

Labor Market Institutions and Policies: Help or Hindrance to Economic Development?

Richard B. Freeman

This paper examines the wide disagreement about the value of institutional interventions in developing country labor markets between (World Bank) economists who see government regulation of wages, mandated contributions to social funds, job security, and collective bargaining as "distortions" in an otherwise ideal world and International Labour Organisation (ILO) economists who stress the potential benefits of interventions, hold that regulated markets adjust better than unregulated markets, and endorse tripartite consultations and collective bargaining as the best way to determine labor outcomes. It presents a scorecard of evidence to judge which view is closer to the truth on particular issues.

The paper finds little support for the notion that interventions are major impediments to resource allocation, structural adjustment, or stabilization programs, although in some cases they have sizable costs. At the same time, it finds little evidence on the value of social pacts and related consultative modes of adjustment favored by the ILO. The paper proposes a different perspective on labor market policies and institutions-as factors in the political economy of economic reform-and develops a model designed to capture the role of interventions and institutions in buttressing support for economic reforms.

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 1990b, p. 63)

Minimum wages have an important role to play in protecting low income groups . . . structural adjustment also calls for a sound industrial relations system and a commitment to tripartite dialogue . . . Over the long run suppression of free industrial relations jeopardizes prospects for economic development. (ILO 1991b, p. 5) The 1980s highlighted . . . the need to regulate the labor market. (ILO 1991a, p. 65)

Richard B. Freeman is professor of economics at Harvard University, senior research fellow at the Centre for Economic Performance of the London School of Economics, and director of labor studies, National Bureau of Economic Research, Cambridge, Mass.

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As the preceding quotations indicate, there is considerable disagreement about the value of institutional interventions in developing country labor markets. On one side are economists who see unregulated labor markets as neo-classical bourses in which government regulation of wages, mandated contributions to social funds, job security, and collective bargaining create "distortions" in an otherwise ideal world. These economists view their task as the technical one of measuring the adverse effects of these policies. The view that interventions are first and foremost distortions pervades most World Bank analyses of labor issues, and I shall accordingly call this the Bank Distortion View, although some Bank analysts reject it and many economists outside the Bank endorse it.

On the opposite side are institutionally oriented economists who believe that the social aspects of labor markets create such large divergences from the competitive ideal as to make that model a poor measuring rod for policy. These analysts stress the potential benefits of interventions, hold that regulated markets adjust better than unregulated markets to shocks, and endorse tripartite consultations and collective bargaining as the best way to determine labor outcomes. When efficiency conflicts with the social protection of labor, they place greater weight on the latter. The view that interventions are first and foremost socially beneficial dominates ILO analyses of the labor market, and I will accordingly call it the ILO Institutional View. *Towards Social Adjustment* (Standing and Tokman 1991) forcefully presents this perspective, superimposing the word "social" over the word "structural" in its title.

The differing views of how labor market interventions affect social well-being have contradictory policy implications. If you believe that interventions reduce growth and hamper adjustment, you will recommend that countries eliminate them and will make elimination a condition for adjustment loans under the slogan of deregulating labor markets. If you believe that interventions improve well-being, you will advise governments to encourage unionism and collective bargaining under ILO conventions, and to regulate market outcomes and adhere to labor standards.

Is there compelling evidence for either the World Bank or the ILO point of view? Does experience in developing country labor markets and labor market research provide greater support for one or the other?

In this paper I examine these questions. There has been little open debate between ILO and World Bank researchers, and their analyses often coincide on particular issues. I play *agent provocateur* here because I believe confrontation will increase our understanding more than a continuation of the status quo, with

1. The key two conventions are No. 87, Freedom of Association and Protection of the Right to Organise, and No. 98, Right to organise and Collective Bargaining, with article 4, "the right to negotiate wages and conditions freely without outside interference is a fundamental aspect of the freedom of association." Excluding certain matters, making collective agreements subject to prior approval or enabling them to be declared void because they run counter to government economic policy is incompatible with article 4. In addition, convention 131 on minimum wage fixing and convention 154 on collec

each school of thought proceeding along its own path, implicitly dismissing rather than seriously addressing the claims of the other.

The paper has four sections. Section I introduces the combatants. Section II provides a scorecard of evidence to judge which view is closer to the truth on particular issues. Section III offers a different perspective on labor market policies and institutions-as factors in the political economy of economic reform that has surfaced in both World Bank and *ILO* analyses. Section IV summarizes conclusions and offers suggestions for future research.

I. THE COMBATANTS: BANK DISTORTIONISTS VERSUS ILO INSTITUTIONALISTS

In the blue corner, from Washington, D.C., we have . . .

The Distortionist Case: Interventions Are Bad

The distortionist case hinges on four claims about interventions: they misallocate labor, waste resources through rent-seeking, impair adjustments to economic shocks, and deter investment, thereby reducing rates of growth.

Since the claim that interventions misallocate resources follows from basic price theory, all economists know the basic arguments and the provisos about market failures that qualify those arguments. The major premise is that absent interventions, labor markets set wages at opportunity cost levels and determine Pareto-efficient levels of employment, work rules, training, and so on. Since the unfettered market meets optimality conditions, interventions can only make matters worse. The resultant allocative distortions are typically measured by Harberger welfare triangles.

The possibility of transferring income from one group to another through interventions suggests that interest groups will devote resources to rent-seeking instead of to activities that raise national output (Krueger 1974). Irrespective of the success of such rent-seeking, those resources are deadweight losses to society as a whole. The economics of pressure groups also suggests, however, limits to the resultant distortions because taxpayers will organize against policies with especially large deadweight losses (Becker 1985). While no political regime, least of all a democracy, can eliminate rent-seeking, a state committed to few interventions presumably will see less such activity than a state in which interventions are common. Rent-seeking distortions are measured by the resources spent to alter or preserve ownership rights and, depending on the way rights are established, may come to equal the value of the rents (Krueger 1974).

Distortionists also believe that interventions reduce wage or employment flexibility and thus adjustment to economic shocks. Collective bargaining or wage indexation schemes that maintain real wages when national output falls or that preserve relative wages when changes are needed to induce labor to move across sectors to meet balance of trade problems reduce the ability of the economy to respond to new situations. Because economic theory has less to say about dynamic adjustments than about comparative statics, the a priori case for adjustment distortions is weaker than the case for allocative distortions.

A final potential adverse effect is to reduce rates of return to investment. Administratively set or collectively bargained wages that redistribute economic rent from capital to labor are bad because they reduce the profitability of investments. Taxes or fiscal deficits that fund public employment are bad because they crowd out funds for more productive private investment. Many small interventions and rent-seeking activity may interact to lower overall economic efficiency and returns to investment (Olson 1982). Since growth rates cumulate to massive differences in per capita output over time, the existence of intervention-induced growth distortions is potentially the most important argument in the distortionist armory.

