

# Breaking the Rules?

## Economic Development and Labor Market Institutions



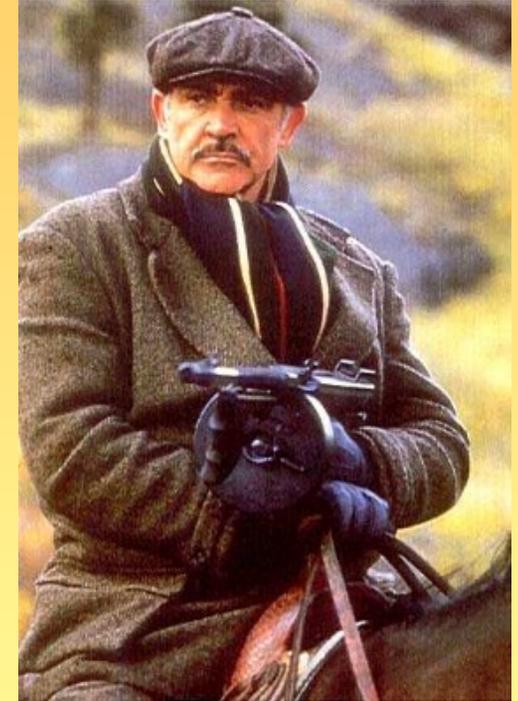
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# **This talk**

- I. Introduction – Starting the debate**
- II. Today– the retreat of the WB/IMF from Washington Consensus claims**
- III. Labor Debate Redux**
  - cross country evidence**
  - within country evidence**
  - what should convince us**
- IV. Where do we stand?**

# I) 1992 World Bank Development Meetings– Washington DC:



**Why the Muscle for Protection?**

**PEAK OF WASHINGTON CONSENSUS. WB “knew”  
how to grow economies: deregulate; fight urban bias;  
weaken unions; government role in economy;**

*“Labor market policies – minimum wages, job security regulations, and social security – are usually intended to raise welfare or reduce exploitation. But they actually work to raise the cost of labor in the formal sector and reduce labor demand ... increase the supply of labor to the rural and urban informal sectors, and thus depress labor incomes where most of the poor are found.” (World Bank 1990, p. 63).*

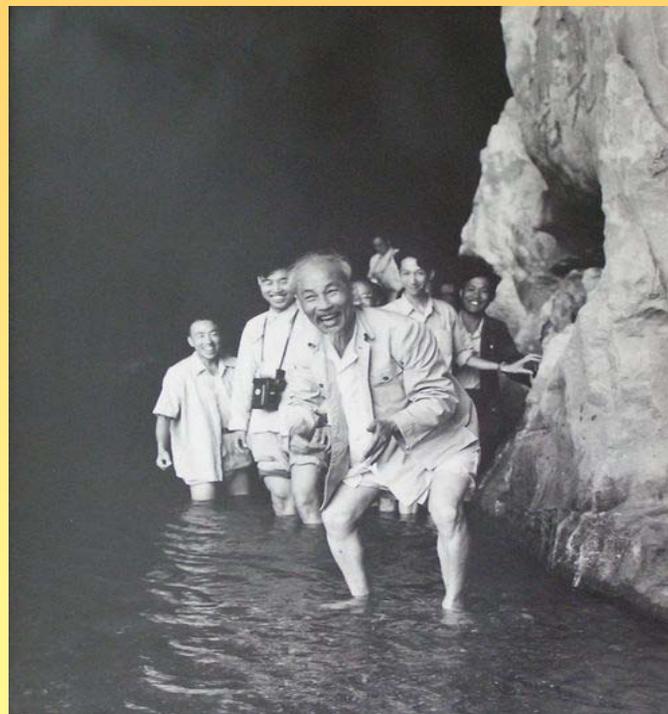
**Harris-Todaro model blamed institutional wage-setting  
for large informal sector; joblessness; other ills.**

**IMF/Bank worried that labor institutions would undo  
necessary macro/structural adjustment policies;  
restrict shift of resources to traded goods sector**

Some argued for Big  
Bang Economic  
Solution to Transition



Others for gradual  
“crossing river one  
stepping stone at a time”



