Available online at www.sciencedirect.com
ScienceDirect
Emerging Markets Review 8 (2007) 38–49
EMERGING MARKETS REVIEW
www.elsevier.com/locate/emr

Institutional enforcement, labor-market rigidities, and economic performance ☆

Cesar Calderon [a], Alberto Chong [b], Gianmarco Leon [b,*]

[a] World Bank, USA
[b] Research Department, Inter-American Development Bank, Stop B-0900, 1300 New York Avenue, NW, Washington, DC 20577, USA

Received 29 August 2006; received in revised form 26 October 2006; accepted 6 November 2006
Available online 16 January 2007

Abstract

This paper compares non-enforceable and enforceable measures of labor rigidities as a measure of the quality of labor institutions, and tests whether such labor rigidities are conducive to long-run growth. We find that non-enforceable labor regulations do not have a bearing on economic growth, but enforceable labor regulations do. In fact, when using a GMM-IV method for a panel data of countries during the period 1970–2000 that accounts for weak endogeneity, we find that such a link is negative and statistically significant. It appears that labor rigidities are thus negatively linked with long-run economic growth.

JEL classification: O10; E60; J08; O40

Keywords: Institutions; Enforcement; Labor rigidities; Growth; GMM-IV

1. Introduction

In this paper we study the issue of institutional enforcement of regulations by focusing on labor-market policies and their potential link to economic performance. We test the different impacts of enforceable and non-enforceable labor regulations by proxying non-enforceable labor

☆ A previous version of this paper was prepared for the 7th Annual Conference of the Central Bank of Chile, "Labor Markets and Institutions." We are grateful to Osvaldo Larrañaga, Norman Loayza, Hugo Ñopo, Luisa Zanforlin, and anonymous referees for comments and suggestions. The findings and interpretations are those of the authors and do not necessarily represent the views of the World Bank, the Inter-American Development Bank, or their corresponding executive directors. The standard disclaimer applies.
* Corresponding author. Tel.: +1 202 623 1536; fax: +1 202 623 2481.
E-mail address: albertoch@iadb.org (G. Leon).

1566-0141/$ - see front matter
doi:10.1016/j.ememar.2006.11.001

rigidity measures using data on conventions from the International Labor Organization (ILO). It has been argued that non-enforceable conventions – that is, those that exist on paper and are simply *de jure* regulations – appear to be more distortionary and tend to be the least enforced in practice (Squire and Suthiwart-Narueput, 1997). According to Freeman (1993), these conventions reflect the ideal regulatory framework from an institutionalist perspective and cover a variety of labor market issues, from child labor to placement agencies. Whereas in theory, a country's ratification of ILO conventions gives the country legal status and thus supersedes domestic regulations relating to those issues, in practice the degree of labor-market rigidity depends on how the conventions are enforced. It is the outcome of the regulations that matters, rather than their number. Different observers emphasize different outcomes: minimum wages, mandated benefits (such as old-age pension, health insurance, or maternity leave), mandated job security and high firing costs, large and powerful trade unions, and the government's share of the labor force. Note that distortions of this latter sort do not necessarily stem from a "thick" labor code, which re-emphasizes the distinction between non-enforceable and enforceable measures (Forteza and Rama, 2006).

There are two broad views regarding the role of labor-market regulation in economic performance. The distortionists argue that government regulations in labor markets – such as minimum wages, social security contributions, job security, and collective bargaining – create distortions (World Bank, 1990). In this view, labor-market regulations are obstacles to growth for at least three reasons: they prevent wages from equaling their marginal product in equilibrium, leading to a misallocation of resources; they hinder the adjustment of the labor market to shocks, and finally, labor regulations that redistribute economic rents from capital to labor reduce the profitability of investment and lead to lower growth rates.

The institutionalists claim that market failures generate divergences from the ideal world and emphasize the benefits of government interventions in the labor markets (ILO, 1991). Labor regulations fulfill redistributive roles for low-wage workers or constitute insurance against adverse market outcomes (Standing and Tokman, 1991). Labor standards force employers to focus on enhancing their labor force through either training or technical innovation (Freeman, 1993). Finally, standards on mandated benefits may help solve moral hazard or selectivity issues that prevent firms from offering socially desirable benefits or contracts (Summers, 1988).[1] Typically, the conventions issued by the International Labour Organization reflect the ideal regulatory framework from an institutionalist perspective, as their ratification gives them legal status, thus superseding domestic regulations on those issues (Forteza and Rama, 2006). In fact, many labor advocates support ILO conventions. This stems from the view that the bargaining power of employees is seen as weaker than the one from employers, which translates into conventions that are designed to restrict the ability of employers to decide on the terms and conditions of work. That is, labor advocates tend to focus on issues related with microeconomic issues about labor exploitation rather than macroeconomic arguments related with economic performance. Nevertheless, while the signing of ILO conventions may make it more likely that legislatures will later pass regulations in a country it is not clear such regulations will, in fact, be binding or enforceable. The classic example of a non-binding regulation is the case of the

[1] Forteza and Rama (2006) study the role of labor-market regulations in the success of economic reforms. They find that wage adjustment and labor reallocation in outward-oriented economies will be faster if labor markets are flexible. Potential losers from economic reforms, such as workers in the public sector or unionized labor, usually try to hinder the adjustment process (Alesina and Drazen, 1991; Fernandez and Rodrik, 1991). Besley and Burguess (2004) assess the role of labor-market regulations in explaining the performance of the Indian manufacturing industry between 1958 and 1992, and find that regulations designed to protect workers actually reduce growth and increase poverty.