Claims that labor market interventions have an adverse effect do not follow mechanically, it should be noted, from "pure theory." Distortionist analysts make selective use of economic theory. For example, those who believe that social security payroll taxes adversely affect savings and investment reject Ricardian equivalence; those who use nonwage costs to measure interventionist distortions reject the fungibility of modes of compensation; those who argue that employment protection laws have efficiency costs ignore Coase's theorem that property rights do not affect efficiency. Even distortionist criticisms of minimum wages involve more than applying optimizing calculus. A small country whose modern sector capital stock is foreign owned can benefit from labor market interventions that "soak" foreign capital just as it can benefit from an optimal tariff. ² Distortionist arguments are not the final word of economic theory.

To validate claims that interventions have major allocative, rent-seeking, adjustment, or growth costs requires empirical evidence that interventions are effective in producing differentials in pay or conditions of work that would not otherwise arise in unfettered markets and that they have sufficiently large adverse effects on resource allocation to affect the overall economy. The issue of magnitude is critical, for the general finding that welfare triangle losses are relatively small has led many economists who accept the basic tenet of distortionism to regard the costs of labor market interventions as of second-order importance compared with macroeconomic distortions. Distortionist arguments should weigh heavily in policy only if estimates of static welfare losses are misleadingly low, if adjustment distortions seriously impair stabilization programs, or if distortions deter investment enough to reduce growth. And in the red corner, from Geneva, Switzerland . . .

The Case That Interventions Are Good

Because there is no general institutionalist theory, the case for interventions is more diffuse and less analytically grounded than the case against them. A major

2. Consider the extreme case in which all modern sector capital is foreign owned and a minimum wage

and hiring/ firing law presents foreign capital with an all-or-nothing labor market choice. Then, imposing this legislation benefits domestic workers. In a dynamic setting the gains from redistributing quasirents to local workers must be balanced against potential loss of future investments.

strand of institutionalist thinking simply rejects the relevance of neoclassical analysis: "The choice between various wage policy options must not be based on the conclusions drawn from an ideal economy" (ILO 1990, p. 38). One problem with the theory is its "overbearing focus on prices" (Standing 1991b, p. 25) and neglect of other adjustments that may offer more socially desirable directions for

competition (Sengenberger 1991, p. 237). When actual labor markets operate differently from the ideal, institutional modes of influencing outcomes, such as collective bargaining, tripartite negotiations, and government-mandated wages or labor standards, can be Pareto improvements. In the institutionalist view, they usually are.

Institutionalists invariably stress the benefits of interventions in the form of, say, insurance from adverse market outcomes or redistribution to low-wage workers:

The quest for labour security is a legitimate objective . . . market mechanisms may need to be circumvented in the interest of social values Social progress and labour standards should not be sacrificed in the name of efficiency. (Standing and Tokman 1991, p. 1)

The market system is a powerful tool for economic management [but] . . . there may be some side effects on economic security and equity that . . . give rise to a need for state intervention . . . [to] moderate income inequality and provide some minimum economic security. (World Bank 1991, pp. 41-42)

Standard economic analysis allows us to measure the posited benefits of interventions. One can derive demands for unemployment insurance, social security, and the like from individual maximizing behavior under risk aversion; calculate the consumer surplus attributable to programs that meet those demands; and compare the surplus with the inefficiency costs that result from labor supply responses to the program. (Risk aversion parameters may be harder to estimate than elasticities of demand or supply, but difficulty of estimation has never stopped an econometrician.) Hansen and Imrohoroglu's (1992, p. 118) simulation of the benefits and costs of unemployment insurance suggests that for the United States "replacement rates as high as .65 are optimal and the welfare benefits of unemployment insurance are quite large," although moral hazard and nonoptimal replacement rates can produce costs in excess of benefits. What ever the result, it is important to measure rather than assert the posited benefits of interventions.

ILO support of collective bargaining is based on a moral imperative:

Countries which are members of the ILO are presumed to accept the value judgment that free collective bargaining between employers and autonomous pluralistic trade unions is the best method of determining terms and conditions of employment. Access to such mechanisms is regarded as a basic human right. Therefore, governments are expected to introduce legis-

lative provisions to encourage the development of trade unions and free collective bargaining. (ILO 1990, p. 39)

But support for collective bargaining or other institutional modes of wage setting (such as extension of contracts by ministers of labor to nonunion workers, as in Western Europe) can also be grounded in theories of bargaining. Analyses of prisoners' dilemma games, for instance, show that bargaining partners with long horizons can reach cooperative solutions. This in turn underlies the standard argument that "neocorporatist" centralized bargaining resolves the prisoners' dilemma of wage-wage inflation at lower costs of unemployment than decentralized arrangements.

There are two arguments for labor standards or legally mandated benefits. The first asserts that standards force employers to "overcome the misguided preoccupation with cost-cutting (via lower wages), and [redirect] attention to the strengthening of productive power (via training, technical innovation, etc.)" (Sengenberger 1991, p. 249). This claim asserts but does not demonstrate that managers have a bias toward cheap labor solutions rather than toward equally-or even more-productive high-wage modes of competing. The second defense for mandated standards is that they are solutions to moral hazard or selectivity issues that make it unprofitable for firms to offer socially desirable benefits or contracts and thus are akin to lump sum users' taxes (Summers 1988). This argument resonates with standard theory of market failure.

In short, economic theory is rich (weak) enough to provide arguments for interventions as well as against them. The more the world is filled with prisoner's dilemma games, certain types of moral hazard problems, and the like, the greater is the institutionalist case. The closer the world is to the competitive ideal, the less compelling is that case. The game theory finding that modest differences in the rules of games (that is, institutions) can substantially affect outcomes implies that one cannot dismiss institutional claims as atheoretic, although the claims may be wrong. All of which means (no surprise) that we must look at evidence to decide who is closer to the truth.

II. THE SCORECARD

In this section I assess World Bank, ILO, and other research on the validity of the distortionist and institutionalist views in several areas: sectoral wage differentials, nonwage labor costs, minimum wages, wage adjustments, employment security regulations, and collective bargaining. Because each developing country has its own experiences with labor market interventions, in principle I should draw on hundreds of cases for my scorecard. Instead of essaying this herculean task, I have limited my review of studies to Bank and ILO research in the 1980s and to the smattering of countries on which I have first-hand knowledge. I recognize that cases or studies which I missed might lead to a somewhat different scoring of the debate.

Are Sectoral Wage Differentials an Indication of Distortion?

In the 1960s and 1970s there was general agreement that massive public private, formal-informal, or urban-rural wage differentials in developing countries, particularly in Africa, proved that something was wrong with wage determination that affected the overall pattern of development. Intervention in favor of formal sector workers was an obvious culprit. But much changed in the 1980s. As Colclough (1991, table 5, appendix tables 1 and 2) and Lindauer, Meesook, and Suebsaeng (1988, table 3) document, for many countries in Sub Saharan Africa public sector pay fell markedly in relation to gross domestic product (*GDP*) per capita, particularly for higher-wage public employees. With government accounting for much of modern sector employment, traditional urban-rural differentials also dropped, in some cases sharply (Jamal and Weeks 1992). In Latin America, government wages also fell significantly, falling 40 percent in real terms from 1985 through 1989 in Venezuela, for example.