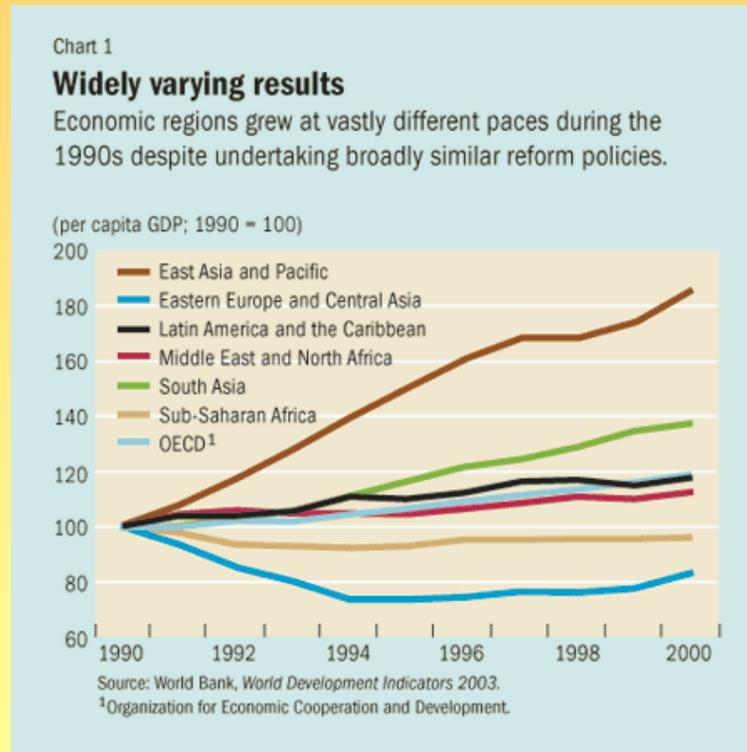
# The Hatman Message

1. Labor Institutions no great deterrent to growth
  2. Minimum wages, other regs largely “sawdust” in crisis, often not enforced in LDCs
  3. Evidence that institutions are big villain is sparse
  4. Coase Theorem says institutions not bad; Information analyses say could be good
- Squire/Suthiwart-Narueput “*natural limits to the efficiency losses engendered by such regulations*”

**So spend your resources fighting other villains**

## II) Today

*The Washington Consensus has been dead for years,”*  
**Wolfman I (World Bank President Wolfensohn)**  
*‘Scaling Up Poverty Reduction’ in Shanghai on 25 May, 2004.*



**“Goodbye Washington Consensus –Hello, Washington Confusion” D. Rodrik, JEL, Dec 2006**

# **Nails in coffin: trade and Inequality**

**Expected: increased trade benefits low wage workers in developing countries.**

**Reality: increased trade/globalization associated with rising wage inequality (Review by Goldberg & Pavcnik in JEL, 7 countries: 5 Latin American; India, HK; Robbins in ILO, 7 Latin American with 3 in addition to G&P; weaker results for Asian countries.)**

**The question now is: why trade did not help the low wage – time period; tech transfers of skill biased TC; measure of who competes with less skilled workers in advanced countries; advent of China and India**

# Another nail: Aggregate Latin American Experience:

Chart 2

## A decade of disappointment

Although nearly every country in Latin America and the Caribbean (LAC) has pursued economic reform, growth has been slow.

Distribution of reform index for 16 LAC countries  
(box plots showing mean, 10th, 25th, 75th, and 90th percentiles)



LAC regional growth in GDP per capita



Sources: Reform data: Eduardo Lora, 2001, "Structural Reforms in Latin America: What Has Been Reformed and How to Measure It," Inter-American Development Bank. Growth data: World Bank, *World Development Indicators* 2003.



# The curious case of Argentina, 2001-Present:

IMF's star pupil collapses, then recovers against the rules

1990-2000 largest Rise Ever in Fraser Economic Freedom Index:  
from 100 to 28 in ranking; then drops to 74<sup>th</sup> in 2004

	Before		After		After <sup>2</sup>
	1985	1990	1995	2000	2004
Econ Freedom	4.3	3.9	4.8	7.2	6.2
Marginal Tax	2.0	7.0	9.0	8.0	7.0
Legal prop rights	4.2	4.6	5.5	5.4	3.8
Sound Money	2.5	2.5	5.4	9.5	7.4
Trade	2.9	4.3	6.8	6.5	6.2
Int'l Capital Market	0.0	0.0	9.5	6.6	6.8
<b>Labor Market</b>	<b>3.7</b>	<b>3.5</b>	<b>5.9</b>	<b>6.1</b>	<b>5.1</b>

**Act I: Star Pupil:** Dollarization stops bad inflation; economy grows (**but higher unemployment and inequality**); IMF helps with loans; foreign capital buys govt enterprises

**Act II: ECONOMIC BASKET CASE:** Peso drops from \$1.00 (12/31/01) to \$3.86 (6/25/02); interest rate rises from 530 (March 00) to 7000 (July 02) basis pts; real GDP drops 18% to '02; Unemployment rises, 12.4% to 21.5%

### **Three analyses:**

A citizen: "All of our economy ministers have gone to Harvard – to learn what? To rob the country?" said one frustrated woman, voicing widespread anger at a political class seen as corrupt and inept (FT)

An economist: "If Argentina had a more flexible economic system, especially in its labor markets, its economy would have been more able to adapt to the rigors of the convertibility plan ... (But) the fundamental cause of disaster (was) the chronic inability of the Argentine authorities to maintain a responsible fiscal policy" (Mussa)

"IMF Says Its Policies Crippled Argentina" (WP, 2004 headline for IMF Report)

# Act III Recovery



**Labor institutions:** In crisis Peronista unions control protests; Government accepts mild disorders by piqueteros; special employment programs; pay 150 pesos per month family unemployment benefit

**Debt restructuring:** huge write-off, 70-75%; country refuses IMF/other financial advice and threats

**US State dept:** “Argentina's economy began a recovery in March 2002 ...far more robust than anticipated... An export-led boom (led to ~9%) growth in real gross domestic product beginning in 2003; unemployment dropped from 20.4% in Q1 of 2003 to 10.4% in Q2 of 2006. Investment in real terms jumped 22.7% in 2005. A higher tax burden and the recovery... (produced)... a primary fiscal surplus in 2005 equivalent to 3.7% of GDP.”

