

**REVIEW OF LAW AND EMPLOYMENT:
LESSONS FROM LATIN AMERICA AND THE
CARIBBEAN WITH AN EMPHASIS ON
BRAZILIAN LABOR INSTITUTIONS**

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Labor regulation is often created with the purpose of protecting workers from the effects of negative economic shocks as well as from exploitation by employers. This was true in most Latin American countries where pro-worker regulation was instituted in the early 20th century. For example, Brazil created labor regulations in the early 1930s including: regulation of child and female labor, paid weekly breaks, paid vacations, and capping the workweek at forty-eight hours. They established a minimum wage in 1940 and consolidated labor codes that included social security and pensions in 1943.

Even when these regulations are created to protect the workers' welfare, economists are generally fond of pointing out the irony that they generally reduce the welfare of workers in the aggregate. However, a controversial article by Card and Kruger concerning the impact of minimum wages rekindled the debate concerning the effects of labor regulation on employment, unemployment, wages, and welfare in general.¹ The specialized literature still disputes whether labor market regulations have only distributive effects or whether they also affect efficiency.² *Law and Development: Lessons from Latin America and the Caribbean* takes sides with those that believe labor regulation not only has distributive consequences but important efficiency implications.³ The final balance of the studies contained in

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1. David Card & Alan B. Krueger, *Minimum Wages and Employment: A Case Study of the Fast-Food Industry in New Jersey and Pennsylvania*, 84 AM. ECON. REV. 772, 772–84 (1994).

2. Heckman and Pagés are proponents of the efficiency view. For the distributive view, see R.B. FREEMAN, SINGLE PEAKED VS. DIVERSIFIED CAPITALISM: THE RELATION BETWEEN ECONOMIC INSTITUTIONS AND OUTCOMES (Nat'l Bureau of Econ. Research, Working Paper No. 7556, 2000); S. Nickell & R. Layard, *Labor Market Institutions and Economic Performance*, in 3 HANDBOOK OF LABOR ECONOMICS 3029, 3029–84 (O. Ashenfelter & D. Card eds., 1999).

3. LAW AND EMPLOYMENT: LESSONS FROM LATIN AMERICA AND THE CARIBBEAN (James J. Heckman & Carmen Pagés eds., 2004) [hereinafter LAW AND EMPLOYMENT].

this book is that “mandated benefits reduce employment and that job security regulations have a substantial impact on the distribution of employment and on turnover rates . . . the individual country studies demonstrate that regulations promoting job security reduce covered worker exit rates out of employment and out of unemployment, and on balance reduce employment.”⁴

There are two major reasons that the contributions made in this book are important for the debate over the effect of labor regulation. The first reason focuses on Latin American and Caribbean countries (LAC), whereas most of the literature to date has focused on countries of the OECD. The advantage of studying labor regulation in LAC is that these countries have typically experienced several cases of important structural changes in labor regulation in recent history, whereas in more developed countries, such changes tend to be marginal adjustments that affect the magnitude but not the nature of the constraints. The great shifts in regulation in LAC allows for the identification of their effect by comparing labor market outcomes, such as employment, unemployment, and income levels before and after the changes. Netting out the effect of the regulation from all other concurrent impacts remains tricky, but the greater variation affords several valuable research opportunities, as shown by the impressive array of clever empirical tests illustrated in the text.

The second merit of the book is the use of microdata in a literature where the norm has been the use of cross-country time series. The critique of cross-country studies is forcefully made on the second page by James Heckman and Carmen Pagés where they state that the use of such methods is “one reason why relatively little is known about the impact of regulations in Europe, despite an abundance of cross-country time series papers analyzing policies in that region.”⁵ Coming from an econometrician of the stature of James Heckman, this critique is quite an indictment. In order to amplify their point, Heckman and Páges, in section I.5 of their introduction, revisit the results of a previous paper of their own in which they estimated the impact of labor regulation on employment and unemployment in a large number of countries using time series of cross-section averages typical in most of the literature.⁶ This time they improve upon their earlier analysis by extending, updating, and improving the data and by using better measures of labor market

4. James J. Heckman & Carmen Pagés, *Introduction*, in *LAW AND EMPLOYMENT*, *supra* note 3, at 1, 2.

5. *Id.* at 2.