The drop in public and urban salary premiums in the 1980s has several implications for the distortionist-versus-institutionalist debate. It refutes fears that institutional rigidities make pay-setting inflexible in the modern sector (of which more later) and obsolesces much distortionist concern over sectoral wage differentials and urban bias in labor market outcomes. Most important, it raises new questions about the effect of low pay for government workers on the operation of the public sector (Lindauer, Meesook, and Suebsaeng 1988). In many countries the issue for the 1990s is not how to reduce excessive government pay but rather how to build a productive public sector capable of operating social safety nets for those who lose from adjustment and stabilization programs and capable of managing infrastructure and education systems for long-term development.

Microstudies of wages in several developing countries have revealed sizable pay differentials among comparable workers that cannot be explained by state or union interventions, which casts further doubt on the distortionist interpretation of wage-setting. Summarizing studies of the Bombay labor market, Mazumdar (1989a, p. 11) concluded that "the popular (Bank) view exaggerates the role of institutional interventions in creating and maintaining this wage gap" because "long before the era of trade union or government intervention, wages in large textile factories were high in comparison with alternative earnings," and that "large wage differences are found in urban labor markets in countries (Indonesia) where the institutional apparatus for wage determination is at a rudimentary level" (p. 2).³ These findings resonate with U.S. research that shows sizable wage differentials among similar workers absent institutional interventions, in contrast to small differentials in interventionist Sweden.

3. Mazumdar (1989b, pp. 10-11) further notes the wide variation in wages among villages in India and the uniform daily wage rates for laborers with differing skills, absent unionism or government pay regulations.

To see how the dispersion of earnings across sectors varies among countries with differing levels of development and interventions in the labor market, I calculated standard deviations of log earnings among manufacturing industries using data from the ILO *Yearbook of Labour Statistics* (1991c).⁴ The results, in table 1, show that differentials are greater in low-income and lower-middle income countries than in upper-middle-income developing countries and higher-income countries; are greater in less interventionist than in more interventionist high-income countries; and are least in formerly Communist countries.⁵ This pattern suggests that interventions reduce rather than increase differentials in the industrial sector, which certainly rules out the use of high wage dispersion across industries as an indicator of interventionist distortions and suggests, if anything, the opposite: that low-wage dispersion can be taken as an indicator of interventionist distortion. The evidence supports the use of low dispersion as an indicator of interventionist wage policies in the industrial sector (Freeman 1988), but not necessarily as a measure of distortion. The reason is that the sizable variation in sectoral wages in relatively unfettered labor markets can be interpreted as the "failure" of those markets to establish equal pay for equal work in accord with the neoclassical model rather than as the "right" wage structure. Studies in the United States that have sought to explain wage variations in industry have generally concluded that a sizable proportion of the variation is rent-sharing because firms in sectors that do well pay above-market wages even though there is no union or other intervention.

Are Nonwage Costs an Indication of Distortion ?

Another often-mentioned potential labor market distortion is institutionally induced nonwage costs of labor (ranging from payroll taxes and unemployment compensation to other fringe benefits). To the extent that these costs add to the competitive market cost of employment, they will reduce the number of workers in affected sectors. Exploring this possibility, Riveros (1989) found "no clear time trend in relative labor costs which would suggest that enforcement of these costs introduces (rising) distortions" (p. 19); "that in most less developed countries the existence of nonwage costs does not necessarily constitute a distortionary factor" (p. 22); and that "a certain level of nonwage costs associated with deferred payments or with an insurance system may not be all that distortionary" (p. 20). Whether the failure of nonwage costs to proxy distortions arises from the fungibility of labor costs, the quality of the data, the short time-series to which it was applied, or a more fundamental problem with the distortionist

4. These data are based on establishment surveys and are exceedingly crude because of differences in the size of units reporting in the different countries.

5. Note that I follow World Bank practice in placing China among the lower-income countries rather than the Communist countries.

Table 1. *Standard Deviations of Log Earnings across Industries in Manufacturing, by Level of Economic Development*

<i>Category of economy</i>	<i>Year</i>	<i>Standard deviation</i>
<i>Low-income</i>		
Burundi	1985	0.222
China	1990	0.172
Gambia, The	1987	0.473
India	1986	0.234
Kenya	1989	0.419
Malawi	1988	0.483
Myanmar	1989	0.126
Average	n.a.	0.304
<i>Lower-middle-income</i>		
Chile	1990	0.345
Colombia	1986	0.089
Dominican Republic	1985	0.460
Egypt	1987	0.330
Fiji	1987	0.351
Guatemala	1985	0.363
Mauritius	1990	0.254
Mexico	1990	0.189
Netherlands Antilles	1986	0.351
Panama	1985	0.312
Peru	1988	0.383
Philippines	1987	0.453
Turkey	1988	0.274
Zimbabwe	1987	0.313
Average	n.a.	0.319
<i>Upper-middle-income</i>		
Argentina	1989	0.179
Cyprus	1989	0.219
Greece	1988	0.143
Korea, Rep. of	1990	0.278
Portugal	1987	0.290
Puerto Rico	1990	0.211
South Africa	1988	0.353
Uruguay	1989	0.116
Yugoslavia	1989	0.212
Average	n.a.	0.222
<i>High-income, less interventionist</i>		
Canada	1990	0.245
Hong Kong	1990	0.210
Ireland	1989	0.216
Japan	1989	0.251
Spain	1989	0.243
United Kingdom	1990	0.176
United States	1990	0.267
Average	n.a.	0.230
<i>High-income, more interventionist</i>		
Austria	1990	0.228
Belgium	1989	0.175
Denmark	1990	0.114
Finland	1990	0.153
France	1987	0.140
Germany	1990	0.160

(Table continues on the following page.)

Table 1 (*continued*)

<i>Category of economy</i>	<i>Year</i>	<i>Standard deviation</i>
Israel	1986	0.252
Luxembourg	1989	
		0.196
Netherlands	1989	0.144
New Zealand	1990	
		0.167
Singapore	1990	0.214
Sweden	1990	
Average		0.104
	n.a.	0.171
<i>Centrally planned</i>		
Bulgaria	1986	
		0.133
Cuba	1988	0.101
Czechoslovakia	1989	0.109
Hungary	1990	
Poland	1989	0.216
Romania	1989	0.141
Ukraine	1989	0.108
U.S.S.R.	1989	0.095
Average		0.100
	n.a.	0.125

n.a. Not applicable.

Source: Calculated from ILO (1991C).

view is debatable. What is clear is that the exercise did not yield a serviceable measure of distortions for cross-country comparisons. ⁶

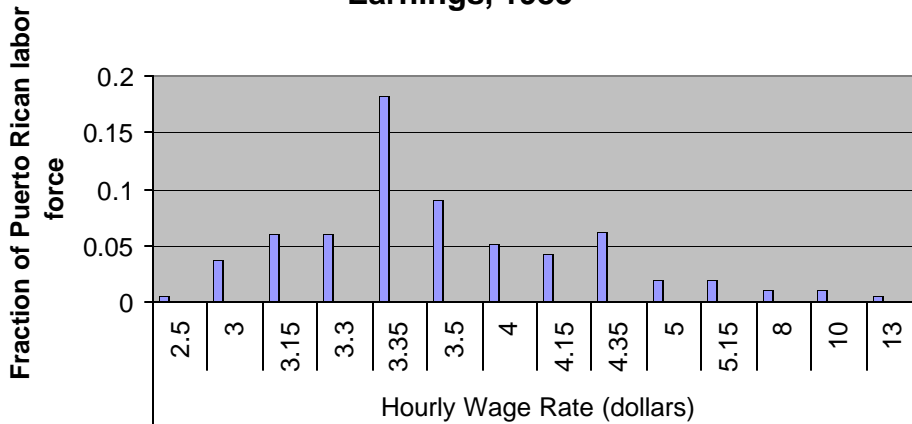
The inference I draw from evidence on interindustry wage dispersion and nonwage costs is that there is no easy way to measure interventionist distortions using market price data. What is needed instead is to look at specific government programs that intervene in wages or employment, to which I turn next.