## Another Nail: The East Asian Miracles due to ...

“sound development policies, **tailored interventions**, and an unusually rapid accumulation of physical and human capital. ...the government intervened---systematically and through multiple channels---to foster development, and ... specific industries. Policy interventions took many forms... to bolster savings, build strong financial markets, and promote investment with equity ... keeping deposit rates low and maintaining ceilings on borrowing rates to increase profits and retained earnings, establishing and financially supporting government banks, and sharing information widely between public and private sectors ...targeting and subsidizing credit to selected industries, protecting domestic import substitutes, supporting declining industries, and establishing firm- and industry-specific export targets.” (WB, The East Asian Miracles)

Robert Wade, Alice Amsden, Lee Yuan Kew – you were right!

# Another Nail: the strange pattern of capital flows

Chart 1

## Downhill or uphill?

The relative income of capital-exporting countries has fallen when compared with the United States.

(relative per capita GDP weighted by current accounts)



Source: Authors' calculations.

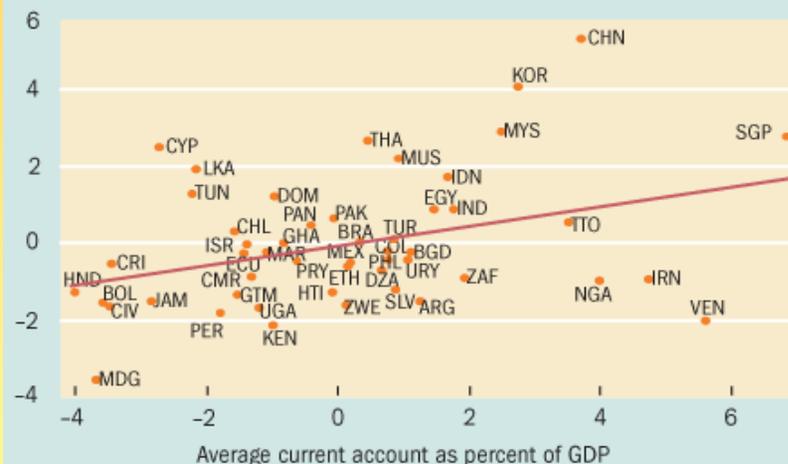
Notes: For each year, we separate our sample of countries into two groups—those with current account surpluses and those with deficits in that year. For the first group, we then take each country's share of the total current account surplus accounted for by all countries in that group. We then multiply that share by the relative purchasing power parity-adjusted per capita income of that country (measured relative to the per capita income of the richest country in the sample in that year). This gives us a current account-weighted measure of the relative incomes of surplus countries. We do the same for current account deficit countries. This enables us to compare the relative incomes of surplus versus deficit countries in each year.

Chart 4

## Stand alone

Developing countries that have relied less on foreign capital have, in general, grown faster.

(average per capita GDP growth, percent)



Source: Authors' calculations.

Note: Sample excludes Nicaragua.

ARG=Argentina, BGD=Bangladesh, BOL=Bolivia, BRA=Brazil, CHL=Chile, CHN=China, CIV=Côte d'Ivoire, CMR=Cameroon, COL=Colombia, CRI=Costa Rica, CYP=Cyprus, DOM=Dominican Republic, DZA=Algeria, ECU=Ecuador, EGY=Egypt, ETH=Ethiopia, GHA=Ghana, GTM=Guatemala, HND=Honduras, HTI=Haiti, IDN=Indonesia, IND=India, IRN=Iran, Islamic Republic of, ISR=Israel, JAM=Jamaica, KEN=Kenya, KOR=Korea, Republic of, LKA=Sri Lanka, MAR=Morocco, MDG=Madagascar, MEX=Mexico, MUS=Mauritius, MYS=Malaysia, NGA=Nigeria, PAK=Pakistan, PAN=Panama, PER=Peru, PHL=Philippines, PRY=Paraguay, SGP=Singapore, SLV=El Salvador, THA=Thailand, TTO=Trinidad and Tobago, TUN=Tunisia, TUR=Turkey, UGA=Uganda, URY=Uruguay, VEN=República Bolivariana de Venezuela, ZAF=South Africa, ZWE=Zimbabwe