6. *Id.* at 65–85.

regulations derived in section I.3, based on cost rather than subjective indices.⁷ The new estimates initially show some interesting impacts of regulation: indemnities for dismissal reduce employment and increase unemployment in the OECD but have no effect in LAC; higher seniority pay surprisingly increases employment for the entire sample; and higher social security contributions are associated with lower employment and higher unemployment in all samples. But having reached these results, the authors proceeded to do a very candid robustness check. Some factors in the robustness check included: using random effects rather than fixed effects; using alternative measures of labor regulation costs; changing the specification to include year effects, region specific year effects, time trends, and region-specific time trends; changing the sample size (simply excluding Germany, Brazil, or Peru alters some of the main results); and checking for outliers. The results indicate that “few empirical regularities emerge when an honest sensitivity analysis is conducted,” though the result that payroll taxes reduce employment is robust.⁸ This exercise makes one very skeptical about studies using time series cross-sections with aggregated data where typically only the “best shot” estimates are reported.

There are several reasons that, despite their popularity, cross-country panels are unsatisfactory and why the use of microdata for individual countries, as used in this book in the context of country-specific case studies in each chapter, is a more promising avenue. One reason is the fact that the use of averages for each country masks crucial variation within regions, sectors, industries, skill levels, and worker characteristics. Although these variations could conceivably be taken into account in cross-country studies, the difficulty in obtaining comparable data across a large sample of countries tends to force the specification toward a simpler common denominator. The lack of comparability of the data from different countries, as well as the variation in reliability is a second important problem with these studies. In particular, the use of indices to quantify factors such as “stringency of labor regulation” or “rule of law,” which have become very popular in the past years, suffer from a series of similar problems.⁹ Despite frequently giving intuitive results (i.e., “rule of law” promotes economic growth) by construction, these measures

7. *Id.* at 6–39.

8. *Id.* at 65.

9. The labor regulation cost measures constructed by Heckman and Pagés in section I.3 are an attempt to get around such limitations by constructing measures of the direct cost of complying with labor regulation in each country. *Id.* at 6–39.

tend to be arbitrary, subjective, and lack true comparability across countries. When indices are constructed by considering several features or components of the issue being measured, it is possible for two countries to have the same index value when each component is radically different for each country, information that is then lost in the regressions. In the end, these indices generally tend to tell us what we already know but reveal little about the mechanism through which the controlled factors affect the dependant variable. They express average effects for the entire sample but do not illuminate much for any individual country. The country-specific results that emerge from the chapters of this book (derived from taking into account many specifics of the labor markets and institutions of each country) provide much more insight into the effect of labor regulation than could possibly be garnered from macro-based time series cross-country analyses. The fact that the results may differ across countries and are thus less conducive to general statements is not a weakness, but rather reflects the fact that labor regulation simply affects outcomes differently in countries with different institutions.

Another way to put this point is to note that cross-country regressions by assumption force the estimated coefficients to be the same for all countries.¹⁰ However, it is really too much to expect that the effect of a given explanatory variable will be the same in terms of magnitude, sign, and significance in countries that have inherently different labor markets, histories, and institutions. With so many differences between countries, why should the effect of, for example, the size of mandated indemnities in cases of firm-initiated dismissal on unemployment be the same in all countries. Why should the channels or mechanisms by which changes in these variables affect labor market outcomes be the same when so much else is different?¹¹ One defense of this approach is that fixed effects control for the idiosyncratic influences on the dependant variable not captured by the right-hand-side variables. Yet, there is only so much that a simple dummy variable for each country can do to account for the myriad of

10. Although interaction terms can be used to relax that assumption, limitations on degrees of freedom restrict what can be done through that instrument.

11. This variety in the effect of explanatory variables across countries first shows up in the introduction where the editors graphically analyze the bi-variate relationship between regulations and employment and they find that "(t)hese figures suggest that periods of less stringent job security regulations coincide with higher employment rates in some countries, while the reverse is true in other countries." Heckman & Pagés, *supra* note 4, at 68. In a multivariate analysis, the editors report that "(e)stimates vary across countries, with some countries showing gains in employment after reducing job security and others showing little benefit to the employment rate or even employment reductions after such reforms, but no clear pattern emerges from the aggregates." Heckman & Pagés, *supra* note 4, at 84.

uncontrolled factors that affect each country's dependent variable. The approach used in this book, of presenting a series of country case studies with a common framework, is able to avoid such pitfalls. Each chapter carefully explores the idiosyncratic details of each country's setting and the empirical tests can be specifically built to control for the most relevant factors and explore those special circumstances.