Minimum Wages

The minimum wage is a *bête noire* to distortionists because it is the textbook case of an intervention that misallocates resources: an effective minimum wage reduces employment. The major question is whether the induced increase is worth the loss of jobs. If it does raise the wages of the most poverty-stricken at little cost to employment, many would find this an appealing way to redistribute income. If, by contrast, the cost is many jobs, and only a few highly paid formal sector workers benefit at the expense of lower-paid informal or rural sector workers, few would favor minimum wage policies. What does the evidence show?

There is evidence that an enforced minimum wage substantially reduces employment. Consider, for example, the application of the U.S. minimum wage to Puerto Rico, where productivity and earnings are considerably below main land levels. As figure 1 shows, the U.S. minimum of \$3.35 an hour essentially dominated the distribution of earnings in Puerto Rico in 1983, creating a

Figure 1. Effect of US Level Minimum Wage on the Puerto Rican Labor Market: Distribution of Hourly Earnings, 1983



Note: U.S. minimum wage = \$3.35 an hour.

Source: Castillo-Freeman and Freeman (1991).

remarkable spike at that rate of pay. Analyses by Castillo-Freeman and Freeman (1991) show that the imposition of the minimum wage raised average earnings on the island, lowered the aggregate employment-population ratio by a significant amount, and shifted employment away from low-wage sectors (which had to raise pay substantially to meet the minimum).

But such minimum wage intervention is far from the norm in the developing world. Many countries set minimum wages too low or are too lax in enforcing the law for the regulation to have much effect. In an assessment of Mexico's minimum wage law, Gregory (1986, pp. 260-61) concluded that "the relationship of legal minimum wages to market-determined wages has evinced frequent and substantial changes at different times . . . and increases in the former were not a necessary precondition for raising real wage levels of those employed toward the lower end of the urban wage distribution." Similarly, Fallon's (1987, pp. 7-8) study of labor regulation in India rejected the importance of minimum wages: "unskilled wages were substantially above minimum rates in large establishments . . . [implying] that the latter are also ineffective. In smaller establishments . . . most firms paid at or within 20 percent of the minimum . . . con-

7. Noncompliance rates in Mexico are 25 percent; in Costa Rica 20 percent; in Jakarta, Indonesia, 70 percent (ao 1990, p. 27). See also Stan's (1981, pp. 138-41) study of minimum wage fixing.

sistent with the view that advisory boards use going wage rates in small establishments as the basis for setting minimum rates in the first place."

By contrast, Fallon and Lucas (1991, p. 397) regard the large increases in minimum wages in Zimbabwe after independence as substantially affecting the wage structure. Paldam and Riveros's (1987) review of minimum wages in Latin America reports mixed effects of the minimum on wages and a "lack of causal connections between minimum-wage changes and aggregate employment" in Chile, the one country for which they analyzed the relation between the minimum and employment (p. 26). They conclude that the "existence of minimum wage causes aggregate effects only when it is used aggressively as a policy tool" (p. 1). In a less structured regression analysis, too, researchers report statistically insignificant relations between changes in real minimum wages and changes in real average wages in the 1970s and 1980s in fourteen African and Latin American countries, leading them to reject any impact from the minimum in these cases (ILO 1990, table 21).⁸ Additional work by López and Riveros (1989) on the effect of minimum wages on skilled and unskilled workers in Latin America raises doubts about the value of World Bank or ILO exercises based on limited time-series: the regressions suggest that minimum wages raised the wages of skilled workers in Argentina; reduced their wages in Chile, Colombia, and Uruguay; and had weak effects on the wages of unskilled workers in all cases (López and Riveros 1989, tables 1 and 2)—a pattern of results that does not make much economic sense.

What negates concern that minimum wages have in fact been highly distortionary, however, is not the weak results from multivariate regressions but rather the evidence that when push came to shove in the 1980s, real minimums fell precipitously in many countries (see table 2). The minimum floor proved to be sawdust—not hardwood, as distortionists feared.

Does evidence that the minimum wage (and possibly other labor market interventions) rarely distorts the labor market seriously also mean that these policies fail to accomplish their institutionalist goal of providing protection for workers? In part, it does point out their limited effect. But there is another way to interpret the evidence that I think is more useful. This is to view the interventions as endogenous to economic conditions, and thus sensitive to their costs and benefits, rather than as exogenously given. From this perspective, countries will rarely set minimum wages at levels that cut seriously into employment. If extensive unemployment results, the minimum will often be unenforceable because both workers and employers will have incentives to collude to avoid the law and save jobs. I hypothesize that in many cases countries follow a strategy of "optimal selective enforcement" of minimum wage (and other) regulations; that is, they effectively implement these laws to

8. The ILO and Bank studies overlap for four countries. The ILO regressions show no effect in Argentina, Brazil, Chile, and Mexico. The Bank study finds little effect in Argentina but effects in the other countries. The number of years covered and the mode of statistical analyses vary.

protect workers when the cost is modest in terms of lost jobs (demand is high in the labor market; employers have low elasticity of demand for labor), but they enforce the laws weakly when the cost of employment is sizable (demand is low; elasticity is high). Such a story is consistent with observed experience and points to the possibility of a more formal "political economy" model of optimal minimum wage-setting and enforcement.

Job Security and Other Employment Regulations

Job security regulations require firms to gain the approval of government or other institutions (such as works council in much of Western Europe) for layoffs and in some cases mandate high severance pay. Such regulations raise the cost of reductions in staff and potentially affect the speed of adjustment and total employment. Evidence on the effects of these provisions for developed countries, where they are strictly enforced, is mixed. Houseman (1991) found that strong job guarantees in continental European countries resulted in smaller job losses in the declining steel industry than in the laissez-faire United Kingdom. Lazear (1990) found that mandatory severance pay reduced employment across Organization for Economic Cooperation and Development (OECD) countries, although the results were "not especially robust to specification" (p. 725) nor to before-and-after comparisons for the same country. For developing countries, Fallon and Lucas (1991) estimated wage and employment adjustment equations **before and after** passage of job security laws in India and Zimbabwe and found little evidence that the laws affected wages or speeds of adjustment but considerable evidence that they reduced total employment in relation to output—an odd finding, since job security provisions that do not affect wages or the speed of adjustment carry no extra cost that would deter employment. On the other side, Standing (1989, pp. 46-48) reports that almost all firms in a recent ILO survey stated that a comparable Malaysian job security law had no impact on employment.

