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Job Creation

The Effects of Rigid Labor Regulations in Latin America

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Rigid regulations may prevent labor markets from being efficient. We quantify, for 14 Latin American countries, the extent to which rigid labor regulations affect both the hiring and dismissal decisions of firms. Making regulations more flexible would lead to an average net increase of 2.1 percent of total employment. These net employment gains would be the result of increased dismissals being more than compensated for by increased hires. These increased dismissals may explain the opposition to labor reforms designed to make regulations more flexible, despite the fact that total employment would increase. Unemployment insurance, which is designed to protect workers who lose jobs rather than protect the jobs themselves, may be more effective than rigid labor laws both at protecting workers and at creating jobs.

The challenge of labor market policy is to devise a framework for contracting between employers and workers that is at once efficient and fair. Most people would agree that excessively rigid labor market regulations prevent the labor market from operating efficiently. The resulting losses to employment and productivity therefore reduce opportunities for workers to find good jobs. Most people would also agree that some regulation is necessary to codify and protect basic standards of fair treatment for workers. Regulations may also introduce a degree of predictability to, and reduce the cost of, contracting between employers and workers. The debate over the design of labor market policy centers on the question of how much and what kind of regulation is necessary to efficiently achieve these goals—and when regulation becomes "excessive."

There is considerable evidence that rigid labor regulations, such as high legally mandated severance payments, mandatory retraining of redundant workers, or restrictions on hours worked, may prevent labor markets from operating efficiently. Botero et al. (2004), for example, find that countries with heavier labor market regulations have lower rates of labor market participation and higher levels of unemployment. Besley and Burgess (2004) find that rigid labor regulations in India negatively affect employment and productivity and increase poverty. Amin (2009) also shows that rigid labor regulation in India has substantial and negative effects on employment. A more complete review of the literature on the effects of labor regulations in developing countries can be found in Djankov and Ramalho (2009).

By exploiting a dataset in which firms are asked how many workers they would have hired and dismissed in the absence of rigid labor regulations, the relationship between labor regulations and these labor market flows is examined. We focus on the effects of rigid labor regulations on worker flows (hires and dismissals), which are of crucial impor-

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tance both for understanding the effects of labor reforms and for understanding why the relaxation of rigid labor regulations is often met with such opposition.

We use data from 14 Latin American countries.[1] All firms in these countries were asked: "In fiscal year 2005, would this establishment have hired or dismissed permanent workers had it not been for having to comply with labor regulations?" When a firm answered yes to this question, the firm was asked specifically how many workers would have been hired or dismissed. This information, combined with the number of permanent workers who were actually employed, enables the calculation of the following three items for each country:

1. New hires as a percentage of total employment that would have occurred if labor regulations were made more flexible
2. Dismissals as a percentage of total employment that would have occurred if labor regulations were made more flexible
3. The net percentage increase in total employment that would have been achieved by making labor regulations more flexible. This net change in employment is simply the hiring percentage minus the dismissal percentage.

Making labor regulations more flexible would lead to more new hires than dismissals.

Why Do We Care about Labor Market Flows?

We measure the effects that rigid labor regulations have on employment flows - both the net effect on employment and the flows behind the net changes. One way that net employment could increase with the removal of rigid regulations is that 10,000 people can be hired with no one being fired. Another way to achieve the same net change in employment would be if 50,000 people are hired as a result of removing rigid labor regulations, but 40,000 people are dismissed.

There are at least two reasons why these labor market flows are important. The first is that a labor market in which employment is high is not necessarily a well-functioning labor market. Each worker should be working where he or she is most productive. The evidence presented later in this note—that both hires and dismissals would increase if labor regulations were more flexible—is therefore evidence that rigid labor regulations cause workers to be employed in places where they are not most productive.

The second reason for studying labor market flows and labor regulations is to understand who would gain and who would lose as a result of making labor regulations more flexible. The fact that making labor regulations more flexible would lead to more new hires than dismissals suggests that many people stand to gain by making regulations more flexible. The fact that making labor regulations more flexible would cause many workers to lose their jobs, however, suggests that many incumbent workers would be made worse off if labor regulations were made more flexible.

We do not present the technical details of the calculations of labor market flows in this note. Much more detail, including exact formulas, can be found in the more extensive Kaplan (2009).

Rigid Regulations Protect Some Jobs But Deter Job Creation

Table 1 presents these data items for each of the 14 countries.

Table 1 Job Rotation Statistics

	Net percentage change in employment if labor regulations more flexible	Additional hires as percentage of employment if labor regulations more flexible	Additional dismissals as percentage of employment if labor regulations more flexible
Argentina	2.8	5.1	2.3
Bolivia	3.3	7.2	3.9
Chile	0.8	1.7	0.9
Colombia	5.3	6.7	1.4
Ecuador	1.9	3.4	1.5
El Salvador	0.7	1.6	0.9
Guatemala	1.5	2.5	1.0
Honduras	0.3	1.1	0.8
Mexico	1.0	1.4	0.3
Nicaragua	0.0	0.4	0.4
Panama	0.4	1.7	1.3
Paraguay	4.0	8.8	4.8
Peru	3.1	3.8	0.7
Uruguay	3.9	5.4	1.6
Averages	2.1	3.6	1.6

Source: Enterprise Surveys.
Note: Calculations based on data from Enterprise Surveys. Weights are used in the calculation of country-level statistics to approximate the values that would be obtained by using a census of firms. The net percentage may not equal the hiring percentage minus the dismissal percentage due to rounding error.

