

More Good Jobs for a Growing Labor Market
Saturday, January 27, 2007

1. **Mexico needs to be more productive to compete internationally.** With the rise of globalization, Mexico faces intense competition from around the world and the economy will have change how labor is used. Mexican firms will increasingly have to focus on increasing the value added of labor and focusing more on developing competitive advantages. However, this is complicated by the low human capital of the labor force and by the high transaction costs in the labor market that serve as a tax on labor and creates incentives for firms to operate illegally.

2. **Mexican labor law provides extensive rights to workers but is hard to enforce.** Effectively, employers face three different transaction costs when hiring workers. In addition to the salary, they have to pay non-salary labor costs (such as vacation pay and mandatory bonuses), the cost of firing workers (in terms of mandatory indemnifications), and tax and fiscal charges on their payroll (such as social security). High transaction costs deter the hiring of workers including high uncertainty related to the litigation process. Workers may or may not fully benefit from all of these charges.

3. By law, employers contribute a percentage of the payroll to help finance workers' health insurance, life insurance, housing programs, and old-age security. The contribution for housing programs, at 5% of payroll, is particularly high.¹ In addition, there are strict rules on dismissing workers and the appropriate payments required. Employers also have to pay an annual bonus to all workers in addition to their standard salary. Workers who do not receive all of these benefits are considered outside of the formal sector. Including costs such as vacation time and bonuses, total non-wage costs in Mexico amount to 47.2% of payroll.

4. Uncertainty related to dismissals is huge. Around 30 percent of workers who consider themselves unjustly dismissed do not initiate legal suits; (b) the cases of close to 70 percent of those who do initiate legal suits for layoffs end in private settlements well below the provisions contained in the law; and (c) besides being subject to long waiting periods and high levels of uncertainty (including those who engage in private settlements), those who do bring suit have to pay labor lawyers, who typically charge between 30 and 40 percent of what the worker gets as a severance payment.

5. Thus, according to recent calculations, 30 percent of the laid-off workers do not get any severance payment (because they do not file a legal complaint). About 50 percent (that is, 70 percent of the remaining 70 percent) make private arrangements with the employer, in which they usually accept an amount less than provided for in the law (in many cases it amounts to half of the legal severance), and pay some percentage to the lawyers. The remaining 20 percent sees the legal suit to the end, which takes a long time and the result is uncertain and, in any case, the award must be split with the lawyer. In addition, it must be taken into account that this calculation pertains to workers covered by the severance regulations which, at most, are those in the formal sector (that is, about half

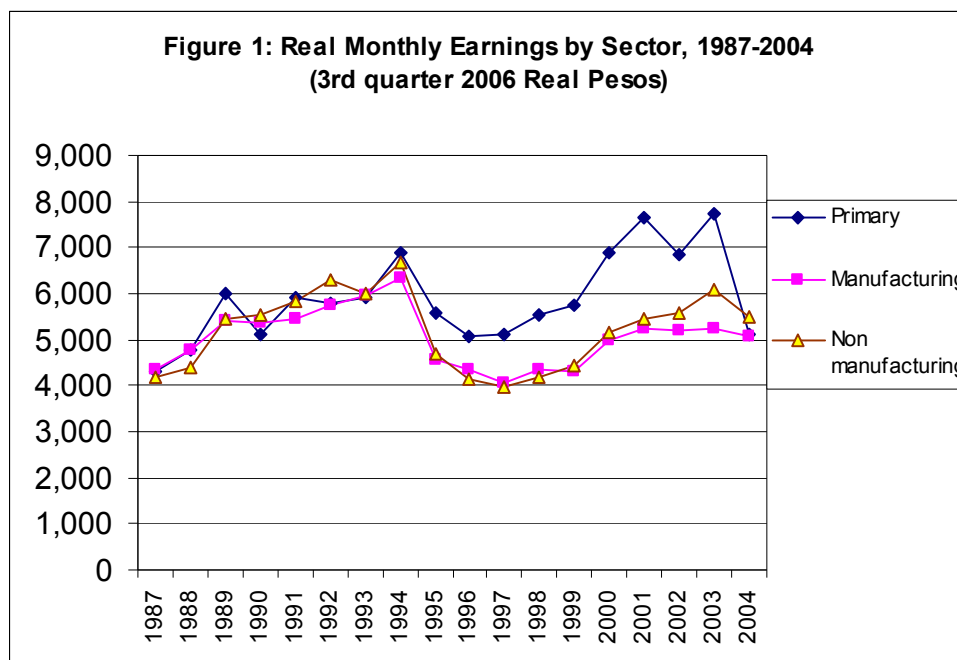
¹ See chapter XX on Social Protection for more details.

of the Mexican working population). Thus, despite the lack of conclusive statistical evidence, it seems clear that the existing system to protect workers against one of the worst possible shocks, unemployment, is, in fact, rendering very poor service to its target population.