# Honest responses

**Trade:** “Few economists would doubt the beneficial effects of trade, despite the adverse impact on some group. Yet the hard evidence supporting such gains from trade – either in a dynamic or static sense– is surprisingly thin” –Rob Feenstra (NBER) ; “Rising trade volumes are unambiguously related to growth, but the direction of causation is unclear.” –Zagha, Nankini, & Gill (IMF, 2006)

**Capital Flows:** “further research is clearly needed in a number of areas before one can derive strong policy conclusions. ... some of the more extreme polemic claims made about the effects of financial globalization on developing countries, both pro and con, are far less easy to substantiate than either side generally cares to admit. *Kose, Prasad, Rogoff, & Wei* – (IMF, 2007) ; “(G)reater caution toward certain forms of foreign capital inflows might be warranted”– Prasad, Rajan, & Subramian (IMF, 2007)

**Growth:** ”expectations about the impact of reforms on growth were unrealistic ...governments need to be made accountable, not bypassed ...should abandon formulaic policymaking in which "any reform goes" ... our knowledge of economic growth is extremely incomplete. This calls for more humility in the manner in which economic policy advice is given, more recognition that an economic system may not always respond as predicted, and more economic rigor in the formulation of economic policy advice.-- Zagha, Nankini, & Gill (IMF, 2006)



# III) The Labor Debate Redux

Mirrors debate about OECD countries: strong priors that dominate empirical analysis, followed by rebuttals

My criterion: three levels of evidence: enough to raise suspicion; to bring charges; to convict, civil vs criminal

My reading of the evidence:

Cross-country → inconclusive

Within country: India cross-state regulations; min wage; union → inconclusive

China – growth with creation of labor market, but still low in labor market “freedom index” and most other measures – huge anomaly

“900 pound Gorilla” – informal sector; our close relative, we thought formal would grow and informal shrink, but ...



# Cross-country data 1: Forteza and Rama (2002):

Measure institutions with ILO conventions; Min W, Benefits; union; govt share of# employment, 1970-1999; “time-variant indicators of labor market rigidity cannot be used in the empirical analysis.” Half of ten most flexible are: South Africa, Uganda, Zimbabwe, Kenya, Tanzania; and China. Conclude that “organized labor as a key opponent of economic reforms”– unionism and govt employment.

## Analysis compares countries before/after WB loans -- measure of reform

Rigid more likely to need WB NO

Rigid do worse overall NO

Rigid make smaller recovery UNCLEAR

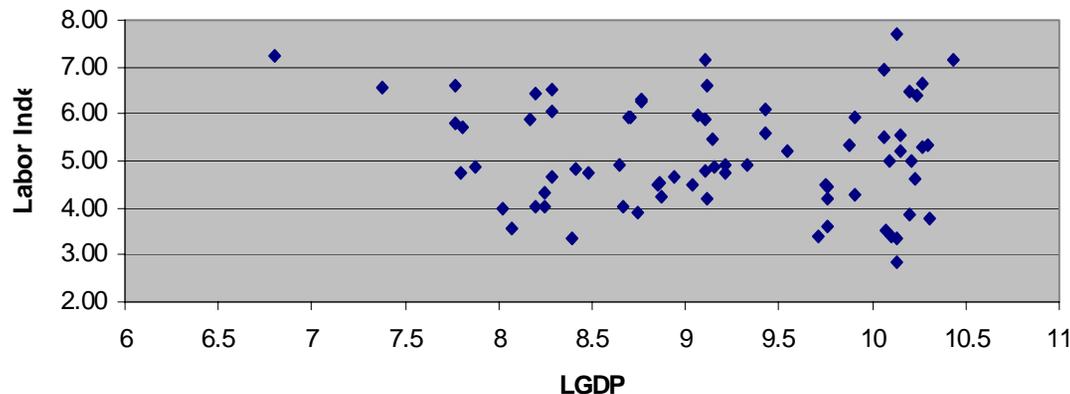
## Interaction of labor rigidity index in fixed effects (\* for sign)

before after before after

<b>ILO</b>	<b>-.025</b>	<b>-.013</b>			
<b>AGG</b>	<b>-.094*</b>	<b>-.097*</b>			
<b>Min</b>	<b>.056*</b>	<b>.026</b>		<b>.035</b>	<b>.010</b>
<b>Benefits</b>	<b>.003</b>	<b>-.020</b>		<b>-.007</b>	<b>.004</b>
<b>Union</b>	<b>-.030</b>	<b>-.047</b>		<b>-.023*</b>	<b>-.008</b>
<b>Govt empl</b>	<b>-.066*</b>	<b>-.069*</b>		<b>-.020</b>	<b>-.016</b>

# Cross-country 2: Fraser index Linked to Gini, not to GDP per capita: 2000 cross section

Figure 1A: Labor Index by LGDP



Labor index:

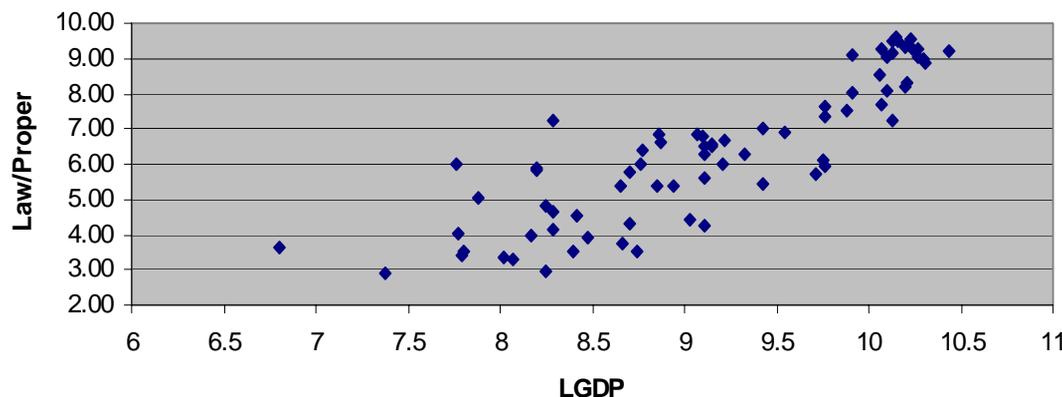
Less adverse to development?

OR

Simultaneity with  
Labor regs  $\rightarrow$  less  
GDP

But GDP  $\rightarrow$  more  
labor regs

Figure 1B: Law/Property Rights by LGDP



# Regressions with labor index and other Fraser

**Cross Section 2000,  
47 Developing countries**

	<b>Ln GPD / cap</b>	<b>Gini</b>
<b>Labor Index</b>	<b>-0.20 (.06)</b>	<b>1.48 (1.46)</b>
<b>Legal/ Property Index</b>	<b>.33 (.05)</b>	<b>-3.80 (1.11)</b>
<b>R<sup>2</sup></b>	<b>.54</b>	<b>.22</b>

**Fixed Effects, In GDP/Cap  
1970-2000 every 5 years  
52 countries, 24 DCs**

	<b>ALL</b>	<b>DC</b>
<b>Overall Ec Freedom Index</b>	<b>.030 (.014)</b>	<b>.054 (.025)</b>
<b>Labor Index</b>	<b>.006 (.007)</b>	<b>.055 (.176)</b>
<b>Lagged GDP/capita</b>	<b>-0.29 (.042)</b>	<b>-0.34 (.079)</b>
<b>N</b>	<b>238</b>	<b>77</b>

## **Cross-country 3: Calderon/Chong (2005); Cd/Chong/Valdes (2005); Cd/Chong/Leon (2006) Using RA Indices, cross-section and time variant with panel**

Find adverse effects of some labor regs on growth in instrumented equations for LDCs, particularly using GMM-IV, but not in cross section or in panel with time or country dummies

Finds that “regulations are weakly associated, overall, with improving income inequality” but higher minimum wage worsens distribution while unions, govt employment, maternity leave improve it.

For all countries, find no effects in cross section, some impact in fixed effects due to minimum wage and maternity leave, not union (ILO convention 87) or government employment

Comment: Panel results are problematic given warning about using data over time. Min wage not well enforced in many LDCs. Will results stand up to measure of real impact, different instruments, other measures?

## **Cross-country 4: Bertola (2005)**

“The evidence fails to support simplistic views of labor market institutions.” -- regressions of unemployment and employment rates on measures of flexibility of firing and CB rights, with OECD and Latin American countries show little. Weak link with EPL found in other studies (Kugler; Heckman & Pages)

## **Cross-country 5: Caballero et al (2005)**

Contrast establishment level speed of response of labor productivity to cost in Chile, Mexico, Brazil, Columbia, VZ against US. Finds that “While more inflexible than the United States, Brazil, Chile, Columbia exhibit a relatively high degree of micro-economic flexibility”; small firms are less flexible; but finds Chile lower flexibility over time, and could have large impact on growth.

# What would convince skeptic?

1. Show policy has effect in reality – ie on measured variables (min wage spike type test)
2. Genuine longitudinal analysis with good measures of policy that passes 1).
3. Before/after “diff in diff” with evidence that counterfactual valid ala Abadie et al (2007)
4. Andrews type test – can you find the policy in outcome data time series or in cross country outcomes?
5. Show impact plausible on aggregate even with large informal sector
6. Show party that allegedly benefits truly benefits or explain their stupidity