While the results of these studies are equivocal, Spain's experience with job security regulations provides a strong case in which relaxation of regulations spurred job growth. In 1980 the government introduced a fixed-term employment contract as an alternative to permanent contracts (that dated back to Franco's dictatorship), and in 1984 it enlarged the fixed-term contract option. The result was a growth of aggregate employment, consisting almost exclusively of persons on fixed-term contracts, beyond what was likely on the basis of past productivity trends and output expansion. But employment growth is not the full story, for, as one would expect from human capital theory, workers under fixed-term contracts appear to get less training than permanent employees, which bodes poorly for their future (Alba-Ramirez 1991). Marshall (1991) also found that labor laws affect the kind (although not necessarily the volume) of employment and concluded that temporary and part-time work was more common in Lima than in Buenos Aires when Peru encouraged temporary contracts to reduce unemployment while Argentina did not.

Table 2. *Indices of Real Minimum Wages and Real Average Earnings in Selected Developing Countries*

<i>Country</i>	<i>Real minimum wage (1980 = 100) 1989</i>	<i>Real manufacturing wage (1980 = 100) 1978-88</i>	<i>Real nonagricultural wage (1979 = 100) 1984</i>
<i>Latin America</i>			
Argentina	68.4	94.0	140
Bolivia	-	-	48
Brazil	68.6	106.8	108
Chile	63.5	99.3	120
Colombia	105.0	119.3	94
Costa Rica	110.2	85.0	-
Dominican Republic	87.4'	-	-
Ecuador	43.7	74.76	96
El Salvador	35.6	68.16	-
Guatemala	78.5a	77.3	136
Haiti	97.6	-	-
Honduras	74.0	92.0	-
Mexico	46.9	64.7	75
Panama	99.8	-	-
Paraguay	136.5	107.9	94
Peru	23.2	89.2	106
Uruguay	78.6	117.3	75
Venezuela	77.1	-	77
	1985-86	1980-86	1984
<i>Africa</i>			
Algeria	85.06	-	-
Botswana	92.1	-	-
Burkina Faso	88.9	-	-
Burundi	115.0	122.7	117
Cameroon	108.0	-	-
Central African Republic	57.5	-	-
Congo	62.2	-	-
Côte d'Ivoire	78.6	-	-
Ethiopia	77.0	-	-
Gabon	86.8	-	-
Gambia, The	65.0	-	-
Ghana	154.6	140.6	44
Guinea	63.6	-	-
Kenya	58.8	77.2	85
Liberia	83.0	-	-
Madagascar	64.0	-	-
Malawi	120.1	61.9	73
Mali	91.46	-	-
Mauritius	76.0	103.7	-
Morocco	117.96	55.06	-
Niger	77.0	-	-
Nigeria	79.0	89.0a	-
Rwanda	73.4	-	-
Senegal	74.3	-	-
Sierra Leone	-	29.8	46
Somalia	16.1	-	-
Sudan	44.2	-	-

Table 2 (*continued*)

Country	<i>Real</i>	<i>Real</i>	<i>Real</i>
	<i>minimum</i>	<i>manufacturing</i>	<i>nonagricultural</i>
	<i>wage</i> (1980 = 100) 1985-86	<i>wage</i> (1980 = 100) 1980-86	<i>wage</i> (1979 = 100) 1984
Togo Tanzania	32.8	74.06	57
Tunisia	76.7		—
	110.4		—
Zaire	112.0	—	—
Zambia	80.5		
Zimbabwe		58'9 97 6	79 101

- Not available.

Note: These data are highly suspect because of the size of firms covered and the price indices.

a. 1988.

b. Other years.

Source: ILO (1990); Standing and Tokman (1991, p. 213).

Government Employment

High and increasing government employment in some developing countries in the 1970s raised concerns that a large public sector might itself be a major distortion in the labor market. These concerns are forcefully exhibited in Gelb, Knight, and Sabot's (1991) nightmare scenario of the public sector as a sinkhole of waste. Their simulations show that under some conditions a bloated government sector can choke off productive employment and economic growth and suggest that distortionists should concentrate more on the number of public employees and their job activities than on pay differentials. This warning recalls some African experiences, where reductions in government budgets generally took the form of lower pay rather than lower employment, with disastrous effects on public sector competence (Lindauer, Meesook, and Suebsaeng 1988).

There is, however, no economic law that public employees are nonproductive. Malaysia's experience of rapidly growing public sector employment in a period of economic expansion serves as a fruitful counterexample. More generally, Kormendi and Meguire (1985) report that growth of public sector spending in relation to output across countries is uncorrelated with growth of per capita income. I interpret this as indicating that while government employment beyond some level may prove disastrous, few countries let things get that out of hand. Here, as with minimum wages, there are presumably political checks and balances that limit the distortionist nightmare from becoming reality.

Wage Adjustments

In the 1980s the sluggish world economy and the debt crisis were major tests for the labor markets of developing economies. Did institutions obstruct stabilization and adjustment programs in accord with distortionist dogma? Did countries that relied more on consensual modes of adjustment fare better than others in accord with institutionalist dogma?

Table 3. *A Numerical Model of Declining Support for a Beneficial Economic Reform Program for Five Periods of Time after the Reform*

Period	I,		Expected gain	Percentage in favor of reform
	Winners	Losers		
0	-	-	0.10	100
1	0.25	-0.75	-0.50	25
2	0.44	-0.56	-0.12	44
3	0.58	-0.42	0.16	58
4	0.69	-0.31	0.38	69

Note: The reform gives winners a gain of one unit in each **period and costs** losers one unit in each period. Of the population of losers, 25 percent advance to the winners' group in each period. The discount rate is 0.9.

In period 0 the present value of gain is $-0.5 - 0.11 + 0.13 + 0.28 + 0.35 = 0.10$. Support is 100 percent.

After period 1 the discounted gain for losers is $-0.5 - 0.11 + 0.13 + 0.28 = -0.20$. Support is 25 percent (winners only).

After period 2 the discounted gain for losers is $-0.5 - 0.11 + 0.13 = -0.48$. Support is 44 percent (winners only).

After period 3 the discounted gain for losers is $-0.5 - 0.11 = -0.61$. Support is 58 percent (winners only).

The answer to the first question is no. At a crude level, the sharp drops in real wages shown in table 3 refute distortionist fears that labor market institutions or interventions produce wage rigidity when declines are necessary.⁹ Detailed studies of labor markets in twelve countries (Horton, Kanbur, and Mazumdar 1991, p. 17) confirm this reading of the data. In Costa Rica wage indexation rules contributed to rapid downward adjustment of real wages during inflation. In Bolivia the elimination of much labor legislation did not produce economic recovery. Analysis of microsurvey data in Côte d'Ivoire shows further that aggregate wages can significantly understate real wage flexibility by failing to allow for compositional changes associated with reduced employment (Levy and Newman 1989). Between 1979 and 1984 aggregate real wages in Côte d'Ivoire rose 17.5 percent, apparently contributing to the loss of modern sector employment that accompanied structural adjustment. But research based on microdata that adjusts for changes in the skill composition of the work force shows that real wages corrected for changes in skill composition fell 8 percent! The misleading aggregate data failed to take into account the fact that the least skilled were more likely to lose their jobs, biasing upward the average wage. In fact, the disaggregated data show considerable downward flexibility of wages among new hires. Fallon and Riveros (1989, p. 23), who studied sixteen countries, including Latin American and African countries whose labor institutions are often severely criticized, concluded that "there is little prima facie evi-

9. I recognize that the real wage data used in this cable suffer from potential problems with the universe surveyed and the price indexes. In some cases the underlying data show sharp fluctuations in real wages in short periods that must be at least in part due to data problems. Still, the overall pattern shown for so many countries is unlikely to be the result of flaky data.

deuce on downward real wage rigidity as often suggested by opponents of exchange rate devaluation."