6. **The poor depend on labor as their primary source of income.** Many poor are self-employed, often with little or no capital. Other work for wage employment, often in the informal sector with little formal protection or the benefits mandated by law. Without better employment opportunities, they have little opportunity to rise out of poverty.

7. **In urban areas, real wages for the extreme poor have declined since 1991.** Pay levels have started to recover since 1996, but the improvement has not brought wages back to their 1991. However, real wages for the poor have recovered and are now above pre-crisis levels due to the positive growth of the economy in the last year in several sectors of the economy including maquila and services.

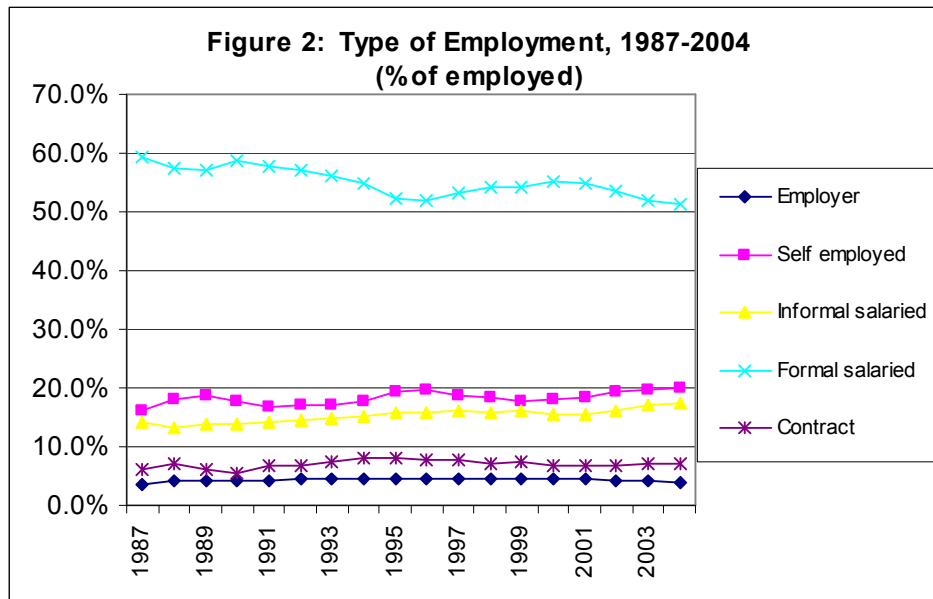
8. **In rural areas, lack of sufficient dynamism in the small-scale farm sector,** concentration of growth in the more commercial sector, and limited access to high-return jobs in the rural non farm sector are key factors in explaining stagnant income growth for the rural poor. Slow productivity growth is a general problem for the Mexican economy and is the main factor behind the slow growth in earnings in urban and rural areas.



9. Informal sector employment has expanded significantly from 1990, when it represented only 31 percent of total employment, to 37 percent of employment in 2004.²

² Definition includes self-employed and salaried informal workers, and excludes employers.

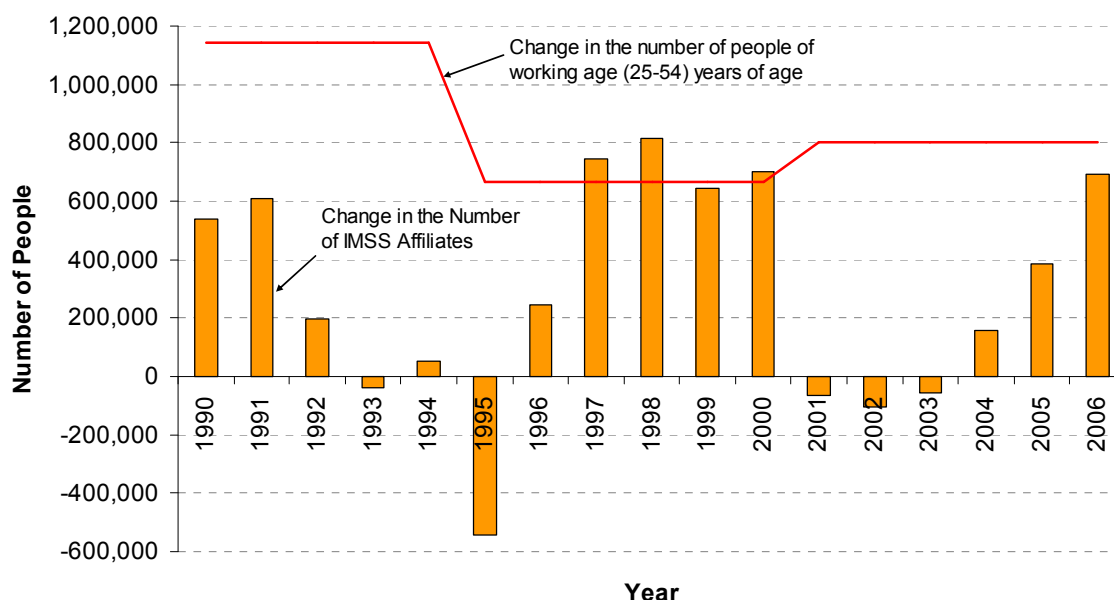
At the same time, average wages of the self-employed fell 27 percent between 1994 and 2004, implying that increased labor supply to the sector pushed down wages further.



