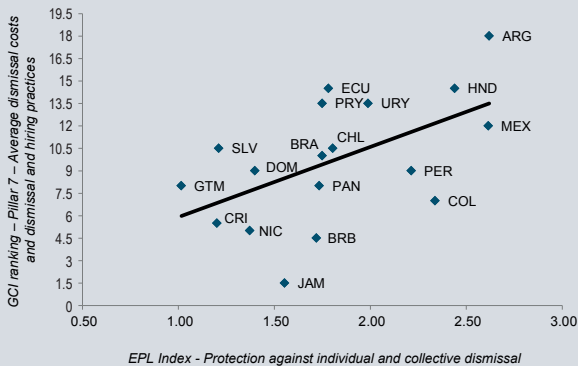
| Level 1 & 2 Scale 0 - 6 | Level 3 Scale 0 - 6 | Level 4 Scale 0 - 6 | Weights |
|--|--|---|---------|
| Temporary contracts (EPT) | Fixed-term contracts (EPFTC) (1/2) | 10. Valid cases for use of fixed-term contracts | (1/2) |
| | | 11. Maximum number of successive contracts | (1/4) |
| | | 12. Maximum cumulative duration | (1/4) |
| Temporary work agency employment (EPTWA) (1/2) | | 13. Types of work for which they are legal | (1/3) |
| | | 14. Restrictions on number of renewals | (1/6) |
| | | 15. Maximum cumulative duration | (1/6) |
| | | 16. Authorization and reporting | (1/6) |
| | | 17. Equal treatment | (1/6) |

Source: OECD (2013a).

Box 5.3 What do employment protection indicators measure?

There are many indices that attempt to comparably measure the degree of employment protection in each country. Some of them include objective measurements, others subjective measurements, and still others, a combination of the two. This means that a comparative analysis of countries or regions can yield very different results, depending on the index employed. Here, we are comparing indices that are widely used in the region and globally: the OECD employment protection legislation (EPL) indicators and the labor market efficiency pillar of the World Economic Forum's Global Competitiveness Index (GCI).

Figure 5.3.1 Relationship between EPL and GCI employment protection measures



Source: World Economic Forum (2012) and OECD-IDB (2015) for LAC.

The EPL index considers three types of labor regulations: individual dismissal, collective dismissal, and temporary contracts. It assigns a numeric value between 0 and 6 to 21 dimensions to generate weighted indices of employment protection. It does not consider wage setting or employers' perceptions of labor regulations. In 2013, the OECD published an updated methodology aimed at guaranteeing the comparability of country data. The IDB, in conjunction with the OECD, has used this methodology to calculate this indicator for the countries of the region.

The GCI labor market efficiency pillar is based on a survey of 13,000 entrepreneurs in 148 countries. The survey includes questions about two issues: flexibility and the efficient use of talent. These issues include flexibility in wage set-

ting; hiring and dismissal practices; dismissal costs; the effect of taxes on work incentives, remuneration, and productivity; managerial capacity; and country capacity to attract and retain talent. This index coincides with the EPL indices in two respects—hiring and dismissal practices and dismissal costs—but differs in the measurement method: subjective versus objective.^a

Figure 5.3.1 compares an average of these two dimensions of the GCI with an average of the EPL indices of protection against individual and collective dismissals for 15 countries in the region, ranking the countries from 1 to 15, where 1 represents the least protected (most competitive) country and 15 the most protected (least competitive). A positive association between the two indicators is observed, although a certain discrepancy is seen in some countries, Colombia being the most extreme case: although it is one of the countries with the highest protection according to the objective EPL index, the responses of local entrepreneurs put Colombia among the most competitive nations in this group.

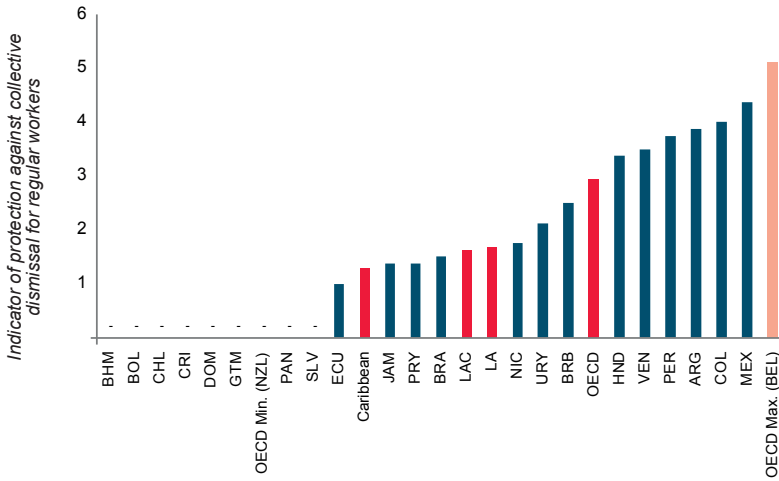
Source: Chaves (2014).

^a For a discussion on the factors that influence the subjective perceptions of firms, see Kaplan and Pathania (2010).

cedes, due in part to the labor reforms of the 1990s (Ciudad-Reynaud, 2004). Temporary contracts are issued to sidestep the regulations and labor costs associated with permanent hiring, and their use is increasingly widespread in the region (Carpio et al. 2011; Meléndez and Pagés, 2011). Temporary contracts reduce the incentives to invest in training and may be responsible for part of the high labor turnover and unemployment volatility in times of crisis (see Box 5.1).

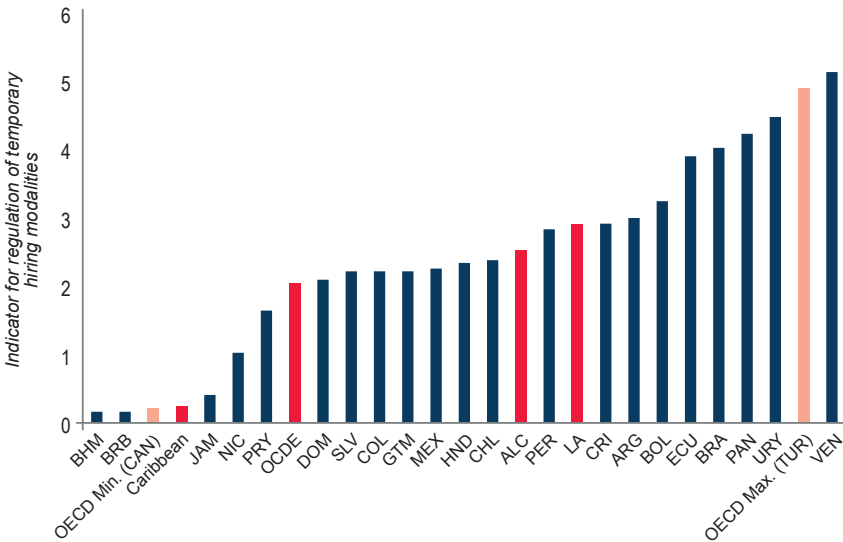
In certain contexts, labor law appears to promote higher labor turnover (see Box 5.4). For example, the wider use of temporary contracts in some countries in the region is causing a sharp decline in the length of formal jobs. These contracts are formal for all purposes related to the payment of the recurrent costs of formality (minimum wage, social security, etc.), although they are associated with a fixed term, which spares the employer from paying dismissal costs once the contract has ended. Traditionally, the region has been fairly strict about the use of temporary contracts (Figure 5.3 shows the indicator for restrictions on temporary contracts in the region in comparison with that of the OECD countries). In this regard, the restrictions on creating formal, but temporary, jobs in the region are generally tighter than in the OECD countries. However, recent years have seen a substantial increase in temporary formal hiring in some countries.

Figure 5.2 Protection against collective dismissal of regular workers



Source: OECD-IDB (2015) for LAC, and OECD (2013b) for the OECD countries.
 Note: Indicator that takes values of 0 to 6, where 0 represents the least strict regulation and 6, the strictest. LAC = average for countries in Latin America and the Caribbean; LA = average for countries in Latin America, excluding the Caribbean (Bahamas, Jamaica, and Barbados).

Figure 5.3 Regulations for temporary hiring modalities



Source: OECD-IDB (2015) for LAC, and OECD (2013b) for OECD countries.
 Note: Indicator that takes values from 0 to 6, where 0 represents the least strict regulation and 6, the strictest. LAC = average for countries in Latin America and the Caribbean; LA = average for countries in Latin America, excluding the Caribbean (Bahamas, Jamaica, and Barbados).

Box 5.4 Labor law and worker mobility: a case of reforming the labor code in Ecuador

Labor law is occasionally a determinant of the length of the employment relationship. This legislation often contains provisions that kick in after a certain month, imposing a series of labor costs. There is an entire body of specialized literature in Europe indicating that the vast majority of temporary contracts are not renewed due to the specter of their becoming indefinite contracts with much higher dismissal costs (Cahuc, Charlot, and Malherbet, 2012; Costain et al., 2010).

Ecuador's labor code provides for apprenticeship contracts. Prior to the 2006 reform of the labor code, the minimum remuneration under these contracts was 65% of the minimum wage for up to six months, after which apprentices would become workers with full benefits. The records of the Ecuadorian Social Security Institute (IESS) clearly show the impact of this legislation on the percentage of workers who separated from a firm (see Figure 5.4.1). In 2005 and 2006, this percentage increased disproportionately in the sixth month, jumping from 6% in the fifth month to 12% in the sixth, suggesting that the legislation led to the separation of many young people from their firm at the six-month mark, simply because the firm did not want to incur the additional costs of an indefinite job.

Under the 2006 reform of the labor code, contracts can be for up to two years. This change in the legislation produced a radical change in the percentage of workers who separated from their firm in the sixth month. In 2007, this figure was below 5%, and from 2008 on, 4%. This is a clear example of how labor law is intimately linked with worker tenure in a firm.

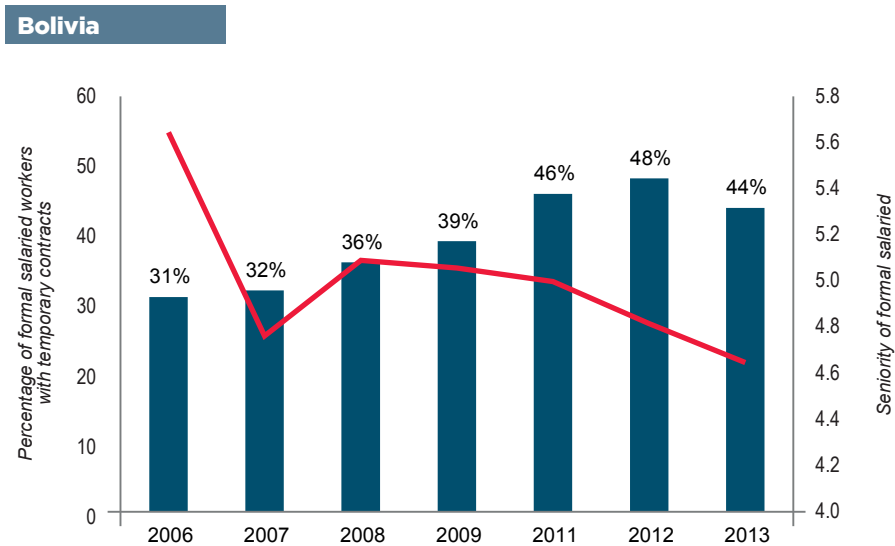
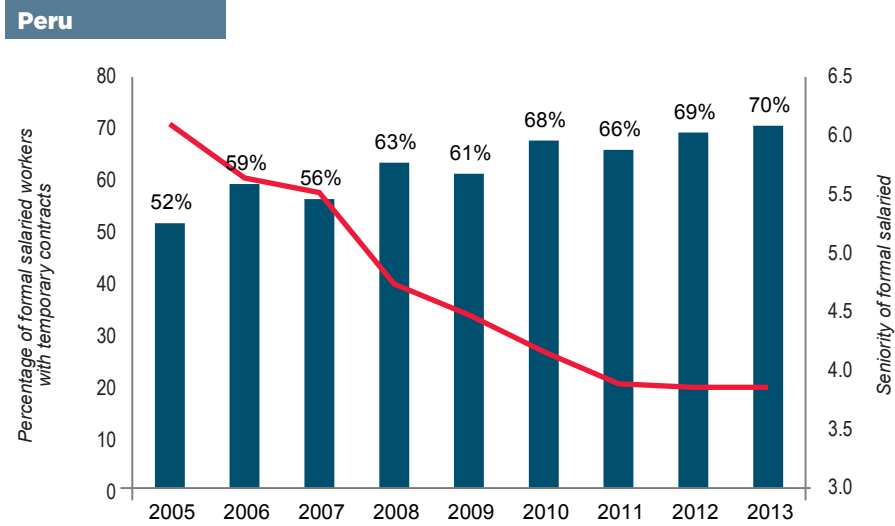
Figure 5.4.1 Percentage of workers separated from their firms



Source: Prepared by authors, based on administrative data from IESS.

Figure 5.4 Percentage of formal salaried workers with temporary contracts and average tenure in formal salaried jobs: Bolivia and Peru, workers aged 25-40, urban areas

■ Percentage of formal salaried workers with a temporary contract
 — Job tenure of formal salaried workers (in years)



Source: Prepared by authors, based on ECH for Bolivia and ENAHO for Peru.

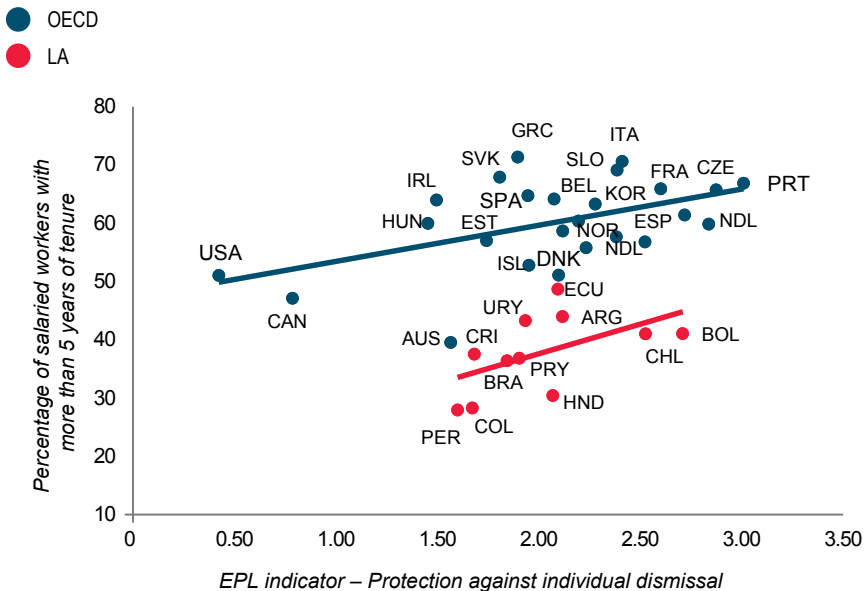
In urban areas of Bolivia, for example, the percentage of formal salaried workers aged 25–40 with a temporary contract rose from 31% in 2006 to 43% in 2013. Similarly, in Peru, these values rose from 50% in 2005 to 70% in 2013. During this same period, the average tenure of formal salaried workers in urban jobs fell by 17% in Bolivia (from 5.6 to 4.6 years) and by 36% (6.1 to 3.9 years) in Peru (Figure 5.4).

In fact, part of the differences in average job tenure among the countries can be attributed to dismissal costs (Figure 5.5). However, for the same dismissal cost, the turnover is higher. In other words, even though the costs of individual dismissals in LAC are similar to those of the OECD countries (Figure 5.1), fewer long-term jobs are created.

Dismissal costs in LAC

Severance pay and advance notice are the monetary costs of dismissal, the former being the most important component in the region. As seen in Chapter 4,

Figure 5.5 Protection against individual dismissals and percentage of salaried workers with more than five years of tenure at their firms



Source: Prepared by authors, based on OECD (2015) and OECD-IDB (2015).
EPL = employment protection indicators, OECD methodology.

severance pay is usually mandatory and primarily covers workers in the private sector once they have passed a probationary period; it is generally issued for dismissal without just cause and is financed by the firms themselves (Holzmann et al., 2011). This benefit is directly related to job tenure, and, in most cases, consists of one month of wages per year worked. On hiring, the employer sees the contingency of dismissal and severance pay, for which provision could be made in the form of savings over time. However, since such savings are not mandatory, more often than not, at the time of dismissal, the employer has not accumulated sufficient funds to cover the payment.

In terms of the cost flow,³ which employers should make provisions for in the event of a dismissal, average total costs in the region are around 8.4% of the annualized wage, with significant variations among countries. For example, Bolivia and Peru have the highest costs in the region: 13.3% and 12.5%, respectively. In Bolivia, severance pay for dismissal without just cause corresponds to one month of wages per year worked; however, three months of advance notice must be given prior to dismissal, or 240 days' pay in the case of workers with five years of tenure. In Peru, while advance notice is not required, severance pay for dismissal without just cause is 1.5 months per year worked; that is, 7.5 months of wages for five years of tenure, or 225 days' pay. At the other end of the spectrum, the country with the lowest dismissal costs is Barbados, with 3.9%, followed by Jamaica and Brazil, with around 5.5%. Compared with the OECD countries, the cost of dismissing an employee with five years of tenure is higher in the region: 8.4% versus 4.9% of the annual wage (see Figure 5.6).

At the time of dismissal, the average regional dismissal cost (stock)⁴ is 42% of the annual wage (calculated for a worker with five years of tenure). Thus, if an employer must pay an employee with five years of tenure the full amount of the severance pay due, it would represent 66.7% of the annual wage in Bolivia; 62.5% in Peru; and 58.3% in Argentina. The countries below the regional average are Barbados, Brazil, Colombia, Costa Rica, Dominican Republic, Jamaica, Nicaragua, Panama, Paraguay, and Trinidad and Tobago. As seen in Figures 5.6 and 5.7 (flow and stock), the Caribbean countries are generally those with the lowest costs.

³ Cost flow is estimated as the annual savings that the employer must accrue to cover the cost of a dismissal, regardless of whether the funds are actually used.

