Breaking the Rules?
Economic Development and Labor Market Institutions

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IZA/WORLD BANK CONFERENCE
June 9, 2007
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)


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:

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

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\textsuperscript{th} in 2004

<table>
<thead>
<tr>
<th>Category</th>
<th>Before 1985</th>
<th>1990</th>
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<th>2000</th>
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<td>3.5</td>
<td>5.9</td>
<td>6.1</td>
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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)

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.

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)

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<tr>
<td>ILO</td>
<td>-.025</td>
<td>-.013</td>
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<tr>
<td>AGG</td>
<td>-.094*</td>
<td>-.097*</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Min</td>
<td>.056*</td>
<td>.026</td>
<td>.035</td>
<td>.010</td>
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<td>Benefits</td>
<td>.003</td>
<td>-.020</td>
<td>-.007</td>
<td>.004</td>
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<tr>
<td>Union</td>
<td>-.030</td>
<td>-.047</td>
<td>-.023*</td>
<td>-.008</td>
</tr>
<tr>
<td>Govt empl</td>
<td>-.066*</td>
<td>-.069*</td>
<td>-.020</td>
<td>-.016</td>
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</tbody>
</table>
Cross-country 2: Fraser index Linked to Gini, not to GDP per capita: 2000 cross section

Figure 1A: Labor Index by LGDP

Figure 1B: Law/Property Rights by LGDP

Labor index:
Less adverse to development?

OR
Simultaneity with Labor regs → less GDP
But GDP → more labor regs
Regressions with labor index and other Fraser

Cross Section 2000, 47 Developing countries

<table>
<thead>
<tr>
<th></th>
<th>Ln GPD / cap</th>
<th>Gini</th>
</tr>
</thead>
<tbody>
<tr>
<td>Labor Index</td>
<td>-0.20 (.06)</td>
<td>1.48 (1.46)</td>
</tr>
<tr>
<td>Legal/Property</td>
<td>.33 (.05)</td>
<td>-3.80 (1.11)</td>
</tr>
<tr>
<td>R²</td>
<td>.54</td>
<td>.22</td>
</tr>
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</table>

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

<table>
<thead>
<tr>
<th></th>
<th>ALL</th>
<th>DC</th>
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<tbody>
<tr>
<td>Overall Ec Freedom Index</td>
<td>.030 (.014)</td>
<td>.054 (.025)</td>
</tr>
<tr>
<td>Labor Index</td>
<td>.006 (.007)</td>
<td>.055 (.176)</td>
</tr>
<tr>
<td>Lagged GDP/capita</td>
<td>-0.29 (.042)</td>
<td>-0.34 (.079)</td>
</tr>
<tr>
<td>N</td>
<td>238</td>
<td>77</td>
</tr>
</tbody>
</table>
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, Colombia 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).
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
<table>
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<tr>
<th>Study</th>
<th>Data Type</th>
<th>Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lemos (2006, 2004) Brazil</td>
<td>Individual data</td>
<td>Minimum compresses distribution in informal and covered, no effect on employment; but 2004 finds some</td>
</tr>
<tr>
<td>Kristenen &amp; Cunningham (2006), LA + Caribbean</td>
<td>Individual data, focus on spikes</td>
<td>In 10 countries minimum affects informal and covered; 4 only informal</td>
</tr>
<tr>
<td>Alatas &amp; Cameron (2004) Indonesia</td>
<td>Individual W spike, firm E geographic time series</td>
<td>Wage effects; no E in large firms; some in small</td>
</tr>
<tr>
<td>Maloney and Mendez (2004), LA</td>
<td>Individual wage data, Longitudinal job loss</td>
<td>Stronger on informal in Brazil, Mexico, Argentina, Uruguay; employment losses in Columbia; job loss greater for low w</td>
</tr>
<tr>
<td>Strobl &amp; Walsh (2003), Trinidad &amp; Tobago</td>
<td>Individual W; longitudinal job loss</td>
<td>Raises wages, lowers employment of affected group</td>
</tr>
<tr>
<td>Maloney et al (2002) LA countries</td>
<td>Spikes in wage data</td>
<td>Four yes, three no</td>
</tr>
<tr>
<td>Rama (2001), Indonesia</td>
<td>Time series,</td>
<td>Modest wage, little aggregate employment but shift from small firms</td>
</tr>
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### Micro Studies: Minimum Wage

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<tr>
<th>Study</th>
<th>Data Description</th>
<th>Findings</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jones (1997), Ghana</td>
<td>Individual data for wage; time series 21 years</td>
<td>W, E shift to informal $\epsilon \sim -0.10$</td>
</tr>
<tr>
<td>Bell (1997), Columbia, Mexico</td>
<td>Firm level data</td>
<td>No effect in Mexico; effect in Columbia;</td>
</tr>
<tr>
<td>Lustig &amp; McCleod, 1997, x-country</td>
<td>Change 1990s vs 1980s poverty measures</td>
<td>Reduces poverty</td>
</tr>
<tr>
<td>Castillo-Freeman &amp; Freeman (1992), PR</td>
<td>Spike, Uses imposition of US min wage</td>
<td>W, modest E $\epsilon \sim -0.10$; large fall in employment in very small industries</td>
</tr>
</tbody>
</table>

**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


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 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.