# Micro Studies: Minimum Wage

Lemos (2006, 2004) Brazil	Individual data	Minimum compresses distribution in informal and covered, no effect on employment; but 2004 finds some
Kristenen & Cunningham (2006), LA + Caribbean	Individual data, focus on spikes	In 10 countries minimum affects informal and covered; 4 only informal
Gindling & Terrell (2005, 1995) Costa Rica	Individual data	Raises wages in informal + formal 1995 study: no loss of employment in formal; gain in informal
Alatas & Cameron (2004) Indonesia	Individual W spike, firm E geographic time series	Wage effects; no E in large firms; some in small
Maloney and Mendez (2004), LA	Individual wage data Longitudinal job loss	Stronger on informal in Brazil, Mexico, Argentina, Uruguay; employment losses in Columbia; job loss greater for low w
Strobl & Walsh (2003), Trinidad & Tobago	Individual W; longitudinal job loss	Raises wages, lowers employment of affected group
Maloney et al (2002) LA countries	Spikes in wage data	Four yes, three no
Rama (2001), Indonesia	Time series,	Modest wage, little aggregate employment but shift from small firms

# Micro Studies: Minimum Wage

Jones(1997), Ghana	Individual data for wage; time series 21 years	W, E shift to informal $\epsilon \sim -0.10$
Squire & Suthiwart-Narueput (1997)	Changes in minimum across countries, 1970-90	Real minimums fall in 16/23 Min/Average falls in 6/17
Bell (1997), Columbia, Mexico	Firm level data	No effect in Mexico; effect in Columbia;
Lustig & McCleod, 1997, x- country	Change 1990s vs 1980s poverty measures	Reduces poverty
Castillo-Freeman & Freeman (1992), PR	Spike, Uses imposition of US min wage	W, modest E $\epsilon \sim -0.10$ ; large fall in employment in very small industries

**Big surprise: Min wages raise pay in informal sector;  
Impact on employment varies by country (Columbia, yes)  
and within country by study (Brazil), stronger  
employment effect in panel data than in aggregate data.  
Reduces poverty**

# Micro Studies: Union Monopoly Wage and Voice

Wage Effects: Fairress (2004) 1996 15% wage effect in Mexico; Butcher and Rouse (2001); South Africa wage diff of 10-20% but too small sector to explain huge unemployment; Schultz and Mwabu (1998), also finds large in South Africa; Teal (1996); Ghana. Panagides and Patrinos (1994) find 10% in Mexico; Standing – 15% to 20% in Malaysia

Non-wage “voice effects”: Fairress (2006, 2007) – Mexico individual and establishment data: reduces dispersion of pay; raises fringe share of compensation; increases training; but quit effect found only in foreign-owned firms; higher productivity in unionized; no clear adverse effect on profits; Standing (1992) – Malaysia: establishment data, lower skill differentials; lower quits, higher productivity, more product and process innovations, increase firm-sponsored training, and enhance enrollment in a pension plan.

Aidt and Zanetos 2003, Unions and Collective Bargaining: Economic Effects in a Global Environment: review based largely on advanced countries reports wage effects and effects on non-wage similar to above.

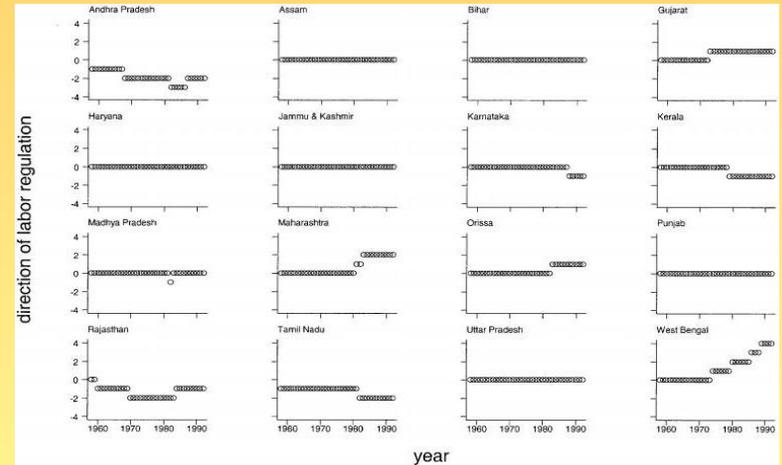
Devarajan, Ghanem, Thierfelder (WB) argue that unions strengthen benefits from reforms (by reducing their scope for monopoly gains)

**RESULTS FOR LIMITED COUNTRIES SEEM SIMILAR TO US FINDINGS ON WAGE AND VOICE**

# India: cross-state regulations

**Besley-Burgess (2003)** compare output, employment in registered and unregistered mfg, earnings, poverty using changes in Indian state labor regulations; (advance over Fallon & Lucas (1993) → Ministry of Finance (2006) “states which have more pro-worker regulations lost out on industrial production”

Study exploits change in laws 1947-97 by creating index, based on changes of 1,0,-1 then cumulates. Finds substitution from formal to informal but no wage change and higher poverty; state-specific time trends make coefficients insignificant



**Bhattacharjea (2006) critique:** 1) scoring of individual measures is erroneous; misreading of law in Andhra Pradesh; Maharashtra, Rajasthan; 2) Combination is strange: gives state that passes 3 laws in one year a 1 vs state that passes 3 in 3 years a 3 (Orissa vs Maharashtra); 3) ignores other laws; 4) misreads some states -- Kerala is pro-employer; Gujarat, Maharashtra pro-worker (“stands out for anyone who is reasonably familiar with India”); 5) cannot infer state’s labour policy from labour laws – strikes. Also, Anant et al (2006). But does not redo!!