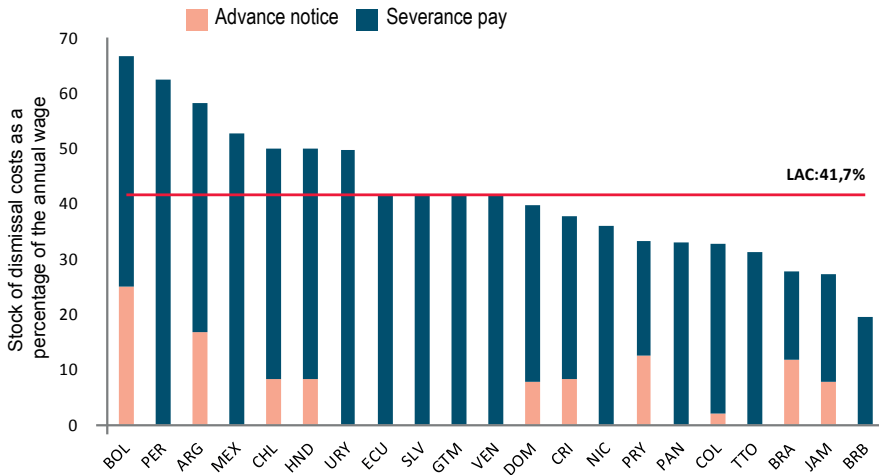
⁴ The cost stock is estimated as the total payment that the employer must make at the time of dismissal, regardless of whether it has accrued monthly savings for this purpose.

Figure 5.6 Annual cost flow for severance pay and advance notice for a worker with five years of tenure



Source: Prepared by authors, based on labor law in LAC in 2013 and World Bank (2014) for the OECD. Note: Five years of tenure are assumed for each country. The cost flow is estimated as the amount that the employer must save annually to cover the cost of dismissal, regardless of whether the payment is made.

Figure 5.7 Stock of dismissal costs at the time a worker with five years of tenure is dismissed



Source: Alaimo et al. (2015).

Note: Five years of tenure are assumed for each country. The cost stock is estimated as the total payment the employer must make at the time of dismissal, regardless of whether it has accrued monthly savings for this purpose.

In the majority of the countries, severance pay is financed internally without prior savings, constituting the threat of non-payment for workers in the event of employer insolvency, whatever the size of the firm.

Institutional weaknesses in the enforcement of labor law and the potential disconnect between regulation and productivity may explain the fact that while LAC and the OECD countries have similar levels of regulation, Latin America and the Caribbean have a substantially higher degree of turnover, as seen in Chapter 2. Micco and Pagés (2006) find that the weaker a country’s enforcement capacity, calculated according to the Rule of Law Indicator developed as part of the World Bank’s Worldwide Governance Indicators, the less the mitigating effect of severance pay on labor turnover (Kauffman, Kraay, and Mastruzzi, 2003).⁵

In short, regulating dismissals reduces the number of dismissals without just cause and can, therefore, directly increase worker welfare since making dismissal more expensive decreases its incidence; indirectly, it can do so by

⁵ See governance indicators at <http://info.worldbank.org/governance/wgi/index.aspx#reports>.

promoting more training, which, in turn, can lower the incidence of dismissals if it has a positive impact on the productivity of the match. However, raising the cost of dismissal may entail a series of adverse effects on formal job creation, productivity, and the labor market entry of vulnerable groups. It can also have an undesirable effect on labor turnover if firms manage to sidestep the regulations by hiring their employees on a temporary basis. It is, therefore, essential to strike a balance between protecting workers and promoting productivity and formality. Chapter 6 revisits this topic and suggests policy options that can move us down this path.

Policies for training active workers

Policies for training active workers seek to maintain and boost the productivity of the employment relationship.

Training policies promote better career paths and higher productivity. This section argues that while these policies have not been used in the region to promote greater job stability, policies to promote lifelong training can meet this objective and foster better career paths and higher productivity without the potential side effects of dismissal regulations. Thus, they are a very interesting policy option for solving the region's problems of low productivity, high informality, and job instability. Policies that promote lifelong training involve the acquisition, updating, and certification of workers' skills and competencies, and—in so doing—foster the productivity and competitiveness of firms, in addition to employment opportunities for workers. This definition includes not only formal education and training, but the training acquired informally in the workplace, which requires mechanisms for certifying competencies acquired informally (Crespi, Fernández-Arias, and Stein, 2014). The developed countries are all stressing education and training (hereafter referred to jointly as training) to mitigate the risks associated with competition from countries with low labor costs and the skill lag associated with rapid technological change. Unfortunately, as we will see below, less importance has been directed toward this issue in LAC, even though the region is facing the same challenges of external competition and rapid technological change.

As stated in Chapter 2, there is a close connection between education and job stability: Labor turnover is lower among workers with more years of schooling. However, the international evidence also suggests that training workers who are already active promotes better career paths by raising wages in current and future jobs and/or reducing the probability of dismissal. Likewise, it indicates that training workers boosts the productivity of firms (see Box 5.5).

There is also evidence regarding the link between training and better job performance in the region, although it is less complete and, in many cases, is limited by a lack of information.

Given the emphasis on human capital, many countries have embraced policies to encourage employers and workers to invest in training. For these policies to be effective and result in higher employer and worker productivity, they must: 1) directly incorporate employer input in the development of training programs, so that workers receive training in relevant areas; 2) promote investment in human capital through public mechanisms to finance training; 3) establish results-based financing mechanisms (apprenticeships, results related to the labor market, and/or certifications); 4) establish public mechanisms to ensure quality control and the relevance of apprenticeships; 5) ensure the availability of information mechanisms to assist firms and workers with decisions about investing in training, steering them toward quality training centers, programs, and courses that are more suited to their needs; 6) ensure that there is a public agency with the capacity to steer training policies, and skill-building policies in general, in the direction of development, productivity, and/or worker welfare; and 7) guarantee the integration of educational and training systems to facilitate training paths that promote lifelong learning (Crespi, Fernández-Arias, and Stein, 2014; Huneus, De Mendoza, and Rucci, 2013; Ricart, Morán, and Kappaz, 2014). As indicated below, a basic problem in the region is that virtually no country has created these mechanisms, which are necessary if the goal is to improve the situation in the labor market and boost productivity in LAC.

Training policies can respond to efficiency or equity objectives, and it is important to understand which objective is to be met to decide on the best mechanisms for allocating funds: supply-side subsidies to finance government institutions and/or public and private service providers, and/or demand-side subsidies—that is, workers and firms. Huneus, De Mendoza, and Rucci (2013) provide examples of government interventions in the training market (see Table 5.1) and stress the importance of understanding the objective pursued in order to prioritize, supervise, and ensure the effective use of such interventions.

Worker training policies in Latin America and the Caribbean

As noted in Chapter 2, the degree of training provided for workers in LAC is several orders of magnitude below that for workers in OECD countries outside the region (Figure 2.17). However, the evidence on how much is

Box 5.5 Summary of evidence on the impact of training on workers' wages, productivity, and probability of dismissal

The literature on the impact of the training that workers receive is rather extensive. It consists largely of studies that estimate the impact on the wages of workers who have received training, using data from developed countries such as Belgium, France, Germany, the Netherlands, and the United States (see, for example, Aralampulam and Booth, 1998; Blundell, Dearden, Meghir, and Sianesi, 1999; Dearden, Reed, and van Reenen, 2000; Frazis and Lowenstein, 2005; Gerfin, 2004; Goux and Maurin, 2000; Konings and Vanormelingen, 2010; Lynch, 1992; Pishke, 2001). The estimated impact is generally positive and substantial. In fact, according to many of these studies, on-the-job training seems to have a greater impact on wages than formal education does (Haelermans and Borghans, 2011).

The literature has also examined the effects of training on the productivity of firms (for example, Almeida and Carneiro, 2008; Barret and O'Connell, 2001; Dostie, 2010; Dearden, Reed, and van Reenen, 2000; Konings and Vanormelingen, 2010; Zwick, 2004). This body of literature is smaller and does not yet provide a consistent picture of results. A major constraint is the absence of cost information that would furnish knowledge about the net returns of training. The exception is the study by Almeida and Carneiro (2008), who found that, in Portugal, the training that firms provide to their employees yields significant net returns (8%), comparable in magnitude to those from investing in education or physical capital.

One methodological challenge that these studies must overcome is the fact that training can be associated with aspects such as wages and productivity without reflecting a causal relationship. For example, factors such as the management skills of administrators can boost worker productivity and, at the same time, investments in training. A few studies take advantage of exogenous variations in training decisions and tend to observe lower impacts (see Leuven and Oosterbeck, 2008; 2004). Nevertheless, a recent publication uses the random allocation of workers at a Netherlands call center to in-house training programs and finds significant effects on worker productivity and positive effects on the peers of the workers trained (De Grip and Sauermann, 2012). Given the size of this sample and the level of detail, it is unclear whether these results can be generalized.

The effects of training active workers are seen not only in higher wages

and productivity, but in diminished job instability, although the latter has been explored far less in the literature than wage effects. According to one OECD study (OECD, 2004), training has a significant impact on objective and subjective measurements of job stability, particularly for older workers with fewer years of schooling. This suggests that training plays a key role for this group because it provides the competencies necessary for keeping productivity in line with wages, thus facilitating job retention.

In the case of Latin America and the Caribbean, the evidence on the impact of training active workers is very scarce and has not yielded conclusive results. The studies of Ibararán, Maffioli, and Stucchi (2009) and Flores Lima, González-Velosa, and Rosas (2014) use information from World Bank Enterprise Surveys to estimate the impact of employer-provided training on productivity. Both studies confine the analysis to the manufacturing sector. Ibararán, Maffioli, and Stucchi (2009) use cross-cutting data in a sample of 16 countries and, to calculate the estimate, construct instrumental variables using segments of peer firms with similar characteristics. Their results show a positive impact on productivity. Flores Lima, González-Velosa, and Rosas (2014), in contrast, use longitudinal data from firms in a sample of 11 countries. Estimating a production function that combines fixed effects, the authors observe that on-the-job training for active workers increases multi-factorial productivity in firms with more than 100 workers.

In short, the literature shows that training generally has a positive impact of considerable magnitude on wages, job stability, and productivity.

invested in training for active workers in the region is very limited, since only a few surveys from some countries collect these data. The World Economic Forum also compiles information on the incidence of training through the administration of surveys to employers (Figure 5.8). While these data are questionable, since they are based on the subjective responses of a select group of employers in each country, they do provide additional information. It can, therefore, be inferred that the incidence of training in LAC is below the world average and below that of other emerging regions such as Central Europe and East Asia and the Pacific.

This is particularly problematic in the context of the region, where the educational level of the labor force is still low (see Chapter 3, Figure 3.2). The deficiencies may be even greater if calculated in terms of skills. Although there are still no measurements of the skill reserve in Latin America's labor force,

Table 5.1. Policy objectives and mechanisms for allocating training

| Allocation mechanisms | Demand | | Supply |
|------------------------------------|--|--|---|
| | Individuals | Firms | Training providers |
| Equity | Attention to training needs of vulnerable groups: workers with low levels of education, the unemployed, etc. | | Provision of free or low-cost training to increase access and participation |
| Efficiency: productivity | Allocation to workers helps increase individual benefits: higher wages, better working conditions, greater job stability, etc. | Better adjustment of supply to the needs of the productive sector | Pursuit of national or sectoral strategies through training |
| Efficiency: market failures | Training subsidies mitigate the problems of little or no credit that people face. | Training subsidies for SMEs that lack access to training due to lack of access to credit | Economies of scale in offering courses |

Source: Huneus, De Mendoza, and Rucci (2013).

the evidence suggests that decades of deficient education have significantly eroded the quality of the region's work force, as demonstrated in the results of the 2009 PISA tests (OECD, 2010a).

This implies that workers in the region do not arrive at the workplace equipped to produce value for themselves and their firms. The available information suggests that this leaves an unmet demand for skills among firms, creating a bottleneck for growth. This is not surprising. One third of firms in LAC—69% in Brazil and 56.6% in Argentina—consider inadequate worker training to be the greatest obstacle to their operations and the main barrier to innovation

(World Bank, 2010). In fact, this percentage is higher than in other regions of the world (Figure 5.9). Furthermore, in a good number of countries in the region, a higher percentage of employers than the world average state that they have problems hiring workers with the necessary skills (Manpower, 2013).

Around 90% of entrepreneurs in Argentina, Brazil, and Chile indicate that they are not finding the competencies they need to produce competitively (Bassi et al., 2012). Likewise, the majority of entrepreneurs in the Bahamas, Honduras, Panama, and Uruguay say that lack of skills is their main recruitment problem (Flores Lima, González-Velosa, and Rosas 2014). Finally, of all the regions in the world, LAC is the one in which a high percentage of firms indicate that the low-skilled work force is a major impediment to their activities (OECD, 2014b).

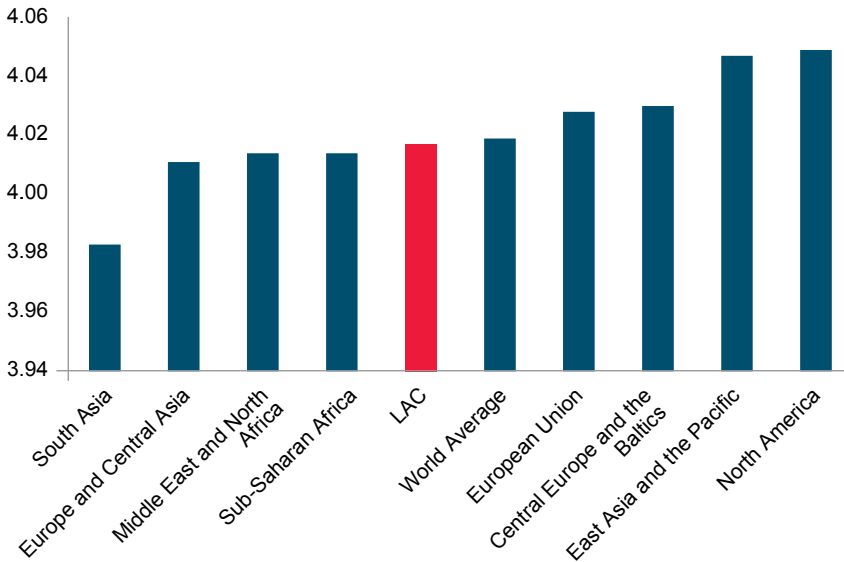
It should be noted, however, that the data are not entirely consistent with large or widening skill gaps, if measured in terms of gender, race, or income distribution. The gap has been closing, at least with respect to formal education (Cruces, García Domenech, and Gasparini, 2012).⁶ One fact that is still difficult to square with the others is that the evidence also suggests that returns on education are falling in the region (Lustig, López-Calva, and Ortiz-Juárez, 2013; Aedo and Walker, 2012; Gasparini et al., 2011). The causes of this phenomenon are not yet well understood, and it is, therefore, challenging to reconcile this trend with the data suggesting the presence of wide gaps in human capital in the region (Ferreira, Firpo, and Messina, 2014).⁷

National training institutes as the cornerstone of the training supply

The predominant way of supporting training in Latin America and the Caribbean today is to subsidize the training supply through the creation of National Training Institutes (NTI). NTIs are public agencies (for example, SENA in Colombia, INFOTEP in the Dominican Republic, INA in Costa Rica, INADEH in Panama, and SNPP in Paraguay) funded—in most cases—by a specific

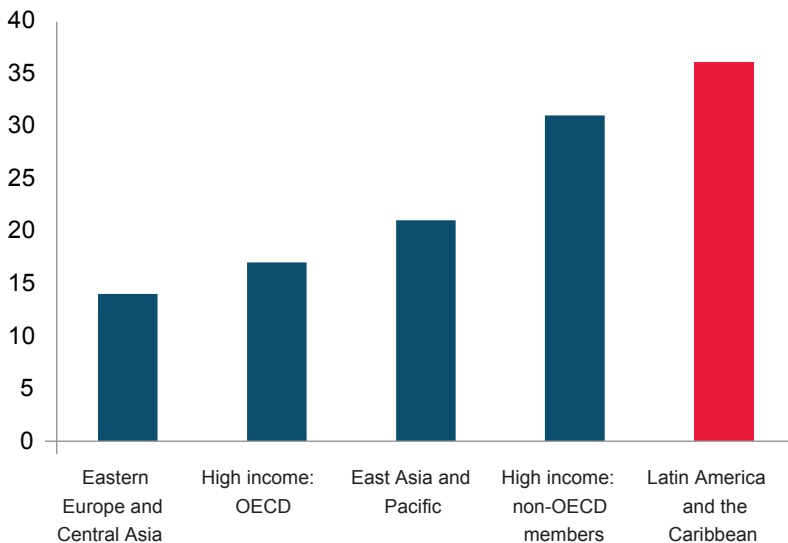
⁶ Cruces, García Domenech, and Gasparini (2012) analyze differences in educational outcomes and access opportunities for the population, including inequalities in years of schooling, gaps in school attendance, skill-based wage gaps, and social public expenditure in the sector. The authors found that, between 1990 and 2000, there was an equalizing effect in terms of income, due to the effect of public expenditure for the poorest sectors and an increase in the relative demand for low-skilled labor.

⁷ A recent publication on this subject (González-Velosa, Rucci, Sarzosa, and Urzúa, 2015) examines the returns on higher education in Chile and Colombia. It reveals that there are actually wide differences in these returns, and that the returns can even be negative, depending on the sectors and training providers.

Figure 5.8 Incidence of training among active workers

Source: World Economic Forum (2014).

Note: The figure represents the answers to the following question: "In your country, to what extent do firms invest in the training and professional development of their employees?" [1 = do not invest; 7 = substantially invest], weighted average 2013–14.

Figure 5.9 Percentage of firms that consider an inadequately trained workforce to be a major obstacle

Source: World Bank (2010).

payroll tax.⁸ These institutes were created in the mid-20th century, when Latin America was in the process of industrialization based on import substitution; like other aspects of labor policy and labor law in the region, they have changed little since then, despite the enormous transformations in the local production model.⁹

NTIs are financed with a specific tax on the payroll of formal workers that ranges from 0.25% (Uruguay) to 3% (Jamaica) (see Table 5.2). The object is to increase the incidence of training by lowering the cost of its financing for firms and workers through the provision of free training services. While there are no mechanisms for measuring the results, there are indications that the system is not working well in the region.

First, despite the fact that some countries have raised and allocated substantial funds for these institutions, the evidence suggests that firms have made little use of the training that they offer.