The importance of going beyond the more direct aspects of the regulation and including a country's governance and institutional factors in the analysis was made in the seminal study by Levy and Spiller, who also presented a series of case studies linked by a common framework.¹² Although they were looking at telecommunication regulation, their methodological message applies just as well to labor market regulation:

The structure of regulatory incentives has been the central preoccupation of virtually all theoretical work on regulation, to the neglect of regulatory governance. An important finding in this study is that the emphasis on incentives is inadequate. Though incentives do affect performance, their full impact occurs only if the proper regulatory governance structure is in place.

Regulatory governance and incentives are choice variables for policymakers. The choices are constrained, however. Choices about regulatory governance are constrained by the specific institutional endowment of the nation, which determines the form and severity of the country's regulatory problems and the range of options for resolving them. Choices about regulatory incentives are also constrained by institutional endowments and by the governance features built into the regulatory system.¹³

That is, if one wants to understand how labor market regulation affects outcomes such as employment, unemployment, and incomes, it is necessary to go beyond the analysis of the regulations themselves and the incentives they create, and consider additionally the constraints imposed by the country's regulatory governance and institutional endowments. Labor is pervasive in any economy and is perhaps the most regulated of all economic activities, so it stands to reason that formal and informal institutions involving several political actors not at the forefront of labor regulation will have an effect on the shape of the regulation that materializes and on its effect on labor market outcomes.

In the case of labor-market regulation, the main issue may be whether institutions exist that enforce rules and arbitrate disputes.

12. BRIAN LEVY & PABLO T. SPILLER, REGULATIONS, INSTITUTIONS, AND COMMITMENT: COMPARATIVE STUDIES OF TELECOMMUNICATIONS (1996).

13. *Id.* at 4 (citation omitted).

How well does the judiciary deal with labor disputes? Are there specific labor courts? How does the judiciary perform in terms of independence (from the Executive or Congress), bias, speed, accessibility, and costs? Is there a tradition with labor unions? Are they powerful? Are they representative or selective? Are there other arbitrating institutions? What is the role of Congress in labor issues? Are there strong labor parties, and how do they influence labor disputes? How big is the informal market? Do some formal market rules also apply in the informal market (as is the case with minimum wage legislation in some LAC countries as noted by Maloney and Mendez in chapter 1)?¹⁴ How prevalent is labor market regulation-related corruption? What form does it take? Note that even if two countries have very similar labor regulations, if the answers to these questions are different, one would expect different labor market outcomes. In addition, it would be very difficult to control for all these outcomes and many other factors in cross-country regressions with fixed effects whether it is the limited degrees of freedom or because of measurement problems and data unavailability, there are a very limited means to mitigate this problem.

Country case studies are able to take into account most of these issues by using both analytical narratives and econometric analyses specifically tailored to the countries' circumstances. The chapter on Brazil is a nice case in point.¹⁵ They take advantage of the change in labor market regulations that took place in 1988 when a new constitution replaced the previous regime of the military period that ended three years earlier. The case-study approach and use of microdata allow the authors to explore the details of the new legislation in ingenious ways and attempt to detect the impacts of regulation on labor market outcomes. The first strategy involves estimating monthly labor demand functions over a period that straddles the constitutional change (1985–1997).¹⁶ The determinants

14. William F. Maloney & Jairo Nuñez Mendez, *Measuring the Impact of Minimum Wages: Evidence from Latin America*, in *LAW AND EMPLOYMENT*, *supra* note 3, at 109.

15. Ricardo Paes de Barros & Carlos Henrique Corseuil, *The Impact of Regulations on Brazilian Labor Market Performance*, in *LAW AND EMPLOYMENT*, *supra* note 3, at 273. We focus on Brazil because we have expertise on the analysis of institutions in Brazil. See LEE J. ALSTON ET AL., *POLITICAL INSTITUTIONS, POLICYMAKING PROCESSES AND POLICY OUTCOMES IN BRAZIL* (Working Paper, Nov. 2004); Lee J. Alston & Bernardo Mueller, *Pork for Policy: Executive and Legislative Exchange in Brazil*, *J. LAW, ECON. & ORG.* (forthcoming Spring 2006).