To what extent ought the finding of real wage flexibility be modified by changes in unemployment in developing countries in the 1980s? Institutional interventions may not have prevented real wages from falling during economic declines, but perhaps they produced a suboptimal rate of reduction with accompanying open unemployment. There is evidence that open unemployment (admittedly poorly measured) rose in several developing countries in the 1980s (see, for instance, Vandemoortele 1991) and that employment in the informal sector grew substantially. Nevertheless, to argue that the solution is even greater real wage reductions than those shown in table 2 for many countries seems excessive, because it puts the entire burden of adjustment to macro economic distress on wages and the labor market. When unemployment rises and real wages fall in industrial countries with little institutional intervention, as in the United States, no one calls for real wages to fall more rapidly; the response is to seek ways of expanding the economy or augmenting the skills of workers. When the reduction in real wages necessary to eliminate open unemployment exceeds the huge reductions observed in many developing countries, I would look beyond the labor market for the root cause of the economic disaster.

Turning to the tripartite forums or social pacts favored by institutionalists, I am unable to judge whether or not they improve the economic or social face of adjustment and stabilization. Such arrangements played a substantial role in reducing real wages during the 1980s in Belgium and Australia, among other OECD countries, but I am unfamiliar with studies assessing the role of these arrangements in developing countries. It would be valuable to see how social pacts such as the Moncloa Pact and ensuing social accords in Spain or the Pacto Solidaridad Económica in Mexico actually work and whether they contribute in an important way to the adjustment process. My limited knowledge of tripartite forums in the marketizing economies of the East makes me suspicious of claims that these institutions are all that important, but the situation could be different elsewhere.

Collective Bargaining

The success in the 1980s of the East Asian economies that suppressed or severely restricted unions (Korea, Singapore, Malaysia, and Taiwan, China) and the mid-1980s success of Chile (after a long period of economic failure under military rule) raises the nasty question of whether suppressing unions contributes to economic growth. No study has dealt head-on with the question for these countries, though Lindauer and others' (1991) analysis of the labor market in Korea shows that suppression of labor was associated with high accident rates and produced a remarkably disgruntled work force despite large gains in real wages. The experience of advanced and developing countries in general does not sustain any generalization that less unionism means more growth but rather shows that unions are no impediment to rapid economic

development. Japan and Germany, in particular, have had outstanding growth records with labor institutions that are a far cry from laissez-faire ideals. The poor performance of the U.S. economy in the 1980s, when the private sector was largely nonunion compared with the 1950s and 1960s, also shows that low levels of unionism are no guarantee of economic success. Studies on the relation between unions and adjustment in Horton, Kanbur, and Mazumdar (1991) find that union responses to adjustment programs range from militant opposition to active cooperation and that the strength of unions need not bear any simple relation to the prospects for recovery (p. i). In particular, "weakening the unions (as in Bolivia) does not seem to be sufficient to ensure recovery" (p. 55). Their conclusion? A warning that more detailed examination of the role of unions and other labor market institutions is needed "before launching into a wholesale advocacy of dismantling such institutions" (p. 57).

The ILO's World Employment Programme has undertaken enterprise-level surveys on the microeffects of unions on wages, mobility, flexibility, training, and productivity. The results from 3,000 establishments in Malaysia (Standing 1989, 1991a) show that unionism is associated with wage and nonwage outcomes similar to those found in industrial countries (Freeman and Medoff 1984): higher wages and reduced employment growth (the standard neoclassical monopoly effect); smaller wage differentials within enterprises, lower turnover, greater fringe benefits, higher productivity (standard "voice" effects); and more job training. The analysis also reveals that industrial unions have greater effects on some outcomes and smaller effects on others than weaker "house" or company unions. The overall effect of unions is positive, despite the welfare triangle losses from higher wages and lower employment.

In sum, extant studies reject the proposition that unions are a general impediment to macroadjustments or to enterprise performance in developing countries, although they may be so in particular cases, such as in Peron's Argentina.

III. LABOR INSTITUTIONS AND THE POLITICAL ECONOMY

The design of adjustment programs should take into account the political support necessary to sustain the program . . . Compensatory measures, such as severance pay and job retraining, should encourage exit from groups that oppose reforms and entry into groups that benefit from (and will support) the program. (World Bank 1990a, p. 8)

A considerable body of experience points to the crucial importance of political and institutional factors in determining the success or failure of structural adjustment programs . . . Where this (a sound labor relations system and a commitment to tripartite dialogue) is not the case . . . the consequences have been popular protests . . . governments have abandoned the adjustment programme, or they have lost power. (ILO 1991b, p. 2)

There is a growing awareness among World Bank and ILO analysts that labor market institutions and policies play a more complex political role than recog-

need in the distortionist-institutionalist debate. Consonant with this position, I offer below a model of how labor market interventions influence attitudes toward reform programs and modes of expressing those attitudes. The discussion, which is based on Freeman (1992), is more speculative than that in the preceding sections.

Time Pattern of Benefits and Costs

Consider an economic reform that pays off in the future but that costs workers in the present. For simplicity, assume that workers initially receive numeraire wage 0 and that the program creates two classes: winners, who earn W (> 0) after they attain that status; and losers, who earn $-L$ (< 0). Assume further a transition probability of p per period for moving from the losing to the winning group. Under these conditions the value of the reforms in year t will be:

$$(1) \quad pW e^{(1-p)t} - L(1-p)^t = W - (W+L)(1-p)^t$$

where the summation is from $i = 0$ to $t-1$. In continuous time, we have

$$(1), \quad -L \exp(-pt) + W(1 - \exp(-pt)) = W - (W + L) \exp(-pt)$$

which is negative at low values of t ($-L$ in year 0) but approaches W as t rises. The present value of the change from 0 to ∞ at discount rate r is:

$$(2) \quad W \sim (\exp(-rt)) - (W + L) \sim (\exp(-rt)) - [(pW - rL)/(r(1-p) + p)]$$

which must be positive for the program to be worthwhile. I assume that t goes to

∞ for algebraic simplicity and vary r to reflect different lengths of working time.

The present value model provides a framework for considering the pattern of support for reforms among workers and over time. Older workers have few years to reap benefits, so r will be high for them, implying that they will be less supportive of reforms than younger workers. More interesting, equation 2 shows that workers may prefer a program that generates more inequality of earnings ($W - L$) to one that generates less inequality. They will prefer greater inequality when their chance of becoming a winner exceeds their discount rate ($p > r$), since they then benefit more from high future W than from lower current L . This is a variant of Hirschman's (1973) "tunnel effect," according to which losers in the early phase of growth tolerate rising inequality because they view the gains of others as a sign of future gains for them.