10. **Whereas NAFTA appears to have spurred job creation,** the period since 2001 has been characterized by weaker economic performance in terms of slower GDP and employment growth, especially in the manufacturing sector. Figure 3 illustrates the problem. There have been few years since the early 1990s when formal sector job creation has kept pace with the growth of the working age population. Looking forward, stimulating economic growth and the expansion of higher productivity activities that require increased labor input at higher skill levels will be crucial for providing adequate jobs – both in number and quality.

Figure 3

Creation of formal sector jobs in México and new entrants into the labor force: 1990-2006



11. **Labor productivity growth has been low over the last 10 years in Mexico.** Table 4 shows labor productivity growth in other countries. Mexico displays the lowest growth in total productivity in both periods. Regarding industrial labor productivity, Mexico outperforms only Brazil and Colombia. Industrial labor productivity grew 2 percent per year in Mexico during the 1990s, while the average for the Latin American countries was 3.2 percent. In addition, the fact that industrial productivity grew at 2 percent while total productivity increased by only 0.4 percent indicates that productivity growth was sluggish in other sectors, notably agriculture and services.

Table 4: Labor Productivity Growth during the 1990s

Country	Growth in Total Productivity		Growth in Labor Productivity	
	1990-1996	1990-1999	1990-1996	1990-1999
Singapore	5.6%	n.d.	8.6%	7.5%
Korea	5.0%	4.3%	7.1%	7.8%
Chile	4.6%	3.6%	4.0%	4.2%
Argentina	4.4%	3.2%	8.0%	5.4%
Uruguay	2.7%	2.4%	3.0%	3.1%
Colombia	0.7%	0.7%	0.4%	1.8%
Peru	0.6%	0.4%	4.5%	4.6%
Brazil	0.2%	0.3%	2.0%	1.5%

Source: World Bank. World Development Indicators.

12. **The Mexican labor market faces two main challenges that constrain productivity growth and a higher level of formality.** First, labor legislation introduces significant distortions into the labor market that make it expensive for firms to grow and to expand their workforce. Second, there is a lack of high skill in the labor force, compared to what is demanded by the productive sector. These challenges affect productivity to the extent that they create barriers to adjustment that inhibit the adoption of new technologies and more efficient organization of production.

13. **Two main messages constitute the basis for the need to improve the labor code:** (a) it should be a priority of reform to address the distortions and barriers to productivity growth and formal employment creation; and (b) a system that better protects Mexican workers and their families is urgently needed. That is, Mexican firms need labor regulations that allow them to take advantage of the new opportunities coming from their greater insertion into the global market, and Mexican workers need a system that moderates the shocks that arise from this greater insertion, and that effectively protects them when the shocks are realized.

14. **Mexico has a variety of active labor market policy interventions that aim to increase employment and improving productivity.** These include occupational training programs, labor intermediation services and direct and indirect job creation programs.

15. **Mexico has a number of programs that aim to improve the technical education to the workforce.** Occupational training programs are key for helping the labor supply keep up with the changing demand. Because firms' investment in training is generally insufficient, the role of the state is important in providing financing and a regulatory framework that provides workers, in particular the poorest, with tools to remain competitive in the labor force. The Program to Support Training (*Programa de Apoyo a la Capacitación* or PAC) subsidizes the hiring of independent instructors. Efforts are made to match firms with local training providers that correspond to their needs. Participant firms exhibit increased investment in training, improved labor productivity, higher capacity utilization rates, reduced personnel rotation, and improved production techniques, among others. The Work Training System (*Sistema de Capacitación para el Trabajo* or SICAT) supports firms meet their training needs. Where there is a large participation of private institutions in the provision of training courses, results have generally been positive. In medium and large enterprises, SICAT has had a positive impact on participants' income and employment and the implementation of training programs has helped these firms' courses' relevant. Results have not been so positive in small and medium enterprises, which are precisely the firms that need the most assistance to innovate and promote workers' training.