NTI budgets differ widely, but abundant resources have been allocated to them in some countries. According to Huneus, De Mendoza, and Rucci (2013), at least three countries in the region (Colombia, Jamaica, and Panama) are spending more than 0.3% of GDP on training—figures similar to, or even higher than, those of the developed countries (see Figure 5.10).¹⁰ In another group (Chile, El Salvador, and Honduras), the figure is between 0.1% and 0.2% of GDP. In some countries, however (Paraguay, Dominican Republic, and Uruguay), the budget is slim, well below the regional average and 0.1% of GDP.

However, according to Flores Lima, González-Velosa, and Rosas (2014), based on a representative survey of formal firms in five countries in the region (Bahamas, Colombia, Honduras, Panama, and Uruguay), most of the training that firms provide is funded with their own resources, taking very little advantage of public promotion mechanisms (see Box 5.6). Why do firms take so little advantage of NTIs to train their personnel? It may be because of the low quality of the

⁸ In Colombia, the specific tax to fund the National Training Institute was repealed at the end of 2013, and the Institute is now funded through general resources.

⁹ As mentioned below, one of the changes is related to the beneficiary of the training. NTIs were originally designed to support the training of workers employed in the firms that financed institute operations, but for equity's sake, many NTIs allocate up to 50% of their resources to train unemployed, low-income people or other vulnerable groups.

¹⁰ Figure 5.10 represents training expenditure in the broad sense and includes institutional training (which would be equivalent to the expenditure of the NTIs), on-the-job training, alternative training (classroom and on the job), and special support for apprentices. Comparing Table 5.2 with Figure 5.10, it is evident that even so, training expenditure in some countries in the region is high.

Table 5.2. Characteristics of national training institutes

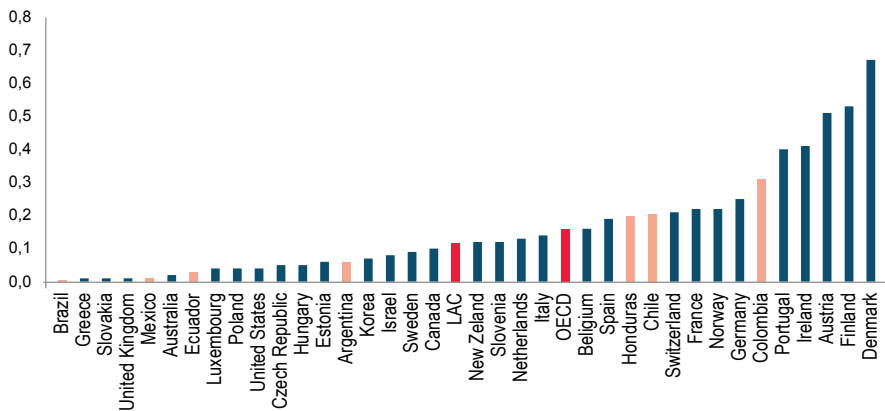
| Country | Institute | Contribution (percentage of payroll) | Contribution (percentage of GDP) | Training system |
|-------------|-----------|--------------------------------------|----------------------------------|-----------------|
| Chile | SENCE | n/a | 0.100 | 1 |
| Colombia | SENA | 2.0 | 0.367 | 4 |
| Dom. Rep. | Infotep | 1.0 | 0.070 | 4 |
| Ecuador | Secap | 0.5 | 0.030 | 2 |
| El Salvador | Insaforp | 1.0 | 0.120 | 4 |
| Honduras | Infop | 1.0 | 0.190 | 1 |
| Jamaica | HEART | 3.0 | 0.510 | 2 |
| Panama | Inadeh* | 1.5 | 0.290 | 2 |
| Paraguay | Sinafocal | 1.0 | 0.000 | 4 |
| Uruguay | Inefop | 0.25 | 0.043 | 1 |

Source: Huneus, De Mendoza, and Rucci (2013).

Note: Type of training systems: 1 = administrator, 2 = almost always administrator, 3 = frequently provides training, 4 = always provides training.

Inadeh was created by the Decree Law of 8 February 2006 and absorbed the former National Institute for Professional Training (Inaforp) and other training programs, actions, resources, and initiatives under way.

n/a = not applicable. In the case of Chile, it is not a payroll tax but an exemption of up to 1% of the tax on profits, based on the resources invested in training.

Figure 5.10 Training expenditures as a percentage of GDP, 2010

Source: Cerutti et al. (2014) for LAC and OECD (2015).

Note: According to the definition used by the World Bank and the OECD, training expenditure includes: institutional training, on-the-job training, mixed training (classroom and on the job), and special support for apprentices.

training provided (which conflicts with the efficiency-productivity objective mentioned in Table 5.1) and the fact that NTIs have been channeling a substantial portion of their resources toward helping unemployed or informal workers enter the labor market (in pursuit of an equity objective).

There is currently no objective indicator of the quality of the training provided (nor information for estimating it). It is likely, however, that the training is not up to the requirements of firms, for at least three reasons (Crespi, Fernández-Arias, and Stein, 2014):

Box 5.6 Training investment by firms

In general, little is known about the nature of the investments in human capital made by the formal firms in the region. According to Flores Lima, González-Velosa, and Rosas (2014), some 30% to 50% of these firms offer their workers training through short, structured courses focusing on specific job skills. The more-skilled workers are more likely to benefit from these courses and get more out of them. Based on a survey of firms in five countries (Bahamas, Colombia, Honduras, Panama, and Uruguay), these authors also state that funding for these programs comes largely from the firms themselves, since State subsidies for promotion tend not to be used and are channeled primarily to larger firms.

■ First, there has been little development of procedures to ensure that training is targeted to the sectors and occupational profiles in demand in the productive sector.¹¹ Only Chile, Colombia, and Mexico—where it is just getting off the ground and not fully generalized—have adopted a competency-based training model to steer training programs toward providing the skills that workers need for each occupational profile, with continuous upgrading of these skills. The absence of this infrastructure makes it very hard to devise relevant training packages (for workers wishing to enter the labor market and those who are already active) that enable workers and firms to constantly update their skills and develop new ones to promote lifelong learning.

¹¹ For example, unlike countries where technical training systems work better, there are few models for prospecting vacancies and/or mechanisms for ongoing dialogue between the training and employing sectors to identify the sectors/profiles in higher demand.

■ Second, also absent are mechanisms for measuring results and impact to verify whether the desired outcomes are actually being achieved. Very few training institutes and centers have good systems for monitoring results, either in terms of labor market entry (if the training is for workers out of the labor market) or the improvement of skills, income, or productivity (if the training is for workers who are already active). Furthermore, virtually none of the institutes uses modern impact evaluation techniques to compare the results of having received some type of training with what would have been achieved—in terms of the job, wages, or productivity—in the absence of that training.

■ Third, not a single country in the region has independent bodies charged with quality assurance of the courses. The lack of such institutions, which are common in developed countries, hinders external performance monitoring of NTIs and other facilities that offer State-funded training. As a result, some countries are investing huge sums in training with no accountability among training providers for the results.

The 1990s saw the emergence of a line of reforms to improve NTIs by converting them to training administrators (that no longer provided direct training). Thus, some countries (Chile, Paraguay, Uruguay, El Salvador) created models in which the institute does not directly offer courses (or does so in a very limited fashion), but issues tenders to public or private training providers to offer courses that meet the specifications of the demand (firms and workers) (see Table 5.2, which lists modalities by country). In another group of countries (Colombia, Honduras, Dominican Republic), NTIs operate as training institutions, offering firms and workers a catalogue of training activities. These reforms were based on the hypothesis that administrative NTIs would surely achieve better results than training NTIs because they would have the freedom to contract different public or private institutions that would compete for funds. This competition would ensure better-quality services than those provided by the training NTIs, which were public institutions with a monopoly on State resources. In practice, however, the inability to verify the quality of the courses offered by the public or private operators has kept competition from working as it should to raise quality standards (Huneus, De Mendoza, and Rucci, 2013).¹²

¹² In other cases, such as Brazil and Peru, there are Sector Training Institutes (such as SENAI and SENATI, respectively, in the case of industry). Since they are sectoral, they may be better attuned to skill needs in the sector.

Direct training subsidies for firms or workers

There has generally been less use of direct subsidies for firms or active workers in the region due to the predominance of the NTI model as an instrument for promoting training. The model in which a subsidy is offered to firms to supplement and increase their investment in the human capital of their workers has been implemented in Chile through a tax exemption. This instrument provides an exemption of up to 1% of the taxes on profits, based on the resources invested in worker training. This type of tool is also found in Argentina; while it would be expected to foster relevance (that is, that firms would contract the training they need), it does not necessarily guarantee results, as it requires the training offered to meet a certain standard of quality and boost the productivity of firms and workers alike. In the case of Chile, the institutional structure of the tax exemption appears to be inadequate for maximizing the quality of the courses. In this same vein, there is no evidence that workers who receive training benefit in terms of wages or employability (Rodríguez and Urzúa, 2011; MTPS, 2011).

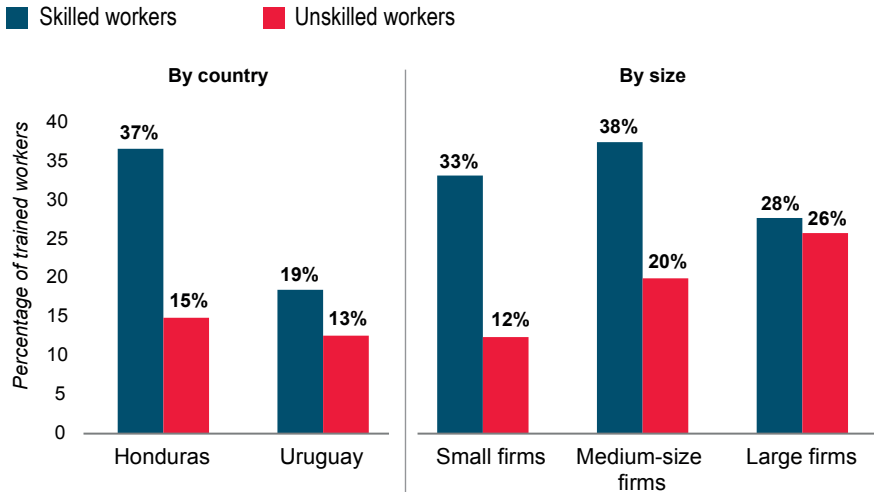
There are also instruments in the region that provide subsidies or bonuses directly to workers so that they can receive training where they want to while employed in their firm. In theory, this type of program should increase opportunities for workers by allowing them to choose what best suits them, given their particular attributes, without the mediation of a firm. Moreover, promoting competition for funds among the various providers should theoretically improve the quality of the training supply. However, this requires that people make good decisions about which courses they need the most or better meet the demands of the market. It also requires that people be able to discriminate among courses and providers to determine which are valuable and relevant. This is unlikely to occur, given the dearth of information on employers' needs and the quality of the training supply in the region. Kaplan et al. (2015) review the international literature on this topic and assess Chile's Bono Trabajador Activo (active worker subsidy), which is a demand subsidy program for workers. The assessment yields negative results with respect to employment and wages as a whole, but positive results for women (especially those with low levels of education), job tenure, and labor mobility. The authors argue that the lack of impact on wages and employment is due to information failures because the program provides neither vocational counseling nor information on the quality of the courses to help beneficiaries make well-founded decisions when selecting training options.

In short, while the investment level in several countries is similar to that of the developed nations, there is a need to increase incentives and the quality of the expenditure to achieve better career paths and greater productivity. Chapter 6 offers some suggestions for progress in this regard.

The policies for training active workers are rather inefficient, not to mention inequitable. To address this issue, a continuing lifelong learning system is needed that provides incentives for all actors involved. For example, leaving everything in the hands of firms may not be the best strategy for achieving efficiency and equity. Firms have no incentive to finance training in general skills, due to the high externalities of this type of training. The evidence likewise indicates that firms tend to provide training for their more-skilled workers, in which case the cost benefit ratio of training tends to favor this group. (Figure 5.11). Flores Lima, González-Velosa, and Rosas (2014) conclude that on-the-job training can exacerbate skill gaps among workers with different levels of education, since it is offered more intensively to the more-skilled workers. This, in turn, can widen the wage gap between skilled and unskilled workers. All of this underscores the importance of complementary strategies to bridge skill gaps in the labor force—strategies that include developing lifelong training systems and strengthening policies to promote adequate training in general skills for people still in school.

Subsidies for labor retention

Some countries have adopted a combination of instruments to prevent dismissal and subsidize employee retention through specific subsidies to train workers who might be affected by a temporary drop in demand during crises. Wage subsidies tend to be the main tool in these cases and are sometimes combined with training. For example, Mexico was one of the Latin American countries hit hardest by the crisis of 2008–2009, due to its proximity to the United States and the influenza crisis of 2009. In January 2009, it adopted a series of measures, notably the Job Preservation Project, which enabled firms to cut the length of the work day instead of dismissing workers and partially compensated workers for lost income through a subsidy.

Figure 5.11 Incidence of training by job category

Source: Flores Lima, González-Velosa, and Rosas (2014).

Note: The size of the firms is defined by the number of employees: small (1 to 19 employees), medium-sized (20 to 99), and large (100 or more).

Conclusions

Labor regulations were created with the objective of protecting workers in their employment relationship with firms, guaranteeing a minimum pay threshold and social benefits and lowering the probability of dismissal. In practice, a context marked by lack of enforcement and low productivity creates incentives for firms to sidestep these regulations through informal hiring. In fact, even in the case of formal workers with the right to severance pay, only a small fraction receive the payment they to which they are entitled. There are no easy solutions. From the social standpoint, it is clear that workers must have a certain degree of protection, but the regulations should be amended to strike a balance that promotes stability with productivity.

Policies for training active workers have the potential to significantly optimize the career paths of workers and the productivity of firms, achieving virtuous cycles in which everyone wins. However, even though some countries allocate substantial resources to this endeavor, much remains to be done to improve their performance and equity. Results, in terms of quality and relevance, must be guaranteed by monitoring program performance and disseminating information to workers and the State, so that all parties can make the right decisions. This is unlikely to occur without institutional reforms that promote a better way of developing skills and closer ties with the productive sector.

These topics will be revisited and explored in greater depth in Chapter 6.



Chapter 6.

Public policies to achieve successful career paths

Summary

For labor markets to enable workers to move in the direction of successful career paths, an integrated labor policy is needed whose various components strengthen and do not interfere with each other. This chapter examines the various proposals for achieving successful career paths, presenting them in two interconnected and complementary lines of action or pillars: policies to increase and equalize opportunities for access to formal jobs and policies to promote productive job stability. This package of proposals is designed to foster successful career paths for workers and sources of growth for the economies.

Introduction

The introduction to this book described successful career paths that reflect our vision for the labor markets of the region. In this vision, workers find jobs where their skills allow them to be productive and experience professional growth. They constantly accumulate human capital, which fosters job stability, spurs wage growth, and enables the majority of worker transitions to be voluntary and toward better jobs. While there will always be workers who involuntarily lose their jobs, in this vision, these workers would receive income support and, after a reasonable time looking for work, would not only secure a new job, but a high-quality one that would enable them to resume a successful career path.

Chapters 1 and 2 argue, however, that the reality in the labor markets is unfortunately very different from the vision of successful career paths proposed in this book. First, many workers in the region have serious difficulties finding a good job and, when employed, are subject to a high degree of job instability. Furthermore, this constant turnover generally does not appear to be in the direction of better jobs, but often, to informal jobs that pay less and/or provide fewer benefits. There is little investment in human capital in the workplace and little protection for the unemployed. Employers, in turn, face obstacles to creating more and better jobs, due to labor regulations that, in some cases, are inconsistent with the level of labor productivity in the economies.

There are a number of reasons for the poor performance of the region's labor markets. Chapter 3 describes multiple market failures that, absent an appropriate public policy response, prevent the labor market from reaching its full potential. For example, information failures make it impossible for employers to find workers with the profiles they need; they also prevent workers and employers from making good decisions about training (Who are the best training providers? What type of training offers the greatest potential for finding a good job? What type of training is most effective?). Decisions about human capital accumulation are also affected by a lack of liquidity that makes it impossible for workers and employers to finance investments in human capital, while high labor turnover renders such investments unprofitable for firms. Moreover, the private market generally does not offer workers' unemployment insurance for income support in the event of job loss; in fact, private unemployment insurance is virtually nonexistent worldwide.

Nevertheless, despite these problems, the news is not all bad. As seen in Chapters 4 and 5, a series of instruments already exists for mitigating the

market failures that plague labor markets. These instruments can be divided into two groups: policies to increase or equalize opportunities for access to formal jobs, and ii) policies to increase productive job stability. Although certain characteristics tend to be missing from these instruments, making them less effective in solving the problems of the labor market, it is also true that many countries already have the seeds of a labor policy that could boost productivity and growth in the region while, at the same time, creating better-paying, better-protected, and more stable jobs.

Based on the lessons from the preceding chapters, the goal of this chapter is to propose a two-pillar labor policy that will make labor markets in the region more capable of promoting successful career paths. Many of the instruments presented in Chapters 4 and 5 will be used in the construction of the pillars, but there will also be an integrated design to guarantee that the efforts under these pillars are mutually reinforcing, with a strong, cross-cutting emphasis on boosting productivity.

The objective of the proposals in this chapter is for labor markets to enable workers to shift toward successful career paths. Job seekers would not only find jobs, but with State support, find formal jobs in which they could certify their skills and have the opportunity for professional growth. In addition, given the fact that workers have the appropriate profile to be productive, firms would take advantage of State financial and institutional support to invest in their workers' development. These investments in human capital would ultimately yield higher productivity and wages, as well as opportunities for workers to find even better jobs with other firms in the future. Likewise, workers who involuntarily lose their jobs would have access to income support during unemployment and also benefit from policies to facilitate labor market reentry so that they may resume a successful career path.

The rest of the chapter is organized as follows: Section 2 emphasizes the importance of an integrated approach between the two pillars and among all instruments. Absent this approach, efforts to meet the objectives of one pillar could have unanticipated impacts that undermine the effectiveness of the other. This section also stresses the need to continue promoting capacity building in many ministries of labor, so that they can design, execute, and evaluate labor policies and increase coordination with other government sectors and ministries that implement policies with implications for employment and productivity. It also underscores the importance of including firms as beneficiaries of the labor policies, even though the ultimate goal is to achieve better outcomes for workers, and the need to bring employer and employee

representatives together in a broad-based social dialogue on the design and implementation of these policies. Section 3 describes the two pillars' lines of action, explaining how these proposals would help correct market failures to move toward the vision of successful career paths. Lastly, Section 4 summarizes the proposals and offers some final comments.