Consider next how support for reforms changes over time in a fixed homogeneous population. Initially everyone favors the program ($2) > 0$). In period one there are p winners and $1 - p$ losers. Winners continue to favor the program, but the present value of benefits falls among losers because they have fewer years to reap the rewards (in the infinite horizon model, r rises). In period two there are $p + p(1 - p)$ winners and $(1 - p)^2$ losers, whose present value of benefits drops further. At some period T the present value turns negative for losers, potentially producing massive opposition (see the example in table 3), after

which support rises as p percent of the remaining losers move into the winning group. The critical period for the reform program occurs when support bottoms out. If more than 50 percent of the population turns against the program, a democratic government might back away from reforms—even though the program has, by assumption, a positive payoff.

The potential for erroneously rejecting reforms will be enhanced when personal experiences influence an individual's expected transition probability. If each person updates his expected p along Bayesian lines, losers will continually revise downward their present value assessment of the program. If people have different unknown transition probabilities, losers with high p s may mistake bad luck for low p s and erroneously place themselves in the low- p group. Similarly, random shocks create the danger that some will misinterpret a bad draw (world economic slowdown; changed terms of trade) for a bad program and reject reforms. All of which strengthens the point of table 3—that support for reforms will follow a U-shaped curve.

What happens if we extend the analysis to a changing labor force, with new cohorts favorable to reforms entering the labor force and older cohorts leaving the labor force to become pensioners in each period? The influx of new workers has the potential for counterbalancing the loss of support among existing workers, modifying the U-curve of support. If all pensioners (including those who gained from reforms) oppose the reforms because they reduce the real value of pensions, however, this may offset the rising support of new workers, so that the relative sizes of the two groups will affect the analysis. But perhaps some pensioners support reforms because their children are likely to benefit or because they foresee increased pensions with successful reforms. To deal sensibly with these and other possible problems (for instance, likely declines in support for reforms in a given cohort when winning is not an absorbing Markov state) the model must be made more complicated. In principle, one can derive separate U-curves of support for various age cohorts under differing assumptions and then sum them to get an aggregate curve of support for the population. As with other issues of aggregation, the weights on the groups will help determine the overall shape of the support curve.

Rather than expanding the model (see Freeman 1992), however, I turn to the more salient issue of how labor institutions and policies can influence the attitudes that underlie the support curve and the actions that those attitudes may precipitate.

Interventions and the Benefits and Costs of Reforms

The most straightforward way for interventions to affect attitudes is through side-payments to losers that alter the benefit-cost calculation. The U-shaped curve of support suggests that the timing of payments may be critical. Interventions will be most valuable when support bottoms out and may be least effective in preserving reforms when they are spread over time (or, what may be worse, if they decline over time as the fiscal costs of interventions become

clearer). With respect to specific interventions, job training and active labor market programs that increase employability are undoubtedly preferable to straight "bribes" or subsidies that keep alive unprofitable enterprises, but the latter may still be worthwhile if they buy additional time for painful reforms. In the United States trade adjustment assistance to workers who lost their jobs because of trade did little to promote employability and may have reduced labor mobility, but this was a small price to pay for additional free trade. Consistent with the notion that transfers may be a price for certain economic policies, Bates, Brock, and Tiefenthaler (1991) present crude data that countries with larger per capita transfer payments programs have more open economies.

Going beyond government programs, an alternative way to attract support is to give losers institutional power to defend their interests in the postreform world—for instance, collective bargaining rights for workers whose market pay falls but who may be able to negotiate a "share" of gains through union activity. Profit-sharing or distribution of stocks or national bonds to workers in firms undergoing privatization can also offer losers options to benefit from the future gains of reform even if they are likely to do poorly in the postreform competitive market. Since side-payments must be paid from taxes (inflation), they will lower the benefits to winners (and expected winners) and extract a deadweight loss from society as a whole. This means that buying support for programs through social or labor market interventions has a clear danger: the payments may build up distortionist inefficiencies that abort the reforms. The benefits of interventions in the form of higher tolerance for the costs of reforms must be weighed against the distortionist costs of the interventions. By normal diminishing productivity arguments, the issue is not one of whether to intervene but rather of how much and in what ways to intervene to give losers some possibility of making gains and thus buttressing support for the reforms.

Labor relations institutions can also influence expectations of gains from reforms. In a world with heterogeneous labor, Hirschman's tunnel effect will work only if losers see persons like themselves benefiting from reforms. This suggests the virtue of unions that include private and public sector workers, not, as in East bloc marketizing economies, unions concentrated in (largely losing) state enterprises. Similarly, policy (collective bargaining) might spur profitable enterprises to share economic rents with workers during the initial phase of reform so that there is a clear example of workers' benefiting from the gains. This thrust is consistent with recent World Bank efforts to encourage governments to package reforms to produce identifiable benefits and create public support for the broader reform effort.

Influencing Reforms through Protest and Voice

When workers decide, rightly or wrongly, that reforms are undesirable, there is a danger that they will protest and attempt to overturn the program. In my model successful protests at the bottom point of the support curve risk a self-

fulfilling prophecy of failure: if people had greater tolerance for the costs of transition, the program would work as planned, but if losers have sufficient power to protest, the program fails, possibly producing a Latin American-style populist policy cycle (Sacks 1990). One way to reduce the likelihood of such a scenario is through labor policies that limit freedom of association or the ability to stage a broad strike—for instance, through laws that encourage enterprise level unions and discourage broader union groupings. A more extreme possibility is to suppress unions for some period. If Korean-style suppression of labor could guarantee 6 to 8 percent annual growth in real wages for two decades, many developing economies would sign on. Although there are no studies linking the suppression of unions to growth, most recent work shows that dictatorships (which usually suppress unions) have lower or no higher per capita growth or success in adjusting than democracies (which invariably permit free unions). (See Scully 1988; Kormendi and Meguire 1985; Remmer 1986; Weede 1983; and Haggard and Kaufman 1990.)

The polar opposite to weak or suppressed unionism is an all-encompassing union organization that negotiates "tripartite pacts" or neocorporatist centralized wage-setting arrangements with business and government. All encompassing unions presumably internalize distortionary costs in favor of a broad national economic perspective (Olson 1982). Empirical analyses suggest that they worked well in certain time periods in industrial countries (Bruno and Sacks 1985; Calmfors and Driffil 1988; Freeman 1988). Such systems are not easy to institute or maintain, however, as the ongoing breakdown of cooperative centralized arrangements in Sweden shows. They require a strong labor movement, with leaders able to assess the economic scene and convince workers to accept current consumption losses for future gains; a business community that accepts labor as a social partner; and a government willing to share some prerogatives with its social partners.