## **But what about the Gorilla?**

**“self-employed; wage workers in insecure and unprotected jobs (unregistered, casual, temporary); household workers”**

**Informal share of workforce is huge (Brazil – 40% to 64%, depending on definition; China (60% of urban) and India (80% urban, 91% all); Ethiopia 71%; Sub-saharan Africa, 78% of nonagriculture; Korea (34% self-employed!)**

**Traditional View: Informal sector declines with development but NOT IN RECENT YEARS: In 1990s rises in 12 of 12 Latin American countries (ILO); Indonesia, 1990- 2003, 71%; Philippines rises (ADB); Ghana (ULO, decrease in formal sector employment); USA and advanced**

**Is informal bad – apple sellers/coat hanger street hawkers? Waiting for formal sector job? – or good – small independent entrepreneurs/specialists? Linked to formal via outsourcing?**

**Whichever, if we want to provide retirement, health and safety, training— “labor protections” – to more than a few, must develop new mechanisms to reach informal sector.**

# China: From no market to labor market

## No Labor Market

Segmented market via Hukou restrictions

Only state enterprises as employer

Management cannot hire or fire: Iron rice bowl

Wages set by national wage grid

State assigns job 1985 <10% find job by self

## Labor Market

Management of SOEs gains rights to layoff, hire, etc

1995 47% find job themselves

Considerable Pvt employed → Wages bargained

## University grads

- 1992 50% assigned jobs according to the Ministry of Education' plan to 2001 <5% assigned jobs

# **Gradual Labor Market Reforms**

- 1978-81 Agriculture – household responsibility**
- 1983-84 factory Director responsibility; attack iron rice bowl**
- 1985 end mandatory grain sales to state → food markets → migration**
- 1985 wage reforms---performance linked**
- 1986 contract labor system for state workers;**
- 1988 allows pvt to hire more**
- 1980s-present allow students to go overseas**
- 1990s/2000s weakening of hukou registration**
- 1994 codifies labor laws**
- 1997 state to sell small and medium SOEs**
- 2001 new trade union law to strengthen ACFTU unions**
- 2007 NEW LABOR CODE UNDER DEBATE – OPPOSED BY US/EU MULTINATIONALS**

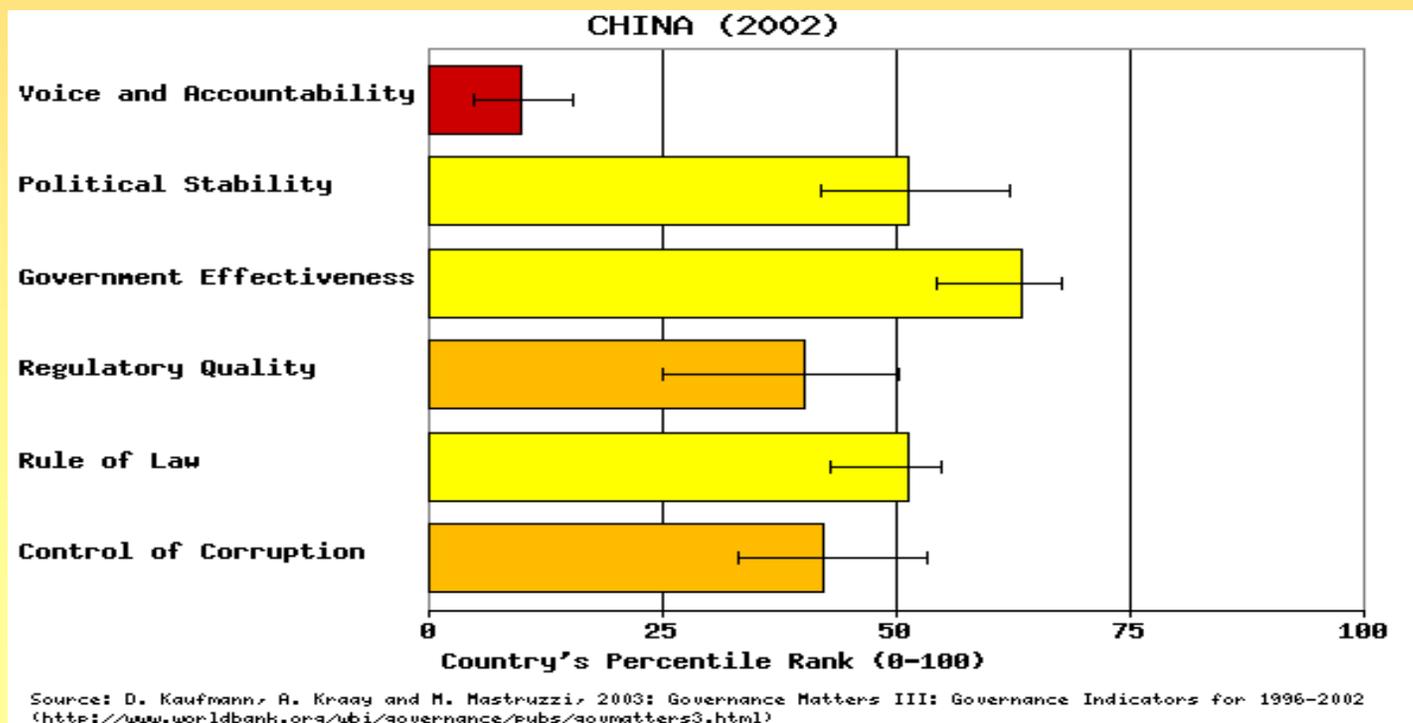
# China Institutions and Governance: By standard measures, Should Not Succeed