As we have emphasized throughout this book, it is important to consider the extreme heterogeneity of the Latin American and Caribbean countries. Indeed, each country is at a very different stage of progress with respect to the proposed agenda. Even so, this book defends the idea that the basic principles outlined here are valid for every country in the region. However, implementation of the proposals and the emphasis placed on each will depend on a series of factors specific to each country.

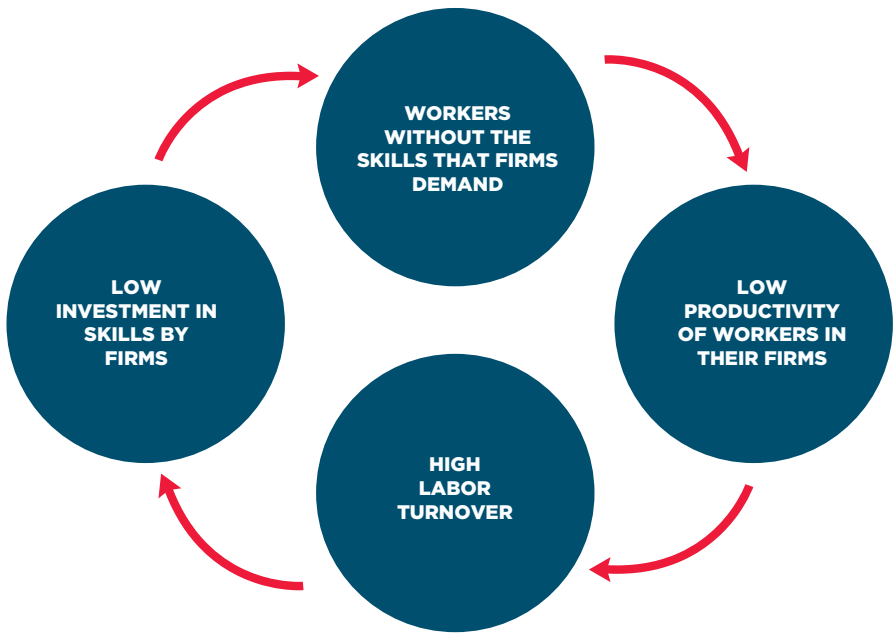
The importance of a comprehensive approach

Before examining the details of the specific proposals, it should be emphasized that public policy design should include a comprehensive approach to meet the objective of promoting successful career paths. Otherwise, there is a danger that efforts to improve one aspect of career paths will be counter-productive, generating unanticipated impacts in another dimension. For example, it would make no sense to promote the job stability of active workers if the result were to discourage formal hiring. It would also make no sense to protect income during unemployment if this support were to significantly reduce the incentives to find a new job.

This section, therefore, stresses the connections between the various labor policies, with a view toward promoting policies that are mutually reinforcing. This will make it possible to propose a package of policies that promote the vision of successful career paths from the time that young people first enter the labor market until their retirement, helping them improve their employment situation over time and protecting them when they encounter obstacles along the way.

Finding the right formal job is the first step toward productive stability

There is no doubt that having the right personnel is essential for a firm to be highly productive. Jack Welch, famed CEO of General Electric from 1981 to 2001, said: "Getting the right people in the right jobs is a lot more important than developing a strategy" (Welch and Byrne, 2001).

Diagram 6.1 The vicious cycle in career paths in the region

Source: Prepared by the authors.

There are many policies for promoting job productivity, which will be described in greater detail below. The approach of these policies will be to promote human capital accumulation so that worker productivity and wages improve with time, and both firms and workers have the right incentives to preserve the employment relationship during economic upturns and downturns. It makes no sense, though, to invest in human capital when workers are in an environment that is unfavorable to them.

Consider, for example, the case of Michael Jordan, who is possibly the greatest basketball player of all time. Notwithstanding, he was unsuccessful as a baseball player, despite two years of effort in the sport. By the same token, a shy person with math skills may be highly productive in many types of jobs, but would not be good in sales.

This vision leads us to an important conclusion about policies to promote labor market entry. It is simply not enough to help job seekers find just any job. If they land a job that is not right for them—where their skills are not useful—it

will probably not last long and they will soon need additional support to find another job. What this would be promoting is precisely the vicious cycle of high turnover without professional growth that currently characterizes labor markets in the region, as depicted in Diagram 6.1.

Diagram 6.1 shows that when workers enter a firm without the skills they need for the job, their productivity will inevitably be low. Since this employment relationship is disadvantageous for workers and firms alike, it will probably not last long and will also be informal, without social security benefits for the workers. The unfortunate consequence of an employment relationship that is informal and/or does not last long is the unprofitability of investing in human capital. The end result is that workers will leave the firm without acquiring any new skills and will find themselves in the same situation they were in before entering into the employment relationship. Far from starting a successful career path, workers who find employment for which they do not have the right profile foster the existence of a labor market characterized by high turnover, low productivity, and little professional growth, as discussed in Chapter 2.

On the flip side, when workers are in the right place, the picture changes dramatically. Simply being successful in the workplace motivates workers to learn and, if the appropriate incentives are in place, encourages firms to invest time and resources in them. As workers consolidate their success in the workplace, both they and their employers realize that, barring some unanticipated event, the employment relationship will last a long time, justifying a solid commitment by both parties to meet long-term objectives. This also increases the value of the employment relationship, contributing to its becoming formal and long term.

Policies to foster labor market entry should, therefore, have a much more ambitious objective. On one hand, there is a need for training policies designed to help workers attain productivity levels that will enable them to find a formal job. On the other, employment services should have the goal of ensuring that job seekers find jobs that are right for them so that they can initiate or resume successful career paths. That is, employment services in the region should make an effort to ensure that job seekers find transformative jobs that launch career paths with increasingly higher levels of wages, productivity, and welfare. Some proposals for meeting this objective are presented below.

Countries should promote job stability, along with formal hiring and greater productivity

High labor turnover, discussed in Chapter 2, poses a real public policy challenge. This phenomenon discourages employers from investing in human capital, as it is unprofitable for a firm to invest in the human capital of a worker who will soon be leaving. High labor turnover also makes it harder to protect the income of workers during unemployment because they have not been employed long enough in the formal sector to be eligible for severance pay or unemployment insurance. Here, there are two major policy objectives that are mutually reinforcing: increasing access to formal jobs and promoting greater productive job stability.

Notwithstanding all of the above, it should be recalled that reducing turnover per se is not the only goal of labor policy. As stated in earlier chapters, impeding the reallocation of workers to firms where they can be more productive is not recommended. Given the difficulty of assessing a worker's skills on hiring, especially if they lack work experience, it is important to allow firms to look for other alternatives once they realize that a worker lacks the necessary profile. If dismissal costs prevent this type of worker reallocation, the consequences will be lower productivity for the country and, hence, lower wages for workers.

Moreover, a disproportionate increase in severance pay, for example, can be counterproductive if firms attempt to sidestep or evade their responsibilities. If firms consider dismissal costs to be too high, then their reaction could be to offer informal jobs and avoid these costs entirely. Another alternative could be to avoid dismissal costs by issuing temporary contracts, which could increase instability and the disincentives to invest in training, instead of lowering them (as seen in Chapter 5, Box 5.1).

This is why the proposals in this chapter for increasing productive stability are focused more on providing incentives for human capital accumulation and reducing inefficient dismissals to a minimum than on promoting dismissal costs that are too high.¹ Instead of furthering job stability through a high monetary penalty for dismissal, the ideal is to promote workers' productivity through the skills they acquire during the employment relationship. Firms would view policies to promote human capital accumulation as a benefit of formalization instead of a cost. If workers turn out to be unproductive despite

¹ A dismissal is considered inefficient if it occurs even though the worker has the right skills for the job and no better employment alternative.

the investment in human capital during the employment relationship, excessively penalizing the firm for its decision to replace them would not be recommended. The best thing would be to provide income support to workers during unemployment and adopt policies to facilitate their effective return to the labor market.

Income support for the unemployed should minimize disincentives to job seeking

As noted in Chapter 3, though it is very unlikely that private insurance will be created to protect workers' income during unemployment, policies to provide income support during that period could improve the way the labor market works, correcting major market failures that prevent workers who lose their jobs from smoothing their income when no wages are being received.

This type of support could have a positive impact on productivity. Acemoglu and Shimer (2000), for example, find that unemployment insurance in the United States boosts labor market productivity because it enables the unemployed to engage in a more effective job search. Income support, at least in theory, enables unemployed job seekers to hold out for a good job offer instead of accepting the first one that comes along.

However, as detailed in Chapter 4, the region's experience with unemployment insurance suggests that this theoretically positive impact on productivity has not materialized. In Chile and Uruguay, it has been observed that such insurance prolongs the job search (Amarante, Arim, and Dean, 2013; Huneus, De Mendoza, and Rucci, 2013), and there is no evidence that, despite the additional time to search for work, the beneficiaries of this insurance find higher-paying jobs.

In this regard, it should be underscored that policies to support income during unemployment are part of policies to increase and equalize opportunities for access to formal jobs. Effort should be made, in particular, to prevent these two pillars from competing with one another. Instead, unemployment insurance should be designed so as to minimize the incentives not to look for work so that income support strengthens labor market entry and reentry policies.

Complementarity with other policies

Although Chapters 4 and 5 examine a wide range of labor policies, this book does not propose to cover all public policies that affect the labor market. It

should be pointed out, however, that any public policy that promotes formal employment will reinforce the labor policies presented in these pages. Income support mechanisms for the unemployed, severance pay, and unemployment insurance, for example, apply only to formal workers. Thus, an excellent system designed to provide income support for workers who lose formal jobs would hardly be effective in a context characterized by high informality.

Chapter 5 presents evidence that, at least in many countries in the region, non-wage labor costs are high, due largely to social security contributions and dismissal costs. The minimum wage in the region also tends to be high in comparison with the average wage. These policy-driven labor costs, however, are not the only factors that can influence the size of the formal sector. Other examples include the administrative costs of employer regulatory compliance and the tax and social security systems. Furthermore, any policy that boosts worker productivity, such as a better educational system, makes it more likely that firms will be willing to shoulder the non-wage costs of a formal job.

Thus, labor policies will be more successful if they are linked to the rest of a country's productive development policies, such as policies to promote innovation, a better business environment, capital market development, and education. The greater the value created by employment relationships, the less informality there will be in the region. This will make the labor policies proposed in this book, many of which apply only to formal workers, far more effective.

It is also essential to continue strengthening the ministries of labor, as the principal agencies responsible for the design and implementation of labor policy, so that they not only coordinate with other ministries connected with employment (finance, economy, education, social protection), but establish labor policies that promote higher levels of formal employment and productivity. Although some ministries in the region now have substantial budgets and staff to carry out their mission, others still lack a mandate to administer labor policies to promote formal employment and productivity. In order to move toward the comprehensive policy outlined below, it will be necessary, in many cases, to bolster the influence of the ministries of labor in the economic domain and improve their ability to design and implement policies and assess the impact of these interventions (Rychly, 2013). In some countries, it will also be necessary to give the ministry of labor a larger budget, along with greater authority to manage human and financial resources.

In addition, to increase the likelihood of success, it is essential to get firm and worker representatives fully involved in the design, discussion, and implementation of the labor policies described in this chapter. While ministries of labor were created with the mission of protecting workers (Rosen, 2014; Rychly, 2013), who are their main beneficiaries, in order to create value, firms must be included as both the clients and beneficiaries of labor policy. The State can play a key role in changing the status quo of high turnover, low investment in workers, and high informality to establish a new model with far more investment in workers, employment relationships in which everybody wins, lower turnover, more formal employment, and higher productivity growth. In order to meet these objectives, labor policymakers can procure better results for workers by promoting greater value in the employment relationship. This will be accomplished by addressing and balancing the needs of employees and employers in labor intermediation and job training systems, labor regulations, and policies to protect the unemployed through a vigorous social dialogue.

Toward a comprehensive policy: errors that should be avoided

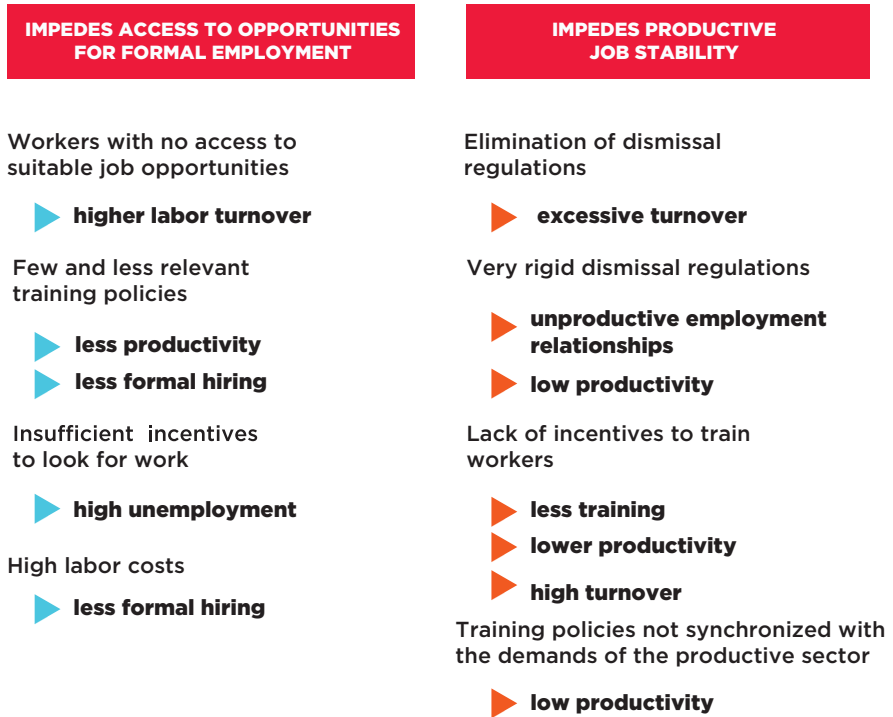
As already noted in this section, labor policy should have an integrated or comprehensive design. Otherwise, it will be inefficient, as the success of each component will be hindered by unanticipated effects in the other components. Diagram 6.2 summarizes these dangers, highlighting the potential risks of designing the two pillars of labor policy separately.

With these lessons in mind, this chapter offers a series of proposals with a comprehensive approach to support workers from the moment they enter the labor market. These policies would promote lifelong wage and productivity growth, and—during episodes of unemployment—serve not only as a safety net for smoothing income, but as a trampoline that would launch workers back onto the successful career paths they were pursuing before losing their jobs.

Proposals for achieving successful career paths

This section spells out our proposals for enabling workers in the region to transition to successful career paths. The two pillars, or general lines of action, of these proposals are: i) policies to increase and equalize opportunities for access to formal jobs and ii) policies to promote productive job stability. In all cases, special attention will be paid to the interconnections between the two pillars to ensure their complementarity.

Diagram 6.2 Consequences of a labor policy without a comprehensive design.



First pillar: policies to increase and equalize opportunities for access to formal jobs

As mentioned in the previous section, the first step toward a successful career path is effective labor market entry through a formal job. When workers land a job in a firm that is right for them, where their skills are useful, they receive the protections stipulated in the labor law, enjoy the benefits of social security, and have the opportunity for professional growth and the possibility of launching a successful career path. Moreover, one of the most important events in a career path occurs when workers, who have acquired new skills, voluntarily take a new job where their productivity and wages are higher. Another crucial event is finding another formal job where, after involuntarily losing a job, workers can resume their former career path with the possibility of professional growth.

Diagram 6.3 Proposals for achieving successful career paths

First pillar: policies to increase and equalize opportunities for access to formal jobs

A) Increase the effectiveness of labor intermediation policies. In particular, make more and better investments in public employment services

- Invest more in labor intermediation services
- Improve performance by increasing institutional capacity, autonomy, flexibility, and the integration of services
- Improve management by forging closer ties with employers
- Improve management, evolving toward a sound result-based management approach

B) Increase employment opportunities for young people looking for their first job and for those who, for one reason or another, must reenter the world of work.

- Provide assistance that enables young people to find a good first job
- Develop active policies to help the unemployed enter the labor market

C) Protect the income of job seekers during unemployment

D) Increase incentives for formal hiring through better regulation and enforcement

- Improve labor regulation
- Improvement of records and databases.
- Investment in better inspection.

Second pillar: policies to promote productive job stability

A) Increase the effectiveness, quality, and relevance of job training expenditure to promote productive stability

- Establishing new institutional arrangements for skill development
- Ensuring that training is better aligned with the needs of the labor market
- Establishing mechanisms to ensure the quality of job training
- Creating financial incentives for training
- Developing information mechanisms on the supply and demand for skills

B) Transitioning to an effective regulatory framework on dismissals

- Set an appropriate dismissal cost
- Allow unrestricted dismissal as long as the firm bears the cost
- Establish the right dismissal costs for both workers and firms
- Recognize special situations

At least two factors keep job seekers from finding a job that more productively uses their skills. The first is the lack of information for both workers and employers. The second is the lack of skills and the obstacles to securing financing for lifelong training. Fortunately, international evidence suggests that there are public policies that can mitigate these market failures and facilitate access to formal jobs.

We propose four lines of action for this pillar. The first is to increase the effectiveness of labor intermediation policies; the second, to improve the stock of human capital, for both young people looking for their first job and others who, for one reason or another, need to reenter the workforce; the third, to support workers during periods of unemployment, smoothing the loss of their consumption capacity and facilitating their return to the labor market; and fourth, to adopt regulations to improve working conditions without affecting the incentives for formal hiring.

(a) Increase the effectiveness of labor intermediation policies. In particular, make more and better investments in public employment services

1. Invest more in labor intermediation services

As discussed in Chapter 4, public expenditure on labor intermediation services in the region is low, averaging only 0.04% of the gross domestic product (GDP) (Cerutti et al., 2014), while the average for the Organization for Economic Cooperation and Development is on the order of 0.17% (OECD, 2011). This low level of investment implies that workers in the region receive little support for finding good jobs. If the countries of the region spent 0.13% more of GDP, they could substantially increase the coverage of these programs. According to impact assessments showing that labor intermediation services are cost-effective (Card, Kluve, and Weber, 2010), the additional expenditure of 0.13% of GDP would prove a profitable investment.