Table 1 shows that, on average, making regulations more flexible would lead to a net employment increase of 2.1 percent. Table 1 also suggests, however, that making labor regulations more flexible might not be good for everyone. On average, 1.6 percent of people currently employed would lose their jobs if labor regulations were made more flexible. In this sense, one can say that labor legislation that is designed to protect the jobs of people currently employed does achieve its goal. On average, 1.6 percent of jobs are being protected by rigid labor laws.

Table 1 also shows, however, that the number of people who are not hired as a result of rigid labor laws is substantially larger than the number of people protected from being dismissed by labor laws. Although rigid labor regulations do protect some workers from being dismissed, they prevent more workers from being hired.

Reform Will Hurt the Most Where It's Needed the Most

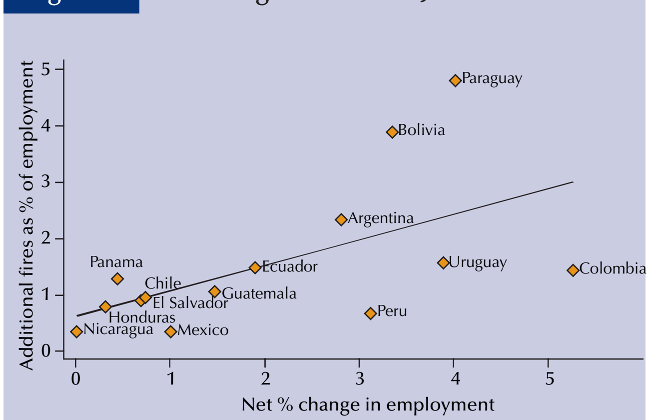
The data permit analyzing the differences in the effects of labor regulations across countries. The vertical axis in figure 1 is dismissals as a percentage of total employment that would arise if labor regulations were made flexible. The horizontal axis shows the percent gain in net employment that would arise if labor regulations were made more flexible.

We see from figure 1 that the countries that would experience larger gains to net employment by making labor regulations more flexible would also experience larger percentages of their workforces losing their jobs.[2]

A concrete example may make the point above clear. Consider, for example, the neighboring upper-middle-income countries of Argentina and Chile. Firms in Chile report that if labor regulations were made more flexible, the net gain to employment would be 0.8 percent, while Argentinean firms report a net gain of 2.8 percent of total employment.

Countries that would experience larger gains to net employment by making labor regulations more flexible would also experience larger percentages of their workforces losing their jobs.

Figure 1 Labor Regulations and Job Rotation



Source: Enterprise Surveys.

The focus of this note, however, is how these gains in net employment are accomplished. Chilean firms report that the additional dismissals resulting from more flexible labor regulations would be 0.9 percent of total employment, while Argentinean firms report an additional dismissal figure of 2.3 percent. We see therefore that, despite the fact that Argentina would gain more in terms of aggregate employment by reforming its more rigid labor regulations, Argentina would also see a higher percentage of its workers losing their jobs. The larger net employment gains in Argentina are a result of high dismissal figures that are more than compensated for by even higher figures for additional hires.

Protecting Jobs Versus Protecting Workers

Rigid labor regulations typically have the protection of jobs as a key motivating factor. The results in this note suggest that rigid labor regulations do protect the jobs of those who are currently employed. This job protection, however, comes at the expense of workers who are not hired as a result of rigid labor regulations. As observed, labor markets in countries with rigid labor markets are characterized by lower levels of aggregate employment. Rigid labor regulations also cut off the natural flow of workers between firms, which prevents labor markets from adjusting to external shocks.

Reform efforts to make labor regulations more flexible might face less resistance from incumbent employees if they are combined with elements of social protection. Unemployment insurance for displaced workers, for example, has been shown by Acemoglu and Shimer (2000) to provide social protection in a way that makes the labor market more efficient. The goal of unemployment insurance is not to prevent workers from losing their jobs. On the contrary, unemployment insurance protects the workers themselves by softening the blow of losing a job. Acemoglu and Shimer (2000) show that unemployment insurance allows workers to spend more time searching for a new job where the worker is likely to be more productive.

In conclusion, rigid labor regulations impede the efficient functioning of labor markets. Rigid labor regulations also do a poor job of providing social protection. Labor reforms that make regulations more flexible, combined with programs like unemployment insurance designed to support displaced workers, might lead to more efficient labor markets that also offer better social protection.

Notes

1. The data can be accessed at http://www.enterprisesurveys.org. The 14 countries are Argentina, Bolivia, Chile, Colombia, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, and Uruguay.

2. The correlation is statistically significant at the 0.05 significance level.

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