16. The second strategy, which we do not analyze in detail here, involves a difference-in-difference methodology using informal versus formal workers, short versus long employment spells and quit versus layoffs, as control and treatment groups to determine the impact of the new labor regulation brought by the 1988 constitution. This requires some strong assumptions regarding the neutrality of the changes on the control group. Although some of these

of the monthly estimated parameters are then analyzed both graphically and econometrically to ascertain the effect on them from the new regulations that significantly increased labor costs. The 1988 constitution is generally perceived as a pro-social charter, particularly in the area of labor regulation, so that it was expected that such a sharp change in regulation would certainly be reflected in the wage elasticity and the speed of adjustment. However, despite the meticulous empirical work done by the authors, no effect was found: “The results presented . . . reveal that even when taking into account macroeconomic variables, we still found no evidence that the 1988 constitution had any effect on the demand for labor.”¹⁷

The result is so surprising to the authors that they felt obligated to add that perhaps there was an impact, but they were not able to detect it. Yet, despite data limitations, their work seems very convincing. We encourage the authors to embrace their results more whole heartedly and search for an explanation for the apparent anomaly. One possible explanation would be to question whether the new constitution actually presented employers with such additional costs that they would have incentives to alter their behavior. In Section 5.2 and Figure 5.1, the authors describe the changes introduced by the new constitution to labor market regulation.¹⁸ An important point that stands out is that the changes significantly increased labor market benefits and restrictions upon employers, thus increasing labor costs, but these changes simply altered the levels of already existing legislation rather than creating new or removing old regulations.¹⁹ For example, the Constitution reduced the maximum working hours per week from forty-eight to forty-four hours, reduced the maximum continuous work shift from eight to six hours, and increased maternity leave from three to four months. On its own, this does not mean that the changes should have no impact on labor demand, as they do imply increased costs of labor. However, there is the possibility that, although the relative size of the increase in costs imposed by the constitution was high, the absolute level was already

assumptions may be too strong for the Brazilian case, the analysis is sound and reaches the interesting result that the regulation changes reduced turnover for short work spells, but contrary to the intended effect, increased turnover for long work spells. This happens because as a worker’s tenure increases, the compensation for dismissal, in the form of access to individual funds (FGTS) that accrue monthly contributions from employers, becomes increasingly attractive. This prompts workers to collude with firms so as to be dismissed in order to receive those resources.

17. Barros & Corseuil, *supra* note 15, at 344.

18. *Id.* at 277.

19. This point is mentioned by the authors in an isolated sentence on page 276, but then nothing is made of the fact.

high before the constitution, so that any additional increase had very little marginal effect. If those costs were already high before the constitution, then the market had probably adjusted to those costs in a variety of different ways, so that when they were further increased, the additional effect was very small. For example, if employers before 1988 viewed three months of maternity leave (which is generous by world standards) as a high cost and discriminated against women of childbearing age, then after 1988, when the benefit was increased to four months, the level of discrimination may have continued practically the same.

Is it the case that regulation-induced costs were that high before the constitution? Figure 5 in the introduction by Heckman and Pagés presents their new measure of regulation-imposed cost (measured in multiple of mean wages²⁰) in several LAC countries in 1987 and in 1999.²¹ The cost for Brazilian job security was already practically twice the average for LAC, and although it did increase from approximately eleven to thirteen mean wages after the constitution, the increase in percentage terms was relatively small. Thus, all the incentives for avoiding labor costs (including input substitution, informality, and corruption) were already present before 1988 and the additional incentives brought about by the constitution may then have been fairly minor, which would explain the result in Barros and Courseuil.²²

In order to determine whether this conjecture is correct, it would be necessary to delve further into the institutional structure of the Brazilian labor market. As argued above, an important element is the role of the judiciary. It is not enough to simply look at the labor market regulation as printed in the constitution and other laws, it is also necessary to check how those rules apply *de facto*. In Brazil, an important issue is how the judiciary works in labor cases because most labor disputes are settled rather than reach the court. It is well known that the judiciary in Brazil is biased toward workers, so settlements occur “in the shadow of the courts.” Lamounier, Sadek, and Pinheiro found evidence of the bias of the judiciary from a survey given to a large number of firms to assess their opinion on the performance of the judiciary.²³ One of the questions asked was, “What was the

20. This measure takes into account the probability that a worker will remain in a job for each additional period without quitting or being dismissed, see Heckman & Pagés, *supra* note 4, at 26–27.

21. *Id.* at 35.