Notwithstanding, the simple act of increasing public expenditure on labor intermediation services would not be enough to ensure better policies that facilitate placement in a formal job. To make this leap, in addition to investing more resources, it would be necessary to spend them more effectively.

The purpose of employment services is to remedy the lack of information about the labor market. Job seekers do not have enough information to conduct an effective search, and employers do not know where to find employ-

ees with necessary skills. In addition, while there are training programs to support labor market entry (especially for youth), a lack of information about the demands of the productive sector can create a gap between the human capital that is acquired and the human capital required by employers.

To remedy this lack of information, employment services must encourage stakeholders who do not ordinarily coordinate with each other (business associations and educational institutions, for example) to do so. This task is even more difficult, considering that each individual job seeker has different needs. Since the ideal job depends on a worker's specific skills and preferences, as well as the local economic environment, employment services should not offer cookie-cutter counseling, but personalized attention to the individual situation of each job seeker.

Three specific actions are recommended to achieve this improvement in public employment services (PES), namely:

- ▶ Develop greater institutional capacity, autonomy, flexibility, and integration of services.
- ▶ Forge closer ties with employers.
- ▶ Move toward a solid results-based management approach.

Employment services must also coordinate or directly provide services that constitute two of the lines of action proposed in this pillar:

- ▶ Assist youth and other vulnerable groups in finding a good job.
- ▶ Protect the income of job seekers during episodes of unemployment.

The first three interventions under this line of action, based on international experience, are described below.

2. Improve performance by increasing institutional capacity, autonomy, flexibility, and the integration of services

One of the most daunting challenges for a PES is to tailor its services to the needs of each job seeker. A PES should offer flexible services suited to the circumstances of each case and the conditions of the local labor market. Guaranteeing this flexibility requires substantial institutional capacity (adequate budget, trained staff, and appropriate channels to offer the right services to the right people). It also implies allocating more resources to the people who need them the most and fewer resources to the rest. Some workers, for example,

will only need access to online job postings. Others will need a diagnostic analysis of their specific needs and individually tailored plans of action that may include technical and social-emotional training before they are steered toward a vacancy.

A prerequisite for achieving this institutional change is to have information on the local labor market. For example, the employment service should have a good assessment of job seekers, or at least of those in need of greater support. The assessment should cover both the skills of each job seeker and his or her job history. The employment service should also have information on the demand for skills; that is, information on which profiles are being sought to fill vacancies.

In this context, it is essential that employment services develop information systems as the backbone of labor market entry and reentry policies. In addition to facilitating the flexible, personalized services required for developing successful career paths, a good information system is necessary for proper results-based management. It should be recalled, however, that a good information system is of little use if the employment service lacks personnel capable of translating all of this information into concrete actions that benefits job seekers. It is, therefore, essential for employment services to be staffed with human resources professionals specialized in specific services (for example, employment services for youth). In addition to hiring personnel with the right profile for the work required, employment services should train their staff according to the services they offer.

The objective of providing personalized services based on the needs of each job seeker has major implications for the institutional design of an employment service. Since job seekers generally do not know what type of support they need, the employment service must assume the responsibility for analyzing each situation and guiding job seekers to the type of support that is most suited to their needs. A possible institutional alternative for this type of support is to integrate most of the services under a single institution. Another is to effectively coordinate the services of several institutions to ensure that job seekers receive the most appropriate package of services at a cost that ensures the sustainability of the services. There is a global trend toward this type of service integration through single windows. A system administered through a single window makes it possible to merge processes and tools, such as individualized assessments for the allocation of services and resources, an efficient multichannel strategy, case management based on the degree of client vulnerability, and vocational counseling with a life cycle approach. These elements

all contribute to the efficient use of the resources that are allocated to an employment service and increase its effectiveness.

3. Improve management by forging closer ties with employers

The ultimate goal of an employment service is to connect job seekers with firms that can hire them. This implies that these services have two main clients: workers and firms. Unfortunately, as already noted in Chapter 2, low coverage in terms of employers who post job vacancies in employment services is a critical challenge for the region.

Establishing and maintaining good relations with employers is key to ensuring the efficiency of an employment service. Here, the initial contact is critical, and the success factors are: streamlining service mechanisms with little red tape; guaranteeing the quality of PES staff and the services provided; and having a good knowledge of the local labor market. High-quality services are essential for building relationships with employers, and the evidence indicates that, in order to increase the number of firms that make use of a country's PES, the following must be emphasized: the provision of services geared to the needs of firms, greater use of information technology, and improved communication strategies.

It should be recalled that firms are also clients of public employment services. Supporting firms is as important an objective as supporting job seekers. In the final analysis, the two types of support are mutually reinforcing, promoting a formal labor market with high productivity, stability, and high wages.

4. Improve management, evolving toward a sound result-based management approach

To achieve successful career paths, employment services must help workers find jobs where they can be productive and have opportunities for professional growth. Meeting this objective will require a series of measures. First, every service that is offered should have clearly defined objectives with measurable indicators to see whether performance targets are being met. Second, processes must be put in place to guarantee information on performance. Third, a transparency and accountability mechanism must be adopted to ensure that these performance indicators will be seen outside the organization.

Box 6.1 Results-based management: What works?

- Close alignment of policy objectives, the socioeconomic context, and the management approach.
- Robust data in the PES information system that provide accurate, timely, and useful information.
- Transparency and adequate supervision to prevent distortions.
- A combination of quantitative and qualitative data for a more exhaustive approach.
- Performance indicators that can be influenced by the PES.
- Firm commitment by policymakers and the PES administration.
- Proportionality between the costs and benefits of collecting performance management data.

Source: IDB-WAPES-OECD (2015).

(b) Increase employment opportunities for young people looking for their first job and for those who, for one reason or another, must reenter the world of work

Public policies play a clear role in helping unemployed, underemployed, and inactive workers to increase the likelihood of finding and keeping a good job. This role is even clearer when the people who largely comprise these groups exhibit some type of vulnerability in the labor market: they may be young people looking for their first job, who need assistance to improve their possibilities of entering the workforce, or they may be others who, having lost their job, need assistance to find new, more suitable employment as quickly as possible. The proposals below are grounded in three basic aspects—quality, relevance, and scalability—that should be taken into account when designing policies to support job seekers.

1. Provide assistance that enables young people to find a good first job

The disconnect between the supply and demand for labor is particularly sharp in the case of young people who are looking for their first job. Young people exiting the educational system tend to have very little information about their possibilities in the labor market, while firms, in turn, have very little information about the skills of this group. This is why it is important to

focus on young people looking to find their first job. One policy necessary for promoting effective labor market entry that reaches beyond the labor domain, but in which the ministries of labor should participate, is to foster the evolution of the educational system to one that is at least partially competency-based. This would provide clarity about what each student who completes a given level should know and be able to do, thus providing employers with information about what a person with a given educational level and specialization knows and is capable of accomplishing.

In many cases, support for young people simply consists of taking advantage of other public policy instruments. For example, a good labor intermediation service can narrow the information gap between young people and firms. There are other policy instruments, however, that could be targeted to youth.

► **Disseminate information about the labor market.** The first step should be to promote the use of better information systems and vocational counseling for young people who are still in school so that they can choose a career path best suited to their aptitudes and preferences and be well acquainted with the present and estimated future work opportunities for graduates in this field.

► **Promote cost-effective and scalable labor market entry programs for youth.** As mentioned in Chapter 4, many instruments have been tested in the region with a view toward increasing youth employability. Many of the programs have been successful in meeting their objectives, but the results have been modest. Moreover, the scope of the programs has been limited in terms of the number of people reached. The region would benefit from continued investment in quality programs to help youth enter the labor market—programs that are geared toward the demands of the productive sector and reach a wider audience of young people, thereby putting them on successful career paths.

► **Implement apprenticeship programs.** Often, what people know has been learned from more experienced people who have devoted time and effort to transferring their knowledge. Apprenticeship programs are based on the premise that more experienced people in a firm will train apprentices so that, someday, they will be able to train a new generation of workers. Given today's limited policy options to support youth employment in the region, one possibility is to explore this type of program. Although apprenticeships aren't traditional in Latin America and the Caribbean, they have been widely used in other regions of the world. They are an attrac-

tive alternative, as they can offer an intensive, structured, and long-term training option for young people who have some of the skills that their firms require but still exhibit significant gaps in soft and specific skills.

Based on the experience of countries that have had success with this type of program, some of the basic characteristics of an apprenticeship program are the following (see Box 6.2):

- ◆ They are backed by a contract between the apprentice and the firm that serves as the basis for a mutual understanding of the responsibilities and obligations of the parties.
- ◆ They promote the solid commitment of the private sector to accept apprentices in firms and co-finance these initiatives.
- ◆ They ensure that quality training based on pre-established, regulated, and certified content is provided to apprentices during the apprenticeship period. The goal is to add value to the skills with which young people join the firm and make them valuable in the future, not only to the firm where they undertake their apprenticeship, but to others as well.

Given the scale of a national apprenticeship project, it is recommended that a pilot program be designed for a single sector of the economy and its performance evaluated before being scaled up to the national level.

► **Implement traineeship programs.** In many countries (see an example in Box 6.3), the target population of apprenticeship programs is young people who already have some of the initial qualities that make them attractive to employers (whether they are still in school and at the same time are working as apprentices, or they have finished secondary school and then do an apprenticeship in the firm). This effectively excludes a large target population in the region from participating in these programs: young people with greater vulnerabilities in the labor market—that is, young people who are neither in education nor working, or at-risk youth in general. For this group, initiatives are recommended that will enable them to acquire basic and social-emotional skills to motivate them to enter the labor market, preparing them for the world of work. The higher the risk to which these young people are exposed, the more intensive the program should be, since there is a wide skill gap that must be bridged. This type of program should, therefore, accurately assess the situation of

Box 6.2 Apprenticeship programs

Apprenticeship programs—that is, longer training programs provided fully or partially in a firm—can be a passport to better jobs for youth who are out of the educational system. For example, an evaluation of Germany's apprenticeship program (German Apprenticeship Training—GAT) that targets these young people finds returns similar to those estimated for general education. Similarly, an evaluation of the U.S. apprenticeship program, Registered Apprenticeships, which targets the same population, finds that program participants obtain relatively high returns, with a substantial impact on income and the probability of being employed, even nine years after graduating from the program (Reed et al., 2012). The cost-benefit estimates for this program are positive across the board, even in the most pessimistic scenarios (Lerman, 2013).

An apprenticeship program in New Zealand consists of a combination of theoretical/academic studies and practical experience (inside and outside the workplace). The two types of training are designed around a competency-based system under which apprentices must complete a certain number of credits, depending on the type of competency they will be acquiring during their apprenticeship. The training provided through the apprenticeship program has resulted in higher average wages. According to the New Zealand Department of Labour, people who complete the apprenticeship program or level 4 of the continuing vocational education program (the highest level of national certification recognized by the New Zealand Qualifications Framework—NZQF), have higher earnings. Part of the reason for these positive results is the close coordination between training program providers and the industry. Through industrial training organizations (ITO), whose functions include supervising apprenticeship programs in their sector, taking the lead in defining industrial training needs, and developing 16 mechanisms for the provision of industrial training, apprenticeship programs focus on providing training that is relevant to the needs of the labor market.

each young person at the start of the intervention and monitor both the learning acquired during the program and the results and impacts when it is over. Finally, at the end of the training, it is important to connect young people with the business sector through some type of on-the-job training, such as through an apprenticeship or internship program that will enable them to learn more about the world of work and reinforce practically the knowledge acquired during the program.

► **Other interventions.** Other policies, such as first employment laws or special arrangements for hiring young people, should be carefully examined. Although they can be widely implemented, they have the drawback of “displacing” other populations in the labor market or undermining youth employment. Interventions of this type should, therefore, be carefully looked at before their mass implementation.

Box 6.3 Traineeships

Australia has traineeship programs that include training outside the workplace by a training program provider, on-the-job training, and hands-on experience for one or two years, as well as three- to four-year apprenticeship programs that combine training inside and outside the workplace with practical experience while the apprentice is employed. Both types of programs have had a positive impact on the employment opportunities of their participants. Specifically: i) three years after the traineeship, trainee wages are higher than those of the control group, and ii) six years after the traineeship, trainee employment rates are 5.2 percentage points higher than those of non-trainees (Fok and Tseng, 2009).

In the United Kingdom, the apprenticeship (traineeship) system was recently restructured and expanded as a result of the high youth unemployment observed in the wake of the 2008 crisis, and the focus has been on providing training equivalent to higher (post-secondary) education for youth who are not full-time students. The system has three levels of apprentices (intermediate, advanced, and higher, based on competencies and qualifications), as well as traineeships such as those in the Australian model. The government finances all (or part) of the training in school, based on the age of the apprentice (100% for apprentices between the ages of 16 and 18, 50% for those between the ages of 19 and 24, and up to 50% for those over the age of 25) for a minimum of 12 months (Mirza-Davies, 2015). The employer, in turn, covers the difference in the training costs and gives the apprentice a paid job at a wage under the market rate for the period stipulated in the apprenticeship contract (apprentices under 21 receive less than the minimum wage). According to a study by the United Kingdom’s Department for Education, 70% of employers have reported increases in productivity and the quality of their products/services as a result of the apprenticeship programs and indicate that, on average, they recoup their investment in a year or two if the apprentice is retained

2. Develop active policies to help the unemployed enter the labor market

Beyond assistance to find the first job, support must generally be provided to enable people who are unemployed to reenter the workforce. An effective way of providing that support is through the labor intermediation services already mentioned in this chapter. These services will offer counseling and assistance to the unemployed so that they can fill a vacancy suited to their skills. It has been observed, however, that many of these people do not find a new job in the formal sector, either because their skills have become obsolete or because, from the outset, they lack the basic skills to perform productively in the labor market. What is needed is a robust labor intermediation system that can connect the unemployed with options for upgrading their skills and, thus, speed up their placement in a new job. In countries such as Australia, the employment service assesses the situation of unemployed job seekers, placing them in different categories and allocating more resources from the service to those with greater vulnerabilities in the labor market. This differentiation of services, which is based on an accurate assessment, makes for more efficient use of the resources allocated to enable an unemployed person to find a job.

In addition to implementing these support policies for placing unemployed individuals in jobs, it is important to consider training for these individuals not just as an isolated measure that is used only during a period of unemployment but an ongoing activity. Later in this chapter, mention will be made of continuing education policies to help people adapt and modify their skills to keep pace with the needs of the job market. It should also be recognized that some populations face specific barriers to reentering the labor market and that, if necessary, policies must be designed to assist these groups.

(c) Protect the income of job seekers during unemployment

The countries of the region, especially those with both lower rates of informality and active employment policies, could consider unemployment insurance to supplement protection for the unemployed. This insurance would have a major advantage over severance pay, as it would add a component of shared risk among workers; that is, workers who do not lose their jobs would subsidize those who do. Moreover, the mechanism could be extended during an economic crisis to provide additional support and have a countercyclical policy that could be rapidly implemented.

However, despite the attractive features of unemployment insurance, two factors must be considered. First, this type of insurance will be less effective in a country with a high degree of informal employment. Coverage will be limited because workers dismissed from informal jobs will not be eligible. Furthermore, many people dismissed from formal jobs will not be eligible either, since formal/informal transitions make it hard to accrue the minimum contributions to the system over time (Box 6.4). Second, it is recommended that labor markets with high rates of informality provide less income smoothing in periods of unemployment than countries without informality problems (Espino and Sánchez, 2014).

Box 6.4 Unemployment insurance coverage in Mexico and other countries

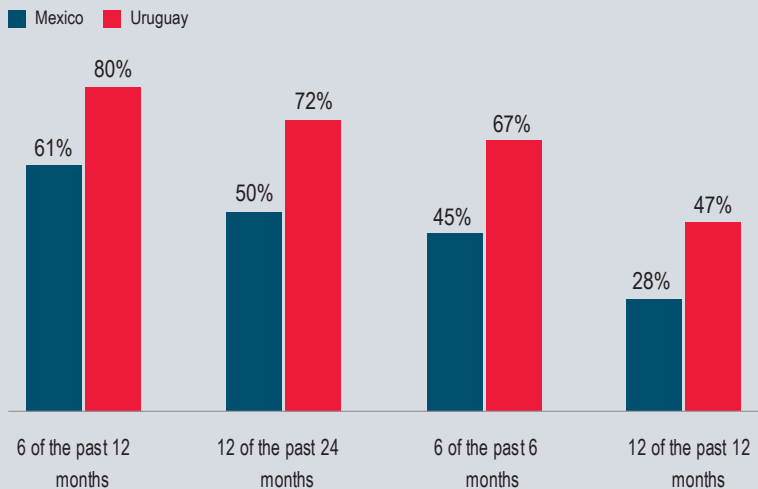
Unemployment insurance does not protect all workers from job loss. For example, it cannot protect those who lose informal jobs. Given the high job informality rates in LAC, unemployment insurance coverage in the region will clearly be low as long as labor markets remain unchanged.

However, it should be remembered that unemployment insurance does not protect all workers who lose formal jobs, either. No unemployment insurance provides benefits to a worker who held a job for only a day. Although eligibility rules vary from country to country, this type of insurance always requires a minimum number of months worked in the past year or two.

To illustrate the importance of this phenomenon, Figure 6.4.1 compares the percentage of workers who lose formal jobs in Mexico and Uruguay who would be eligible for unemployment insurance benefits under different eligibility rules. The differences observed in the hypothetical coverage are attributable to the different turnover rates in the formal labor markets of the two countries.

The results show that, under the different eligibility rules, unemployment insurance in Uruguay would provide greater coverage than in Mexico. This is because formal workers in Uruguay tend to stay with their firms longer, which implies that a higher percentage would be eligible for the benefit after losing their job. The higher turnover in Mexico's labor market limits the coverage of any hypothetical unemployment insurance. These findings yield a basic result: unemployment insurance coverage will be higher in a labor market with less informality and lower labor turnover.

Figure 6.4.1 Percentage of workers who lose formal jobs in Mexico and Uruguay and who would be eligible for unemployment insurance under different eligibility rules



Source: Arim and Dean (2012) and de Buen, Bosch, and Kaplan (2012).

Note: The figure estimates the percentage of formal workers eligible for unemployment insurance based on the minimum number of contributions necessary for eligibility. For example, the first column says that if the system requires 6 months of payments in the past 12 months, 61% and 80% of formal workers in Mexico and Uruguay, respectively, would be eligible for insurance benefits.