Economic Freedom; Heritage/WSJ: 111 of 157; Fraser: 86 of 127

Labor Market Freedom 74 of 102; Global Competitiveness 33/36 out of 80

Democratic Freedoms: Low on associational Corruption 70 of 163;

rights, political rights, rule of law



**Could China have succeeded without real labor market? No good counterfactual but ...**

**Current issue is to develop institutions so that inequality does not produce disorder.**

“if certain social and economic problems are not tackled without delay, the overall stability of the country could be threatened” Jiang Zemin 1998

Party Report (June 2001): “Studies of Contradictions within the People Under New Conditions”: Rising discontent and protests “expanding from farmers and retired worker to include workers still on the job” ; Primary cause is the burgeoning gap between rich and poor – income gap approaching alarm levels; Official corruption as “main fuse exacerbating conflicts between officials and masses”; “Mounting public anger over inequality, corruption ... a picture of seething unrest almost as bleak as any drawn by dissidents abroad”

Non-democratic system needs rapid growth; corruption means no domestic support risks mass protests synchronized by Internet/cell phones and quick implosion: Indonesia

# So, where do we stand?

- 1: Try to resurrect old orthodoxy with better measures/models. (*And new-found IMF/WB humility*)
- 2: Must understand institutions and governance, where interactions matter –give equal space to |”institutionalist perspective”-- cooperative game theory/behavioral economics/information/communication issues;
- 3: No single road to economic nirvana; different strokes for different folks; different roads in different times; covariation of labor market institutions to make systems (Bertola); limited data to make strong statements
- 4: **Learn more about Informal Market as possibly permanent part of economic world**
- 5: **Address transition to true global labor market**

# The Policy Debate Remains

Two competing views on regs/institutions vs labor “reform”

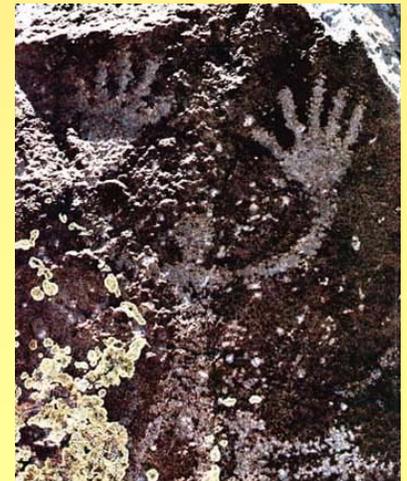
“Labor regulations are not cost-free, but deregulation is not the answer.... Unions are neither the sand in the wheels of the labor market nor the solution to low wages.... better labor market performance is compatible with lower earnings inequality ... The new agenda requires a strengthened labor authority and a complex network of public and private institutions” (IADB, 2003 pp 7-8).

“Labor market reform is the area of structural reform where least progress has been made (in LA) ... (so) remove distortions, many induced by government regulations, that make labor costly and risky (Burki and Perry, WB 1997)

Three questions

- 1) How many resources to spend to fight bad labor regulations? Should we use them to compensate losers?
- 2) How to use institutions for governance and stability; to deliver “labor services” to informal sector workers?
- 3) What growth strategy for world with China/India?

# For answers, need more Research, of course



## With appropriate 'umility

the original dish dates back to 16th Century England and was called "*umbles pie*" — a meat pie made from deer *umbles* (the heart, liver, and miscellaneous innards). These less desirable meats would be taken home by the huntsman who killed a deer for a nobleman, while the nobleman would get the venison. The umbles would be baked into a pie to create a modest dish suitable for a poor man. To eat umble pie meant that you acknowledged your place in the social pecking order. A few centuries changed "umble" into "humble" and also brought about a significant change in meaning



*The first step in making humble pie is to prepare and partially cook the meat filling mixture*



*This up-to-date humble pie makes a great heat-and-serve meal that can be prepared in advance*