22. Barros & Courseuil, *supra* note 15.

23. B. Lamounier, M.T. Sadek & A.C. Pinheiro, *O Judiciário Brasileiro: Uma Avaliação das Empresas*, in *O JUDICIÁRIO E A ECONOMIA NO BRASIL* 37–48 (A.C. Pinheiro ed., 2000).

resolution of labor disputes in the previous ten years?" The result was 10,825 decisions favorable to the firm, 13,553 against the firm, and 18,309 settled by agreement. If one considers that in 98% of the cases the firm is the defendant and that most agreements are prompted by the firm's knowledge that the judges will be partial to the worker, this represents approximately three out of every four cases benefiting the workers.²⁴

The consensus in Brazil is that the judiciary provides strong enforcement of labor laws. This implies that labor market regulations as specified in the constitution and other laws are effectively constraining. However, such an implication is too simple. The same survey showed that the firms are able to exploit the slowness of the courts to their advantage. For the sample of firms in the survey (labor cases in which the case went to court), the average time for a decision was thirty-one months. Firms take advantage of this sluggish pace by economizing on labor costs and then getting workers to accept settlements that cost less to the firm than having followed the rules.²⁵ This explains why only 44% of the firms in the survey considered the slowness of justice to be detrimental to business in labor cases, with 23% finding it beneficial and the rest neutral. In addition, a related survey by Pinheiro with a sample of businessmen found that "although the firms classify the judicial system as precarious, they are generally able to get around it, keeping the judiciary out of their lives, . . . the firms use alternative mechanisms, both external and internal, as substitutes for the role the judiciary should perform."²⁶

Another important characteristic of Brazilian labor institutions is the *Ministério Público* (public prosecutors), which at the federal level is divided into four branches one of which is dedicated only to labor issues. The Constitutionally-mandated function of the *Ministério Público* is the defense of judicial order, the democratic regime, and diffuse and collective interests. The labor branch deals mostly with discrimination, health and safety in the workplace, mediation and arbitration of individual and collective labor conflicts, right to strike, promoting cooperatives, combating informality and outsourcing as a means to circumvent labor laws, child labor and slave labor. Although

24. In all other types of cases included in the survey (tax, commercial, industrial property rights, environmental) the firms won more cases than they lost or settled, with the exception of consumer rights. *Id.* at 41.

25. José M. Camargo, *Labour Standards, Labour Justice and the Brazilian Labour Market*, Pontifícia Universidade Católica (mimeograph) (1996), *cited in* Lamounier, Sadek & Pinheiro, *supra* note 23, at 39.

26. A.C. Pinheiro, *O judiciário e a economia: Evidência empírica para o caso brasileiro*, in *O JUDICIÁRIO E A ECONOMIA NO BRASIL* 51 (A.C. Pinheiro ed., 2000).

many other countries also have public prosecutors or similar entities, the *Ministério Público* in Brazil has some very idiosyncratic characteristics that could affect labor market outcomes. The first characteristic is the absolute independence from all other political actors, including the Executive, Congress, and the Judiciary. This independence derives from budgetary autonomy, inalienability of its members, and insulation from outer intervention.²⁷ It also extends to the individual level with each prosecutor insulated even within the organization. The second characteristic is a zealotry in the defense of society (mostly against government) that permeates the profession. This *esprit de corps* is a motivating force that self-selects for young prosecutors intent on making a difference.²⁸ The final characteristic is a set of legal instruments, the public civil suits (*ação civil pública*), which give the *Ministério Público* the means to make credible threats and effective prosecution. The upshot is an army of loose cannons intent on defending social interests, a purpose that finds many a cause in Brazilian labor markets.

These are only some of the characteristics of the effect of political institutions on the impacts of labor regulation in Brazil. In the end, it is hard to make a clear-cut statement on the impact of the judiciary or the *Ministério Público*. If one were trying to make an index on the “quality of the judiciary” for use in cross-country regressions, how would each of these characteristics be weighed? The purpose here is not to solve this issue but rather to argue that the richness and complexity of institutional detail can only really be understood through detailed case studies such as those presented in *Law and Employment: Lessons from Latin America and the Caribbean*. This book, with its focus on microdata at the country level, will provide an important contribution to the literature of the impact of regulation on labor market outcomes.

27. The President does play a limited role in the appointment of the head of the *Ministério Público* but gains little leverage from this participation. See Arantes for details on the *Ministério Público* in Brazil. R.B. Arantes, *Direito e Política: O Ministério Público e a Defesa dos Direitos Coletivos*, in 14 *REVISTA BRASILEIRA DE CIÊNCIAS SOCIAIS* 83–102 (1999) [hereinafter Arantes, *Direito e Política*]; 1 R.B. ARANTES, *MINISTÉRIO PÚBLICO E POLÍTICA NO BRASIL* (2002).

28. Arantes, *Direito e Política*, *supra* note 27.