The feasibility of unemployment insurance depends not only on the job informality rate, but the extent to which active employment policies have been developed. As pointed out in Chapter 4, the existing unemployment insurance in the region prolongs the job search without improving the quality of the jobs that beneficiaries find. Since the objective is not to promote unemployment but to support the unemployed so that they can resume a successful career path, it is recommended that unemployment insurance be combined with active employment policies to prevent beneficiaries from reducing the intensity of their job search.

In addition to the importance of linking unemployment insurance with active employment policies to mitigate the negative effects of insurance detailed in Chapter 4, there are other aspects of design that can help the design. For example, Babcock et al. (2012) and Hopenhayn and Nicolini (1997) recommend decreasing payments over time to prevent beneficiaries from procrastinating with their job search. A bonus for finding a job quickly, such as the one awarded by South

Korea, could serve the same purpose. Babcock et al. (2012) also state that, for many unemployed people, it may be hard to accept work with wages lower than they were earning in their former job. Thus, they suggest wage insurance to temporarily subsidize wages in the new job when they are lower than the amount the worker previously earned. In a labor market with high informality, this subsidy would be granted only to individuals who obtain formal jobs, which would be another incentive for workers to resume a successful career path instead of finding a relatively unproductive informal job. It is also worthwhile to mention the importance of State support to ensure that these formal jobs are the right ones for the job seeker.

Another justification for the recommendation to design a system that encourages the unemployed to find a job quickly is human capital depreciation. That is, when workers go a long time without finding a job, they become less productive and less employable. Pollak (2013), for example, finds that human capital depreciation is responsible for a large percentage of the adverse effects of unemployment in Germany and the United States.

These lessons yield the following recommendations for the design of unemployment insurance:

- 1) The benefit should be small enough and the maximum length of benefits short enough to prevent unemployment (or its simulation while the worker is employed in the informal sector) from becoming an attractive option.
- 2) The design of the economic benefits should not only encourage a rapid exit from unemployment, but also reentry into the formal sector of the labor market.
- 3) Unemployment insurance should be linked with active employment policies to ensure that beneficiaries are actually job seekers and to support them with the necessary information and training for them to find a formal job suited to their skills and begin or resume a successful career path.

The existence of other income support mechanisms for unemployed workers who have lost formal jobs should also be noted. Severance pay, for example, can provide an economic cushion, as long as the worker actually receives the benefit and it arrives quick enough to finance the job search. This topic will be explored further in the next section, which discusses policies to promote productive job stability.

Another option to consider is individual unemployment savings accounts, such as those found in Chile, Colombia, Ecuador, Panama, Peru, Venezuela, and other countries in the region. With this instrument, the worker or firm deposits a percentage of the worker's wages each month in an account under the worker's name, which he or she can access after any job separation. This type of account can provide workers with additional resources during job transitions without creating perverse incentives since workers only receive their own funds. The countries of the region could, therefore, consider employment separation accounts to smooth the income losses of dismissed workers without introducing distortions in the labor market. While these accounts are not a good substitute for unemployment insurance because there is no risk sharing among workers, they may be a good option for the region, given its high informality rates.

Nevertheless, employment separation accounts and severance pay share a basic weakness with unemployment insurance: They are highly dependent on participation and job retention in the formal labor market. Workers who lose informal jobs, as well as those who lose formal jobs in which they have only short tenure, are not adequately protected by these mechanisms.

Here, it is important to emphasize the role of active policies. While the coverage of unemployment insurance in a labor market with high informality will be limited, active employment policies to support job seekers can have universal coverage. Therefore, without discouraging the efforts of several countries to create unemployment insurance, we stress active employment policies as a basic, though not necessarily sufficient, pillar for supporting all unemployed workers. The existence of income support options for the unemployed that are based solely on self-selection mechanisms should also be noted. Unlike traditional unemployment insurance, these programs, designed so that only those who need the benefit apply for it, do not depend on previous participation in the formal sector. Temporary employment programs, for example, offer a small income support benefit to people with no other alternative in the labor market. Implementation of these programs in the region has yielded many lessons (Gasparini, Haimovich, and Olivieri, 2009; Hernani, Villegas, and Yáñez, 2011):

- ▶ The amount of the transfer must be low—ideally below the minimum wage—to achieve self-targeting and a rapid exit toward employment opportunities.
- ▶ There should be a requirement of a worker contribution in terms of time that should involve work or simple training activities to prevent beneficiaries from receiving transfers when they have a parallel informal job.

- ▶ The programs should include a heavy investment component, minimizing administrative costs and maximizing the amount allocated to transfers.
- ▶ The programs should be short-term mechanisms that can be expanded during crises and contracted during periods of economic growth.

Job training programs with small stipends are another example to consider. Finkelstein and Sarzosa (2012) show that this type of program ensures that only people without good options in the labor market receive benefits, because to receive the stipend the beneficiary must devote time to participating in the program. Espino and Sánchez (2014) find that obligating the beneficiaries of financial assistance to give up some of their time in order to receive the benefit leads to greater income smoothing during unemployment without encouraging informal employment. Thus, active employment policies with stipends for beneficiaries can provide economic support for job seekers while increasing their opportunities to find work without the limitations of unemployment insurance.

(d) Increase incentives for formal hiring through better regulation and enforcement

1. Improve labor regulation

Any factor that raises the job informality rate would be counterproductive from the standpoint of promoting successful career paths. Firstly, one of the characteristics of a quality job is that it provides benefits. Secondly, as noted in Chapter 2, there are strong correlations between productivity and job formality² and formality and the incidence of training. An informal job is therefore unlikely to entail the development of professional skills and provide training in more advanced technologies that would put workers on a successful career path. That is why it is important for each country to determine whether its labor regulations and social security and tax systems are conducive to stimulating the robust growth of formal employment. One of the most important labor regulations is the minimum wage. A very high minimum wage would represent too high a cost for firms and would therefore encourage informal employment. For example, Box 4.10 (Chapter 4) shows that the majority of workers in some countries earn less than the hourly minimum wage. While the minimum wage is a complex issue, it is also true that it is unrealistic to expect a firm to pay wages much higher than the market wage.

² See also Busso et al. (2012).

Nevertheless, this recommendation should not be interpreted as an argument against the minimum wage. This issue has been the subject of intense debate for many years. The exchange between Card and Krueger (1994) and Neumark and Wascher (2000), for example, shows that economists have real differences of opinion about this issue. The fact that in 2014, more than 600 economists—including seven Nobel Prize winners³—signed a letter calling for a minimum wage increase in the United States is evidence that under certain circumstances, it may be advisable. Without going into the details of the debate, we simply point out here that there is a limit—that is, too high a minimum wage would result in unemployment or informality.

The minimum wage is but one example of the potential costs of formality. Generally, as documented in Chapter 2, there are many employer-employee contributions that are used to finance job benefits such as health insurance, pensions, disability and life insurance, and housing. If the value that workers place on these benefits is less than their cost, financing them with premiums or payroll taxes could encourage informality. It is therefore necessary for each country to carefully determine whether the level of non-wage costs is creating incentives for informality and search for alternative mechanisms to finance job benefits if that is the case. The recent reform in Colombia (2012), which changed the health financing mechanism, shows how reforms can be implemented to maintain social benefits and reduce the incentives for informality (Box 6.5). In the case of Colombia, the reforms secured new sources of financing by levying a tax on corporate profits that was designed to avoid discouraging formal employment.

Attracting workers and firms to the formal sector will require administrative measures in addition to economic measures like the ones described here. It is necessary not only to shift to incentive mechanisms that promote formal job creation but also to ensure regulatory compliance, which would improve enforcement and supervision in the labor market. The increased enforcement can take place at different levels depending on the institutional capacities of each country. Two areas for improvement stand out: 1) the creation and coordination of registries and 2) data and investment in resources for inspection.

2. Improvement of records and databases

Consolidating the records of all the beneficiaries of social programs and the tax records of individual taxpayers and firms subject to the corporate tax

³ The letter can be accessed at link <http://www.epi.org/minimum-wage-statement/>.

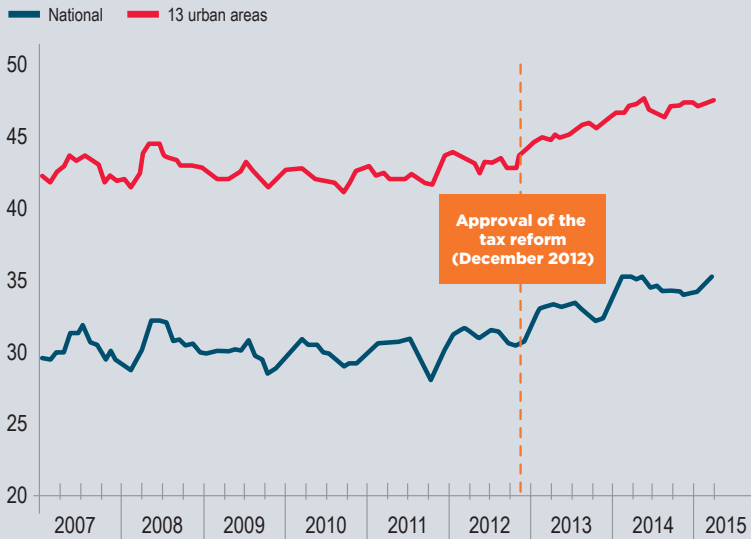
Box 6.5 Reducing formality costs without affecting job quality: Colombia's 2012 tax reform

One of the basic arguments of this book is that there is tension between job productivity and the costs of formal hiring. The higher the productivity relative to labor costs in the formal sector, the greater the probability that formal jobs will be created. Therefore, reducing non-wage labor costs and avoiding too high a minimum wage can help create formal employment. This does not necessarily mean that worker protection will be weakened. For example, one way to reduce the non-wage costs imposed on the payroll is to shift the taxes to another tax base, be it the consumption tax or taxes on corporate profits.

A good example of this practice is the 2012 tax reform in Colombia. The government substantially cut non-wage costs by imposing higher taxes on corporate profits. It specifically eliminated employer contributions to health insurance as well as training and family welfare institutes. The total non-wage costs of formal employment were cut by 13.5 percentage points, or from 52% to 38.5% of the wage. The fiscal losses associated with this reduction were recouped through a new tax on corporate profits.

While there is still no conclusive empirical study on the impact of the reform, data have been found that point to significant effects from the changes in the tax system. Immediately after costs were cut, a clearly positive trend toward the creation of formal employment was observed (Figure 6.5.1). The percentage of formal workers rose from 30% before the reform to around 34% (from 43% to 47% in the 13 urban areas) after the reform. While this is not evidence of a conclusive impact, this change is very consistent with the general equilibrium studies of Anton (2014) and Fedesarrollo (2015), which suggest that the tax reform should increase the percentage of formal workers by 2 to 3 percentage points, which translates to an increase of some 400,000 to 600,000 formal jobs.

Figure 6.5.1 Figure 6.5.1 Percentage of workers who contribute to a pension fund, 2007-15 (national total and for 13 urban areas)



Source: DANE (2015).

would facilitate monitoring of the informal economy. Furthermore, countries could issue a unique social security, tax, or citizen identification number to all workers and develop the capacity to operate a single tax and social security benefit system.

3. Investment in better inspection

As mentioned in Chapter 4, the region suffers from low levels of enforcement, as measured by the number of inspectors per worker. The critical challenge is to focus not only on increasing the number of inspectors but on maximizing their use through technical training, greater use of intelligent systems to predict the risk of fraud, and greater monitoring to prevent corruption.

In a manner similar to the progress observed in tax administration, the institutions charged with enforcing labor and social security law may need additional investments in human resources and information technology.

Second pillar: policies to promote productive job stability

In this pillar, it is recognized that high labor turnover, especially in an environment with little protection for the unemployed, implies high welfare costs for the population. It is also recognized that in rapidly changing environments and those where decisions are sometimes made without enough information, employment relationships need to be terminated when they are no longer productive or advantageous for the worker or the firm. To strike this delicate balance, it is necessary to promote better information for hiring (already considered in the first pillar's line of action, [a]) and a continuing education policy that fosters value creation in the employment relationship as a strategy for reducing involuntary separations. Furthermore, in recognition of the associated social and psychological costs, it is recommended that labor law retain a moderate dismissal cost with a design that does not generate uncertainty in order to encourage the creation of indefinite formal employment and not incite labor litigation.

Therefore, this pillar strongly emphasizes worker training as a strategy for promoting productivity and stability. The idea is to prevent involuntary dismissals and protect, update, and augment the human capital of workers as well as the productivity of the employment relationship. The high turnover rate observed in the region is both a cause and an effect of the lack of investment in human capital. Dismissals become unprofitable as firms invest more in the professional development of their workers, even if the legal cost of dismissal is zero.

Thus, the recommendations of this pillar can be summarized in two parts. The first calls for substantive improvements in policies to promote ongoing training for workers, thus emphasizing the importance of the quality and relevance of the training to not only promote job stability but also ensure that workers are productive in the workplace. The second is focused on moving toward an efficient regulatory framework for dismissals.

(a) Increase the effectiveness, quality, and relevance of job training expenditure to promote productive stability

To have successful career paths, people need the ability to keep upgrading their competencies and increasing their productivity. Moreover, in order to grow, the region must invest in improving the quality of its labor force by endowing workers with skills to develop their potential. In order to accomplish this, policies to promote training in the region must focus both on people

with gaps in basic skills (language and math) and social-emotional and/or technical skills as well as on those who already have an appropriate level of education but need to keep their knowledge current to contribute to the diversification and innovation that the region needs. Meeting these objectives requires considerably more than specific training programs. It will demand a real labor force development system that will facilitate the lifelong acquisition of relevant, quality skills and enable workers to make more effective use of them in the workplace. Although this will require resources, a great deal could be achieved if the region were to redirect the funds that are, in some cases, already being spent in this area.

Given the key role of employers in developing the skills of active workers, it is essential to include firms in the design and execution of policies. The same holds true for worker representatives, who can facilitate investments in training by firms and workers. The government must play a key role in increasing employers' understanding and commitment to training and promote investments that contribute to the country's growth and workers' welfare that might not otherwise be made. All of this is particularly important in the region considering the low quality of the labor force.

Developing a better job training system that will contribute to individual and aggregate economic growth requires the following: 1) establishing new institutional arrangements for skill development; 2) ensuring that training is better aligned with the needs of the labor market; 3) establishing mechanisms to guarantee the quality of job training; 4) creating financial training incentives; and finally, 5) implementing better information systems about the supply and demand of skills.

The manner in which progress can be made in meeting these objectives is detailed below. These solutions are more than theoretical, as they are now being implemented in many locations, primarily outside the region. To illustrate, specific examples of countries that have already made progress by adopting these measures are provided in boxes below.

1. Establishing new institutional arrangements for skill development

In a rapidly changing world with an aging population, it is no longer feasible to only design training programs for youth. Workers must keep learning in order to prevent their skills from becoming outdated and forge successful career paths. This implies developing a system that encourages active learning throughout the workers' careers, inside or outside the workplace,

through short courses to improve or update their skills, or through longer courses that enable them to finish degrees or obtain certifications as adults. In order to accomplish this, the architecture of the training system must change and become more flexible and integrated. The curricula of institutions under the ministries of education and labor must be integrated to develop continuing education paths. This integration should be not only possible but also encouraged. Furthermore, the labor and education ministries need to be on the same page, which also implies a system capable of identifying and anticipating the demand for skills and responding to it in a timely and flexible manner.

In order to meet these objectives and remedy the lack of coordination among government entities involved in skill development and between the government and the productive sector, it is essential to establish new institutional arrangements that will promote greater coordination and integrated management of the system. Especially needed is a state institution, agency, or entity that looks at the system from the standpoint of the demand for skills. This agency would have the following functions: 1) launching national or sectoral strategies for skill development; 2) identifying current and future skill needs at the national, regional, and/or sectoral level; 3) spearheading consultations with the productive sector and translating its demand for skills into competency standards that can be used by training providers for curriculum development; 4) generating relevant information for decision-making and creating training incentives for firms and/or workers; and 5) disbursing resources to stimulate investments in human capital. Examples of such institutional arrangements can be found in various countries outside the region (see Box 6.6). This agency should rely on strong leadership from the productive sector.

2. Ensuring that training is better aligned with the needs of the labor market

The objective of training should be to develop a skillset that enables workers to improve their performance, be more productive in the workplace, or gain access to better job opportunities. To meet this objective, the training they receive must be relevant to the needs of the market. Little is accomplished by training people for careers that are obsolete or in very low demand, and firms will have little interest in investing in such programs.

At the same time, the training should ideally conclude with some type of acknowledgment or certification of what workers learned so that their competencies can be recognized by current and future employers and lead to

Box 6.6 Institutions for promoting an effective, integrated system for skill development: Australia, the United States, and the United Kingdom

Australia, the United States, and the United Kingdom have set up three types of institutional architecture to achieve a more integrated and effective vision of their policy for developing skills in the labor force.

In Australia, the Australian Workforce and Productivity Agency (AAWP) was an independent public agency that advised the government on matters related to skill development. Staffed with specialists in the design and execution of skill development policies, it also directed and disbursed funds for developing skills to meet the needs of the industry. Its functions included: i) administering the National Workforce Development Fund; ii) conducting research on current and future training needs, the quality of jobs, and the future of work in Australia; iii) forging ties between industry, training centers, and the government with respect to skill development; iv) implementing sectoral and regional plans to improve skills; and v) promoting job productivity and spearheading initiatives to foster its growth along with management, innovation, and better use of skills by Australian firms. The head of the agency was a prominent representative of the private sector.^a

In the United States, these functions fall to the Employment and Training Administration (ETA), a Department of Labor agency. The ETA's mission is to contribute to the more efficient functioning of the U.S. labor market by providing high-quality job training, employment, and labor market information. The ETA is also charged with guaranteeing jobs for the unemployed and promoting partnerships between industry and educational and training institutions to create relevant, demand-driven training opportunities that contribute to the country's development. One of its main instruments is non-reimbursable competitive grants to cofinance public-private partnerships for human capital development.