Finally, labor institutions can contribute to a reform program by providing social feedback on program outcomes. Even with the best intentions, governments following World Bank and International Monetary Fund (*IMF*) advice may blunder in the specifics of stabilization and adjustment programs. Inflation costs may be greater than expected. Unemployment and output losses may be bigger. Workers, pensioners, or children may suffer more than anticipated in the short run. If technocrats and politicians are more attuned to the world financial community than to local realities, they may be slow to realize that things are not working and thus to make adjustments. The greater the uncertainty about the success of reforms, and the more removed government officials are from the lives of the citizenry, the greater is the need for independent groups to provide feedback about the real effects of programs and to pressure politicians to make changes. The same unions and business groups that from a rent-seeking perspective endanger reforms can, from a social perspective, contribute to the program's success. More abstractly, "winner's curse" considerations, whereby more optimistic assessments of the outcome of reforms (rather than gloomier assessments)

take precedence in political debate, suggest that nearly all reforms will have greater short-run costs than expected and make the feedback from labor and management critical in correcting errors.¹⁰

Lacking detailed studies of specific reform programs to test the validity of these ideas, I can only offer some examples where a political economy analysis seems relevant. One example is Venezuela, whose adoption of standard ILMF and World Bank policy reforms in the 1990s sufficiently unnerved the population to produce major riots and an attempted military coup in 1992. Prior to its reform program, Venezuela's economic policies fit an interventionists' nightmare; the government wasted the bonanza of high oil prices, interfered in the economy in all sorts of ways, and brought the country to near economic ruin. But the short run costs of the standard prescriptions were greater than anticipated, in part because of the sluggish response of the private business sector to the new economic environment and the inability of an ineffective and underpaid bureaucracy to implement social interventions to buffer the costs of the reforms. In addition, the president and the reformist technicians were unable to enlist the support of the population for the reforms. This set the stage for loss of support as time proceeded, and for some requisite backtracking.

Zambia's failure to stick with its 1985 ILMF stabilization package has been attributed in a Bank report to the "unrealistic assumption that the majority of middle- and lower-income urban Zambians would tolerate pauperization" (Colclough 1989). In other words, the government failed to give adequate consideration to political factors. An ILO paper argues that the case of Zambia shows how faulty assumptions about the labor market led to the failure of adjustment (Vandemoortele 1991, p. 84). In the marketizing economies of Eastern and Central Europe and the former U.S.S.R., a failure to alleviate social costs or to develop appropriate labor market institutions may be prove to be the Achilles' heel of economic reforms.

IV. CONCLUSIONS

There were three surprises to me in preparing this paper.

The first was that studies designed to support the distortionist view of labor markets in developing countries failed to make a stronger empirical case than they did. Part of the problem is the lack of adequate measures of distortions, and part is the excessive attention given to limited time-series data as opposed to detailed studies of worst-case situations. More can be learned, in my opinion, about which interventions are excessive or disastrously implemented from detailed case studies than from cross-country time-series regressions with weak data. If the Uruguayan social security retirement system is the economic disaster

10. The expression "winner's curse" refers to the problem in auctions, in which the person with the most optimistic view of the value of the good will win the auction. As long as the average view of the value is correct, the winner necessarily pays more than the good is worth. Similarly, in political discourse, the reformer who has the most optimistic view will make the biggest promises—"reform will bring nirvana in two years"—and potentially win the policy debate.

that some claim, the distortionist lesson to be drawn is not that social security systems are bad, but rather that systems should not be developed along Uruguayan lines. This research problem aside, the principal reason for the weak distortionist case has to be that declines in the 1980s in real wages-and changes in relative wages-in many developing countries showed that many distortionist interventions were paper tigers at crunch time. It is ironic that distortionists, who generally revere unfettered markets, understated the power and flexibility of labor markets to overcome potentially inefficient interventions.

In hindsight, I should not have been all that surprised at the weak empirical case for the distortionist view nor at flexible real and relative wages in developing country labor markets. Research on labor markets in industrial countries shows that labor markets work tolerably well and that real wages are flexible downward under diverse institutions, ranging from decentralized U.S. labor markets to centralized Swedish or Australian wage-setting. From a distortionist perspective, German labor relations, with strong unions and government extension of contracts, mandated works councils with veto power over some enterprise decisions, worker representatives on boards of directors, and so on, ought to make that country one of capitalism's basket cases. Similarly, imagine what a full distortionist critique would say about the Japanese labor market, with its idiosyncratic institutions and practices. But the German and Japanese economies work quite well. No labor market works exactly according to simple neoclassical models, but most respond reasonably well to shifts in market conditions.

The second surprise is the paucity of studies on two major claims of the disputants: the distortionist claim that labor market interventions impair investment or growth, and the institutionalist claim that consultative modes of decisionmaking or collective bargaining are superior to less structured labor market modes of adjustment. Some Bank researchers have begun to buttress the distortionist model in ways that address the former issue. López (1991b) and Gelb, Knight, and Sabot (1991) show under what assumptions the public sector can kill growth. But much more is needed, both conceptually and empirically. Olson (1982) and Kendix and Olson (1990) offer some evidence linking indicators of institutional rigidities to unemployment rates and growth of per capita income in industrial countries, but more is needed for developing countries. Given the importance of infrastructure and investments in education on growth, we need to examine how these interventions fare in the new economic environment of stabilization and adjustment programs (Birdsall and James 1990).

On the other side, I found little information for assessing the possible role of tripartite decisionmaking bodies and social pacts in adjustment in developing countries and thus had to rely on industrial countries to see such arrangements at work. Because many of the marketizing economies of Eastern and Central Europe, including Russia, have instituted such organizations, it is important to determine whether they can serve useful functions in the absence of a strong private sector. Studies of Spanish and Mexican social pacts and of tripartite and consultative decisionmaking are needed to assess the value of these institutional

interventions or to suggest other institutional mechanisms that could enlist private bodies into the reform process.

The third surprise was the most pleasant: finding convergent World Bank and O interest in the political role of labor interventions in economic reforms. To the extent that this interest reflects problems observed in implementing reforms in the 1980s, it is the best possible empirical support for this paper, though not necessarily for my specific arguments or model. There is an exciting practical research agenda here: determining the conditions under which the political economy advantages of interventions outweigh potential interventionist costs; determining which interventions are most effective in buttressing support, and which are likely to lead to more economic troubles; and determining which reforms outside the labor market are worth interventions in that market. The presumption underlying my analysis is that the benefits from more open economies, convertible currency, stabilization, and the like dwarf the costs of labor market interventions. Is this correct? Looking at labor market interventions as part of the political economy of reform suggests a very different research agenda than that reviewed in my scorecard.

Finally, I was struck by the extent to which views of labor market interventions seem grounded not so much on models or econometric evidence but on observation of specific country experiences. I think it is no accident that the institutionalist perspective comes from Western Europe, where Germany, Austria, Scandinavia, and others provide examples of reasonably successful institutional interventions, whereas the distortionist perspective comes from the Americas, where analysts contrast the largely unfettered American economy with state interventions in Latin America. If I am correct that first-hand experiences in specific cases have greater salience than econometric modeling, research on labor policies and institutions would benefit from more detailed investigations of how specific interventions and institutions work in particular countries as opposed to aggregate statistical analyses. Certainly specific studies are a necessary first step toward making valid generalizations that take account of idiosyncracies that allow some interventions and institutions to work in some places but not in others, and thus to draw lessons across country lines.

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