Finally, another example of institutional arrangements is the U.K. Commission for Employment and Skills (UKCES), financed by the United Kingdom's Department of Business, Innovation, and Skills. The mission of the UKCES

^a In 2014, this agency ceased to be independent and its functions were transferred to the Department of Industry

is to advise the government on matters related to the expansion of employment and skills. As in Australia, this agency is publicly funded but headed by distinguished representatives from the private sector. Similarly, its commissioners are representatives of large and small industries as well as employment experts and trade union representatives. The UKCES has a staff of around 100, and its functions include implementing workforce development policies and supporting employers so that they invest in the skills of their workers. Its 2014–15 priorities have been to create more professional development opportunities for youth, strengthen local networks, make economic sectors more competitive, and increase the number of employers that invest in upgrading the skills of their workers.

Source: Adapted from: <http://www.awpa.gov.au>, <http://www.doleta.gov/>, and <https://www.gov.uk/government/organisations/uk-commission-for-employment-and-skills>.

higher earnings or better job opportunities. The objective, therefore, is to simultaneously ensure the relevance and portability of skills. Virtually no job training system in the region has accomplished this, but if progress is not made in this direction, it will be very hard to reverse the current cycle of low training, high turnover, little learning, and low productivity.

To ensure relevance, the training system must have mechanisms for finding information on changing market needs. This information must translate into competency standards that serve as the basis for training curricula and standards. There are several interesting examples of this inside and outside the region.

First, there is the role of sector skill councils in countries such as Australia, New Zealand, and the United Kingdom. Sector skill councils are entities financed out of the public budget but headed by leaders from the productive sector (see Box 6.7). The role of these institutions is to identify the skills needed by each industry or economic sector, set competency standards, and issue proposals on how to integrate these standards into sectoral training programs. Sector skill councils also engage in prospective activities. That is, they identify current and future trends and try to determine the future demand for each occupational profile. Finally, using the information they receive from the productive sector, they also design learning paths for each occupational profile and anticipate the training packages needed to pursue them. They are also responsible for informing and educating firms in the sector about the benefits of training.

Within the region, Chile's Mining Board is the first example of a sector skills council (Box 6.8) that can serve as a very interesting model for other sectors in Chile and other LAC countries. It should be noted, however, that the Chilean mining sector has the resources and organizational capacity to mobilize its members and identify the competencies needed in the sector on its own. Replicating this experience in other countries may require considering options for providing sector skill councils with additional resources, as seen in Australia, New Zealand, and the United Kingdom.

Another instrument that links training with the productive sector is competitive grants, which finance partnerships among local or regional governments, training centers, and firms to design and provide relevant training in the strategic sectors mentioned earlier (see subsection on training incentives).

3. Establishing mechanisms to ensure the quality of job training

There are currently very few mechanisms to ensure that the quality of job training is high enough to meet the needs of the market. This type of mechanism should

Box 6.7 Sector skill councils in New Zealand

Sector skill councils in New Zealand, known as industry training organizations (ITO), are nonprofit organizations recognized by the Ministry of Education that are authorized to set standards of competency in levels 1 through 8 of the National Competency Standards Framework. Their functions are: i) to advise firms and workers about training opportunities in their respective industries; ii) to set and update skill standards in a particular industry; iii) to coordinate the provision of evaluation criteria and standards for training; iv) to support firms by channeling public resources to them for training; v) to provide industries with leadership in the area of skills; vi) to identify current and future skill needs; and vii) to collaborate with firms and workers to meet these obligations. The training can be provided inside or outside the workplace but must be geared to the acquisition and certification of competencies based on national standards. Sector skill councils are also responsible for the certification of previously acquired skills. The ITO staff may also conduct a training needs assessment in sector firms and recommend employee training packages.

Source: Adapted from <http://www.itf.org.nz/industry-training/industry-training-organisations-itos>.

be established as soon as possible to guarantee that investments in training not only respond to the needs of the market but result in quality training.

Establishing competency-based education—that is, education in which objectives are set in terms of the learning and behaviors that workers should acquire—makes it possible to observe whether individuals finish their training with the skills required by the firm. However, it is necessary to go beyond that and measure institutions by the quality of the skills that workers acquire and/or the results they achieve in the labor market. It is also necessary for training institutions with poor results to be supervised more closely and provided with the necessary support and incentives to achieve better results. These mechanisms can be established for all educational institutions or just those that receive some type of state funding. Australia and the United Kingdom, for example, show how such quality systems are organized (see Box 6.9).

Box 6.8 Chile's Mining Competency Board

The Mining Competency Board (CCM, by its Spanish acronym) is an initiative by the Chilean Mining Board to promote information, standards, and tools so that training for technicians and professionals can be tailored qualitatively and quantitatively to the demands of the labor market in the mining sector. The CCM took its inspiration from Australia's Mining Council, and through a collaborative initiative with that country, developed the Mining Qualifications Framework. This framework has five levels of qualification that correspond to higher degrees of complexity in technical training that range from training in basic entry tasks to highly complex technical skills.

The CCM currently issues the following products: annual studies of the labor force in Chile's large-scale mining sector that project the industry's demand for skills and the supply for each occupational profile; the Mining Qualifications Framework; training packages or proposed training solutions aligned with the qualifications framework; a quality framework for mining training programs, consisting of reference standards to improve the quality of these programs; a quality framework for instructor training and certification; and a worker competency certification system.

Source: Adapted from <http://www.ccm.cl/estructura-del-mcm/ccm/2013-11-26/180221.html>.

4. *Creating financial incentives for training*

As already noted, the existence of numerous market failures makes the level of job training inefficiently low, resulting in low productivity, low wages, and higher employee turnover. This is why many countries are using a variety of incentive mechanisms to encourage training by firms and workers. These incentives are all the more necessary in LAC since, as was indicated in Chapter 3, these market failures are magnified by the low level of training with which the majority of people enter the labor market. While this makes investing in general skills more important, there are few incentives for firms to defray the cost.

Box 6.9 Regulating the quality of training in Australia and the United Kingdom

In Australia, quality control of the training system for active workers is handled by the Australian Skills Quality Authority (ASQA), an independent agency charged with regulating technical, vocational, and training providers and courses to uphold the quality and reputation of the system. It has a staff of 200 and uses a risk-assessment system in which the intensity of supervision and regulation is proportional to the risk of low quality. This allows it to focus much of its attention on providers who are not offering quality training while giving greater autonomy to those who offer better training.

In the United Kingdom, quality assurance is handled by two independent agencies that report to Parliament: the Office for Standards in Education, Children's Services, and Skills (Ofsted) and the Office of Qualifications and Examinations Regulation (Ofqual). Ofsted is responsible for inspecting and regulating all training providers, supervising all centers to see whether they meet the necessary standards, and offering assistance to those that do not so that they can improve their performance. Ofqual, in turn, is responsible for maintaining the quality of the standards and stakeholder confidence in the training centers.

Source: Adapted from <http://www.asqa.gov.au/>, <https://www.gov.uk/government/organisations/ofsted>, and <https://www.gov.uk/government/organisations/ofqual>.

Due to fiscal constraints and the substantial resources some of the countries in the region are already investing in training, it would be advisable to redistribute the expenditure already allocated to national training centers to increase their effectiveness and relevance instead of increasing training expenditures. In principle, some of these resources could be allocated to firms through competitive mechanisms; firms would have the option to purchase training services from accredited providers, including the national training centers. This would create incentives for training centers to forge ties with firms and provide training that is more relevant and consistent with the needs of the market.

The competitive grants mentioned above are a highly effective mechanism for meeting these objectives, although they have not been used extensively in the region. In countries where they are used (for example, Australia, the United States, and the United Kingdom), firms must submit a project, and the state decides which projects should be financed based on national, regional, or sectoral priorities. Grants can also be awarded to develop and/or update competency standards in certain sectors or to specialize training centers (see Box 6.10). In recognition of the particular difficulties that small and medium-sized enterprises (SME) have with investing in training, the state could finance a substantial part of the investments that they make, as Australia does, while promoting greater assistance with identifying the development needs of the labor force.

Training incentives can also be geared to individuals, so that they can receive training in areas they consider more relevant. However, as noted in Chapter 4, these incentives should be accompanied by greater information for beneficiaries about where to register for training and what skills are in demand on the market.

5. Developing information mechanisms on the supply and demand for skills

Information mechanisms must be developed to help workers, the state, and firms make the right decisions. It is important for workers to have information about the supply and quality of training centers. This is achieved, for example, by publishing the information gathered by the quality assurance agency or institution. It is also essential for the state to furnish information about the wages that can be expected in each occupation as well as the education required. This will help guide young people who are poised to make decisions about their education and active workers who wish to advance their careers or take them in a new direction. Information about the training supply and its

Box 6.10 Competitive grants to finance in-house training in Australia, the United States, and the United Kingdom

The Australia Skills Fund has a budget of US\$370 million in competitive resources to allocate over the next four years. Its objective is to help Australian firms train their workers through courses that lead to certifications. It is estimated that the fund will provide 200,000 training slots and be a key element of Australia's Industry Innovation and Competitiveness Agenda. The Fund prioritizes micro-, small-, and medium-sized enterprises that wish to grow in sectors where the country has a clear comparative advantage (advanced manufacturing, the food and medical technology industries, and the mining, petroleum, gas, and energy equipment industries). Firms cofinance from 25% to 75% of the training cost, with the firm's contribution increasing with its size.

In the United Kingdom, the UKCES has a series of funds that can be tapped for training purposes (the UKCES Futures Programme, the Employer Ownership Pilot Fund, the Growth and Innovation Fund, the Employer Investment Fund). The common feature of all of these funds is that they are competitive and geared to firms with the objective of cofinancing skill development in the labor force.

Finally, in the United States, the ETA, under the Department of Labor, also has a series of funds to promote public-private partnerships for skill development in the labor force. The specific objectives of the grants change with the priorities of each administration. Currently, for example, the U.S. government has an open tender in the amount of US\$100 million to finance apprenticeships in priority sectors and others with high growth potential. Other calls for grant proposals are aimed at facilitating the return of ex-offenders and workers with disabilities to the labor market.

Source: Prepared with information from <http://www.business.gov.au/skills-and-training/pages/default.aspx>; <https://www.gov.uk/government/collections/ukces-investment-funds>; http://www.doleta.gov/grants/pdf/ETA_Funding_Opportunities_20141714.pdf.

quality is also very useful for firms looking to invest in their workers to boost productivity. There are several interesting examples of governments that provide relevant information on making decisions about training (see Box 6.11). A related issue is the need to set up monitoring and information systems to access information on the beneficiaries of finished training programs to learn not only whether they completed the training but also whether it enabled them to obtain better results in the labor market. Nowadays, the existence of administrative data—for example, social security records—makes it much more feasible to cost-effectively link beneficiaries (firms and workers) with their performance in the labor market. However, if their use is to be generalized, these record systems must be improved and become more accessible while at the same time guaranteeing anonymity.

(b) Transitioning to an effective regulatory framework on dismissals

Unfortunately, even with the best possible system for promoting human capital accumulation in the workplace, there will be times when firms dismiss workers. Sometimes it is because the worker who was hired lacks the necessary skills and sometimes it is for reasons that have nothing to do with either the firm or the worker—for instance, if the firm encounters lower demand and needs to cut back production and personnel.

Box 6.11 Examples of training mechanisms

The U.S. Department of Labor has created the “mySkills myFuture” website (<http://www.myskillsmyfuture.org/>) to facilitate continuing education for workers. People can upload information to this website about their current and past employment and find options related to the skills they already possess, the training required for each of these occupational profiles, vacancies in each of these areas of development, the average annual and hourly wages of these occupations, and training opportunities in their states (provinces).

Within the region, another example of an information mechanism worth mentioning is the labor observatory of Mexico’s Secretariat of Labor and Social Welfare (<http://www.observatoriolaboral.gob.mx/swb/>). This website provides important information about the employment rate, average wage, hours worked, and other indicators by occupation and enables users to search for vacancies by occupation.

How should the state regulate these dismissals? A series of guidelines for the design of these regulations is presented below:

1. Set an appropriate dismissal cost

It is recommended that dismissal trigger a cost for firms. As Blanchard and Tirole (2008) and Espino and Sánchez (2014) point out, a dismissal can trigger costs that are borne by the state or other parties. A dismissed worker could, for example, collect unemployment insurance benefits from the state or be paid out of a common fund. Here, the recommendation would be to impose a certain cost on the firm so that it takes on the social cost of dismissal into account. In other words, the purpose of dismissal costs is to internalize the social cost of dismissal incurred by the firm's decision.

2. Allow unrestricted dismissal as long as the firm bears the cost

This guideline acknowledges that while dismissal generates a social cost, that cost is not infinite. If a firm is willing to pay the social cost of dismissal through severance pay, forcing it to keep the employee would undermine productivity.

This simple regulatory framework is in sharp contrast with that of countries such as Honduras and Mexico, where workers have the right to demand reintegration or reinstatement instead of receiving severance pay under certain circumstances. In other words, workers can sometimes contest their dismissal and be reinstated to their jobs in addition to receiving back pay (the wages they would have received from the time they were dismissed to the time they were reinstated). This solution is not recommended for two reasons. First, in practice, it substantially increases the cost of dismissal because workers can demand compensation far higher than their severance pay in exchange for renouncing their right to reinstatement. It can also discourage formal hiring if firms anticipate this possibility. Second, as de Buen, Bosch, and Kaplan (2012) document, the possibility of demanding reinstatement introduces complexity into the system, which creates uncertainty and incentives for labor litigation. It may be that uncertainty about the cost discourages formal hiring more than the amount.

3. Establish the right dismissal costs for both workers and firms

With a simple regulatory framework, where dismissal is allowed at a cost, the amount of that cost should be considered carefully. For this reason, perform-

ing simple calculations to determine the potential social costs of dismissal is a relevant exercise.

Consider, for example, a dismissal in Uruguay, where the state pays all of the unemployment insurance benefits. Unemployment insurance pays up to six months of benefits at an average replacement rate of 50%. Therefore, if workers collect six months of benefits, they will have received three full months of wages. In this context, if we assume a 100% chance that a dismissed worker will collect the six months of unemployment insurance benefits and unemployment insurance is the only social cost, the suggested severance pay would be equal to three months' wages. Since not every dismissed worker receives unemployment insurance benefits and not every beneficiary collects the full six months of benefits, the calculation of three months of severance pay could be too high. In contrast, it should be noted that in Chile, where unemployment insurance is paid largely out of workers' individual accounts, the social cost of dismissal would be lower.

An example of a country with no unemployment insurance may also be illustrative. Mexico's *Bécate* program offers unemployed workers a subsidy of one to three months' wages for up to three months while they receive training in a firm. Given these parameters, even in cases where a dismissal would always imply enrollment in *Bécate*, the social cost would be unlikely to exceed three months of a worker's wages.⁴

Nevertheless, there are arguments that could raise our estimate of the ideal dismissal cost. First, as indicated in Chapter 3, there are numerous non-pecuniary impacts, many of them psychological, which can be considered social costs. Second, it can be argued that the state should discourage dismissals that, despite generating no social costs, imply substantial costs for workers who cannot insure themselves against this possibility.⁵ That is, if dismissal were to cause a permanent drop in consumption that workers could not protect themselves against, then higher severance pay could help smooth consumption, especially in the absence of other instruments for meeting this objective. In addition to serving as a rationale for severance pay higher than the figure calculated in the preceding paragraphs, this could justify increasing severance pay as a function of job tenure.

⁴ The most common subsidy is two minimum wages, which is lower than the beneficiaries' average wages.

⁵ Blanchard and Tirole (2008) also explore this possibility.

The right amount of severance pay also depends on other instruments. For example, if it is the only tool for protecting income following dismissal, then setting a very low figure would effectively undermine the objective of protecting income. However, if there are other instruments, such as an individual unemployment account or unemployment insurance, it is important to consider whether the sum of these benefits offers sufficient protection.

Added to all these arguments are other factors that should be considered when determining the amount of severance pay. First, as already mentioned in this chapter, a benefit of this type that discourages formal hiring would be counterproductive, even from the standpoint of protecting workers. The institutional capacity of the state to enforce the law must also be considered. Severance pay on paper that does not materialize in practice does not serve its purpose and could simply lead to uncertainty and labor litigation. Hence, it is important to determine, country by country, whether the amount set for severance pay is the right one for promoting formal hiring while internalizing the social cost of dismissal.

Another factor to consider is the financing mechanism. As mentioned in Chapter 4, the majority of countries in the region use a mechanism in which firms pay the cost with no prior savings.⁶ A financing mechanism that permits a certain degree of prior savings on the part of firms could facilitate the payment of severance pay. However, as Blanchard and Tirole (2008) indicate, prior savings should not cover the entire cost because severance pay would then no longer be a barrier to dismissal. Moreover, there will always be cases in which severance pay cannot be collected, as when a firm goes bankrupt and its assets are insufficient to meet its obligations. Therefore, it would be advisable to consider insurance or a common fund financed by a small employer contribution that would cover severance pay in cases where a firm could not do so due to bankruptcy. This insurance would reduce uncertainty among workers who are afraid of losing their jobs because they have no real protection. Spain has a mechanism with these characteristics known as the Fondo de Garantía Salarial (FOGASA).

4. Other characteristics of labor law on dismissal

While it is recommended that regulatory frameworks be kept as simple as possible, it is also true that labor law should recognize that some employment relationships, by their nature, should not trigger severance pay when they come to an end. For example, certain employment relationships are established for

⁶ See Holzmann et al. (2011) for a detailed review of the characteristics of severance pay in each country.

a fixed period or specific project. In such cases, the employment relationship ends because the stipulated time or work on the specific project ended; this should not entail a cost for the firm as long as the contract did not end prematurely. In this case, the firm is not actually dismissing the worker or failing to honor the contract. Nevertheless, it is important to remember that workers who lose this type of job also need protection. Active employment policies appear to be the natural candidates for helping such workers find new jobs.

Another case in which firms should be exempt from providing severance pay is in the first months of an employment relationship. Lack of information about a worker's skills is highest at the start of the relationship when the firm has had an opportunity to observe his or her performance. A short trial or probationary period is therefore recommended, during which the worker can be dismissed without severance pay.

Allowing dismissals without severance pay in the initial months is also justifiable because it causes little harm to workers with short tenures at the time of dismissal (Amarante, Arim, and Dean, 2011; Kaplan, Martinez, and Robertson, 2005b). Moreover, this policy would promote the hiring of inexperienced people, especially youth, for whom lack of information is a particularly serious problem.

Concerning employment relationships without the right to severance pay, it is important to point out that the aforementioned proposal would provide fewer incentives to abuse these hiring modalities, as Hijzen, Mondauto, and Scarpetta (2013) found. If a permanent contract only involves severance pay equal to a few months of the worker's wages, there will be fewer incentives to hire temporary workers to avoid dismissal costs. If dismissal costs in general are relatively low, there will be less temptation to resort to temporary contracts to avoid them.

In short, we recommend a simple legal framework that is easy to implement and does not create uncertainty or incentives to litigate. This framework consists of low severance pay without major restrictions on dismissal when the firm is willing to bear the cost. We also recommend that temporary or product contracts be exempt from severance pay. Finally, we recommend allowing a probationary period in which firms can evaluate workers without the need to provide severance pay if they prove unsatisfactory.

It is important to underscore that, though the regulatory framework may be flexible in the sense of not penalizing dismissal by imposing a high cost, our

proposal is to foster productive stability through policies that allow both individuals and firms to make better hiring decisions (pillar 1) and promote job training. In our view, job stability that exists when firms are loath to dismiss workers because they have invested in them a great deal is better than job stability created through an obligation imposed by the state.

Conclusions

This chapter presented a series of proposals for achieving successful career paths. These proposals are divided into two pillars:

1. Policies to increase and equalize opportunities for access to formal jobs.
2. Policies to promote productive job stability.

Our proposals could represent a paradigm shift for the region. There is no doubt that many labor markets in LAC are dysfunctional since there are too many workers in unproductive jobs who receive low wages and have no access to many of the job benefits that are considered basic in the OECD countries.

This book presents an ambitious vision. It proposes an integrated set of instruments for transforming the labor markets of the region, thereby promoting successful career paths for workers and sources of growth for the economies. It asserts that this can be accomplished with an integrated package of policies that facilitates the placement of workers in formal jobs through a combination of better information about job vacancies and workers' skills, better training programs, and a regulatory environment favorable to the creation of formal employment as well as a change in the regulatory framework. It calls for abandoning a confrontational framework where dismissal is discouraged by a monetary penalty and transitioning to a system where employers view employees as hard-to-replace assets due to the competencies they have acquired. It also proposes exchanging a safety net for the unemployed for a trampoline that puts them back on successful career paths. Finally, this would be impossible without strengthened ministries of labor exercising their leadership and regulatory role—ministries that view firms as partners for the creation of more and better jobs, that link labor policy with other policies (such as social, productive, or export policies), and that encourage social dialogue.

While this is an ambitious proposal that would take years to fully implement, we believe that the benefits to workers and the economies as a whole warrant the effort. With the support of the proposals outlined in this chapter, labor markets could cease to be inefficient, unproductive, and highly unstable with little protection from unemployment and the risks related to health and poverty in old age. Labor markets could be transformed so that workers and employers create greater value through their labor, thus spurring the countries' growth and improving the quality of life for workers.

Methodological Appendix

Decomposition of GDP per capita growth in different scenarios

General aspects

The growth of gross domestic product (GDP) can be decomposed into two components—GDP per worker and the employment rate of the total population—for the purpose of determining the contribution of labor productivity and increased employment to the growth of the product. Thus:

$$\ln\left(\frac{GDP}{POP}\right) = \ln\left(\frac{GDP}{EMP} \frac{EMP}{POP}\right) = \ln\left(\frac{GDP}{EMP}\right) + \ln\left(\frac{EMP}{POP}\right)$$

where POP is the total population and EMP is the total number of people employed in a country. Therefore, the annual change in GDP per capita per country is estimated as follows:

$$\Delta \ln\left(\frac{GDP}{POP}\right) = \Delta \ln\left(\frac{GDP}{EMP} \frac{EMP}{POP}\right) = \Delta \ln\left(\frac{GDP}{EMP}\right) + \Delta \ln\left(\frac{EMP}{POP}\right)$$

Three time periods are considered when calculating these variations—1993–2003, 2003–2013, and 1993–2013—thus making it possible to calculate the average variations in each component from period to period.

$$\text{Average}\left(\Delta \ln\left(\frac{GDP}{POP}\right)\right) = \text{Average}\left(\Delta \ln\left(\frac{GDP}{EMP}\right)\right) + \text{Average}\left(\Delta \ln\left(\frac{EMP}{POP}\right)\right)$$

This methodology was used in the construction of Figure 1.3, which shows the contribution of the variations in each component to the variation in GDP per capita.

Hypothetical scenarios

1. Calculation of the contribution of female participation to GDP per capita growth

In this scenario, the assumption is that the rate of female participation observed in the countries of the region during the initial period of the variations mentioned in the previous section remains constant. Participation rates were calculated using household survey data on both female employment and the working-age population (WAP) by gender for the different years. These rates were later applied to the employment data from the World Bank (2015b).

Therefore, male employment rates stay the same while the counterfactual of female employment is calculated using the female participation in the total WAP observed in the initial period of the variation as a constant; in other words, the female participation rate in the initial period is used to obtain female employment data in the final period (2003 or 2013), and a new aggregate employment rate is calculated.

In the initial equation, the component that changes would be the one corresponding to the employment rate over the total population:

$$\Delta \ln \left(\frac{GDP}{POP} \right) = \Delta \ln \left(\frac{GDP}{EMP} \frac{EMP}{POP} \right) = \Delta \ln \left(\frac{GDP}{EMP} \right) + \Delta \ln \left(\frac{EMP}{POP} \right)_{Counterfactual}$$

2. Calculation of youth employment's contribution to GDP per capita growth

In this case, we seek to estimate what young people's contribution to economic growth would be if both unemployed youth aged 15–24 and young people neither in education, nor working, nor looking for work (NININIs) were employed.

One alternative is to calculate the new aggregate employment by adding these two groups to the total employed population and calculating a new GDP per capita.¹

$$\ln\left(\frac{GDP}{POP}\right)_{counterfactual} = \ln\left(\frac{GDP}{EMP}\right) + \ln\left(\frac{EMP}{POP}\right)_{counterfactual: \text{unemployed youth and NININIs employed}}$$

This calculation assumes, however, that young people have the same productivity (GDP/EMP) as adults on average, which is a rather dubious hypothesis. Thus, a second alternative is to assume that youth productivity is lower on average than the average productivity of the total population in the same proportion as their wages. That is:

$$\begin{aligned} \frac{Wages_{youth}}{Wages_{avg}} &= \frac{GDP}{EMP_{youth}} / \frac{GDP}{EMP_{avg}} \\ \ln\left(\frac{GDP}{POP}\right)_{counterfactual} &= \ln\left(\frac{GDP}{EMP}\right) + \ln\left(\frac{EMP}{POP}\right)_{counterfactual} \\ &= \ln\left(\frac{GDP_{adults}}{EMP_{adults}} \frac{EMP_{adults}}{EMP} + \frac{GDP_{youth}}{EMP_{youth}} \frac{EMP_{youth}}{EMP}\right) + \ln\left(\frac{EMP}{POP}\right)_{counterfactual} \\ &= \ln\left(\frac{(1 - \alpha b_j)}{b_a} \frac{GDP}{EMP} b'_a + \alpha \frac{GDP}{EMP} b'_j\right) + \ln\left(\frac{EMP}{POP}\right)_{counterfactual} \end{aligned}$$

where b_j is the original participation of youth in total employment and b_a is the original participation of adults in total employment; b'_a is both the proportion of adult employment after including unemployed youth and NININIs in employment and b'_j is the proportion of youth employment after adding the two groups together. Finally, α is the percentage of youth wages in the average wage.

¹ The data on youth unemployment and NININIs were obtained from the countries' household surveys, calculating participation rates in the population aged 15-64. These data were then applied to the population and employment data from World Bank (2015b).

Methodology for estimating changes in individual income after job loss

In order to measure the impact of job transitions on individual income, controlling for the basic characteristics of the individual (e.g., gender, age, education, and job tenure):

A. Consider the following econometric model:

$$y_{i,t} = \alpha_i + \sum_t \delta_t * T_{i,t} + \sum_{t,l} \beta_{t,l} * D_{i,t} * trans_{i,l} + \varepsilon_{i,t}$$

where α_i is a fixed effect of an individual i in period t , $T_{i,t}$ captures the passage of time, and $D_{i,t}$ is a binary variable equal to 1 if individual i belongs to job transition group l . The parameters δ_t measure the change in the dependent variable over time, and the parameters $\beta_{t,l}$ measure the differential changes in the dependent variable for transition group l with respect to the control group.

A concrete example can clarify the purpose of this econometric model. Consider a case in which the dependent variable is an individual's income from work. Let us assume that the control transition group consists of people who had formal jobs throughout the period and the other transition group consists of people who had a formal job in period 0 and were unemployed in period 1. In this case, the parameters $\beta_{t,l}$ would measure the differential change in the income of individuals who were unemployed in period 1 relative to that of those who had formal jobs throughout the period.

In addition to the parameters of the previous model, it may be desirable to consider other characteristics of the individual or job, such as gender, age, or job tenure. For example, people who lose formal jobs are likely to have shorter job tenure, which could imply a different income trend with or without the loss of employment. Moreover, people with many years of tenure are likely to experience greater economic losses after losing their jobs. In this context, it would be desirable to estimate the following model, which includes the effects of tenure:

$$y_{i,t} = \alpha_i + \sum_t \delta_t * T_{i,t} + \sum_t \theta_t * D_{i,t} * X_i + \sum_{t,l} \beta_{t,l} * D_{i,t} * trans_{i,l} + \sum_{t,l} \gamma_{t,l} * D_{i,t} * trans_{i,l} * X_i + \varepsilon_{i,t}$$

Or alternatively:

$$y_{i,t} = \alpha_i + \sum_t \delta_t * T_{i,t} + \sum_{t,l} \gamma_{t,l} * D_{i,t} * trans_{i,l} * X_i + \varepsilon_{i,t}$$

where X_i is the characteristic of interest of individual i in period 0 and the parameters $\gamma_{t,l}$ measure the differential impact on the dependent variable of transition group l as a function of characteristic X_i at moment 0.

1. Dependent variable

The dependent variable used here is

- i.
$$\frac{\text{individual's real income in period } t}{\text{individual's real income in period } 0}$$

In this case, labor income, both numerator and denominator, is deflated by the consumer price index (CPI) for the respective month.

This exercise can be expanded to calculate the effect of the unemployment of individual i on total household income as follows:

- ii.
$$\frac{\text{individual's real income in period } t}{\text{individual's real income in period } 0}$$

As in the preceding case, labor income, both numerator and denominator, is deflated by the CPI for the respective month.

- ii.
$$\frac{\text{real household income in period } t}{\text{real household income in period } 0}$$

B. Transition groups

There are two models. The first is for people who were formal workers in period 0. The transition groups are listed below:

- 1. Trans = F = 1:** People who had a formal job throughout the study period. This would be the control group or excluded category.
- 2. Trans = F = 2:** People who had a formal job in period 0 and an informal job (*) in period 1 regardless of their employment status in other periods.
- 3. Trans = F = 3:** People who had a formal job in period 0 and were unemployed or inactive (**) in period 1, regardless of their employment status in other periods.
- 4. Trans = F = 4:** People who had a formal job in both period 0 and period 1 regardless of their employment status in other periods.

(*) Two different models are estimated. In one model, informal workers are informal salaried workers and self-employed workers; that is, trans = F takes 5 values instead of 4. In the second model, informal salaried workers and self-employed workers are separate. (**) A model that excludes inactive workers from the entire analysis is also estimated.

The second model would be for people who had informal jobs in period 0. The transition groups would be:

- 1. Trans = I = 1:** People who had an informal job throughout the study period. This would be the control group or excluded category.
- 2. Trans = I = 2:** People who had an informal job in period 0 and a formal job in period 1 regardless of their employment status in other periods.
- 3. Trans = I = 3:** People who had an informal job in period 0 and were unemployed or inactive in period 1 regardless of their employment status in other periods.
- 4. Trans = I = 4:** People who had an informal job in both period 0 and period 1 regardless of their employment status in other periods.

Appendix of data sources

Throughout this book, different types of data sources have been used to analyze the situation of the labor market in Latin America and the Caribbean (LAC), notably:

Household surveys. Raw data are taken from the household surveys of each country and transformed so that they provide information that can be compared over time and among countries (IDB [2015c] and IDB [2015b]). The indicators presented are weighted by the population of each country.

Panel data. The household or employment surveys of eight countries were used in developing the panels, as seen in Table A.1.

Table A.1 Surveys used in the labor market analysis

| Country | Survey | Period | Frequency | Maximum number of times that an individual appears in a panel | Maximum number of years that an individual can be observed in a panel |
|-----------|--|-----------------------------|--------------|---|---|
| Argentina | Continuing Household Survey (EPHC) | III 2003-II 2013 | Quarterly | 4 nonconsecutive quarters | 1.5 |
| Brazil | Monthly Employment Surve (PME) | 2002-13 | Monthly | 8 nonconsecutive months | 1.25 |
| Colombia | Fedesarrollo Longitudinal Social Survey (ESL-Fedesarrollo) | 2007-09 | Annually | 3 (one per year) | 3 |
| Ecuador | National Employment, Unemployment, and Underemployment Survey (ENEMDU) | 1998-2001, 2002-06, 2007-13 | Quarterly | 4 quarters | 2.25 |
| Mexico | National Occupational and Employment Survey (ENOE) | I 2005-III 2012 | Quarterly | 5 quarters | 1.25 |
| Paraguay | Continuing Employment Survey (ECE) | I 2010-II 2013 | Quarterly | 5 quarters | 1.25 |
| Peru | National Household Surve (ENAHO) | 2007-12 | Annually | 5 years | 5 |
| Venezuela | Encuesta de Hogares by Sampling (EHM) | 2005-10 | Semiannually | 5 years | 5 |

Since the panel rotation systems in the countries analyzed are different, a single period in a panel can indicate a longer window of time. For the purposes of this analysis, all possible transitions between one quarter and the same quarter in the previous year were used for all of the countries regardless of the panel design.

Social protection surveys. These instruments are specific surveys conducted to provide statistical information on labor and social protection policies. Some of them, such as those of Colombia and El Salvador, have been promoted by the Inter-American Development Bank (IDB). Surveys from four countries were used: the Social Protection Survey of Chile (2009); the Longitudinal Social Protection Survey (ELPS) of Colombia (2012) and El Salvador, (2013); and the Career Path Survey (2012), a module of the National Occupational and Employment Survey (ENOE) of Mexico.

Productivity survey for businesses. The IDB is promoting its Productivity and Human Resources Training Establishments Survey (EPFE) in several countries in the region to compile information on business training practices. This study used information from the Bahamas, Colombia, Honduras, Panama, Paraguay, and Uruguay obtained through cross sectional surveys conducted in 2011 and 2012. Unlike surveys of traditional firms, the EPFE contains detailed information on training practices that can be used to answer basic questions, such as how often firms offer training to their employees, which skills are prioritized in the training, and which workers receive training most often.

Administrative data. The administrative data used in this study are taken from the following sources: the social security contribution databases from the Annual Social Security Report (RAIS) 2002–12 for Brazil; the Mexican Social Security Institute (IMSS) for the period of 1997–2005; and the Ecuadorian Social Security Institute (IESS) for the period 2005–12. These databases provide information on the dynamics of firms and their role in formal job creation and destruction.

PISA results. The study considered the results of the Program for International Student Assessment (PISA), a global project of the Organization for Economic Cooperation and Development (OECD). The objective of this program is to measure the extent to which students approaching the end of compulsory education at around 15 years of age have acquired essential knowledge and skills. This is a population at the point of beginning post-secondary

education or entering the labor force. The assessment measures reading, mathematics, and science competencies.

Useful definitions

Unemployment rate. The unemployed population relative to the labor force (the employed plus the unemployed).

Activity or participation rate. The labor force (the employed plus the unemployed) relative to the working-age population.

Employment rate. The employed population relative to the working-age population.

Long-term unemployment. Proportion of the unemployed who say they have been looking for work for a year or more.

Long-term employment. The proportion of employed people who have held a job for more than five years.

Job tenure. The average number of years that workers have been with their firms.

Formality. This study uses the definition of formality that is linked with social protection, which is that workers are employed in a formal job if either they or the firm contributes to social security so that they have the right to a retirement pension in the future. Thus, a job is informal if neither the worker nor the firm contribute to the system to provide the worker with social security coverage in old age.

Concerning the disaggregations used, it should be noted that:

1. Educational levels were defined as follows: low [0–8 years of schooling], intermediate [9–13 years of schooling], and high [14 or more years of schooling].
2. Firms were classified by size as small [1–5 employees], medium-sized [6–49 employees], and large [50 or more employees]. It should be highlighted that this definition does not apply to all the countries. In cases where it does not, the categories in each survey that were closest to this definition were used.

3. In order to define a worker's qualifications, various categories of the occupational group were combined. Thus, highly qualified workers include senior managers, professionals, and technicians; those with intermediate qualifications include administrative or service employees, and those with low qualifications are salespeople and vendors, non-agricultural laborers, and those in other unspecified occupations.

4. Finally, the branches of activity were grouped as follows: primary or extractive activities (which include agriculture and mining); manufacturing; services (which include commerce, hotels, restaurants, and social services); and construction.

All the definitions used here are consistent with the methodology developed by IDB (2015c) for the construction of homogeneous indicators for all LAC countries. Finally, to calculate the graphs that show comparisons of the years 1993, 2003, and 2013 in countries where no survey is available for one of the three years mentioned, the series was completed with the closest available year.

This book is clearly lacking data and research on the labor market in the Caribbean, primarily due to its absence. While the countries in Latin America regularly produce data and make it accessible to the public, the situation in the Caribbean is very different. Some Caribbean countries only conduct household or employment surveys sporadically. Others produce data, but they are neither public nor readily accessible to researchers. Much of the data used in this book are longitudinal and do not exist in any Caribbean country or are otherwise inaccessible.

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“On the basis of a conceptual framework and new statistical information, Jobs for Growth describes the difficulties that Latin American workers face to successfully insert themselves into the labor market. The book proposes a new set of public policies to ease this situation. This is an important book for academics and for all those who design and implement labor policies in the region.”

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“The authors suggest the necessity of implementing a new, comprehensive set of policies in order to fight the vicious cycle of labor informality and instability that is characteristic of Latin American countries and that explains the low levels of labor productivity. Thanks to its wealthy analysis and information, and to its comprehensive vision, this book is destined to be a center piece in the Latin American debates about these essential topics.”

Jose Antonio Ocampo, Director of the Economic and Political Development Concentration in the School of International and Public Affairs at Columbia University, New York



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