16. **The distribution of occupational training services is very unequal.** From the poorest 10% of the population, only 1.5% attended some training program, whereas among the wealthiest 10%, the participation rate is 32%. This can be partly explained by the fact that the poor are mainly employed in informal firms, which rarely provide training. Evidence suggests that only 17% of the poorest workers who received training did so in the firm where they worked. Results also show that those programs with larger

private sector participation (either privately offered training courses or courses offered in firms) obtain the most positive results.

17. **Efforts in education and training can be complemented by the strengthening of labor intermediation services** to increase the access of poor, low-skilled workers to labor market information and give them access to networks and connections that may boost their chances of finding good jobs. Labor intermediation services should be designed to facilitate the matching of candidates with vacancies and the referral of workers not only in the formal sector, but also more unregulated forms of employment, such as micro enterprises, self-employment, and small business development. Though the experience with current programs, such as CHAMBATEL or CHAMBANET, has been generally positive, evidence suggests that in practice, these programs are more accessible to skilled workers than non-skilled workers, or are designed to cover the unemployed who used to work in the formal sector. The utilization of public resources by people most likely to find jobs, even without these programs, undermines the effectiveness of labor intermediation services and reduces their social benefits.

18. **Worker placement in current programs is fairly high, but targeting could be improved.** Results indicate that the level of worker placement of current programs is 33 percent of the effective demand, a percentage that would be lower if the population that has no access to these services was taken into account. Compared with other countries' experiences (30 percent in Chile, 10 to 25 percent in Europe), this level of placements can be considered a success. An evaluation of the these programs in 2003 showed that workers with very low education levels, the youth, the elderly and those with the largest number of dependants (a possible proxy for the poor) were among those who benefited most from the program. These results suggest that a broader application of the benefits could increase the level of effectiveness and transparency in the use of resources. Such change in the program will probably present operational challenges, however, that should be resolved in the framework of the *Servicios Estatales de Empleo* and access to an increased budget. More generally, a greater emphasis should be placed on targeting the neediest groups, such as the low skilled, the poorly educated, the poor or victims of discrimination, who typically face the highest barriers to job market entry, but seem to be receiving the least assistance.

B. The Way Forward

19. **The labor market is critical both to improving Mexico's international competitiveness and implementing the country's poverty reduction agenda.** Many of the challenges that Mexico faces are institutional and require a review and modernization of existing labor laws. The system as it stands, offers little protection for workers and creates significant barrier for growth for many employers. However some workers do benefit from the system, and efforts are needed to protect and "grandfather" these workers into a new labor regime. In the area of active labor policies, the government should expand and better target existing programs, including job training and job search services.

20. **Labor laws should be aligned to reflect changes in the global economy and Mexico's social protection system.** The labor legislation is about one hundred years old and intended to provide effective social protection to the workers.³ Mexico's can not longer compete with a low productive labor force and a onerous labor legislation. Society should carefully examine each element of the social security system and identify which services are (i) expensive for employers and employees and (ii) of little real value to the employee. Reforms can remove the requirement and offer effective compensation for the affected workers. This will move the debate beyond one of conflict between employers and employees to one that focuses on improving competitiveness and worker welfare.

21. Likewise, many of the termination benefits are expensive for employers and have little benefit for employees. This is because many employers do not comply with the law, or because of the high uncertainties associated with the legal process, leading to costly legal action. Alternative arrangements, such as "no-fault" termination, with a defined annual contribution by the employer, and transformed severance payment system into an unemployment insurance may help to lower the uncertainty and high cost associated with hiring and firing in Mexico.

22. **The government should promote job training and help with job search.** The evidence suggests that wage subsidies, on their own, are unlikely to have a long term impact on the employment or earnings of the poor and are probably not cost efficient. Given the large degree of "informality" in the labor market, it is difficult for firms to directly train many of their workers. Credit constraints may restrict the access of the poor to private sector training opportunities. Expanding programs like PAC and SICAT and improving their efforts to train workers from smaller firms. The current system largely benefits formal sector workers who work in well-established firms. Reforms should aim to make the benefits of training available to the whole working population.

23. **Improving information for the workforce and for youth entering the workforce is important to ensure that the education provides future workers with the right skill mix.** Job search and job matching services can also help improve access to the formal sector for new job entrants. The education system should also work more closely with the private sector as a partner to ensure that that courses offered are relevant for firms. Existing programs have been successful but have mostly benefited formal sector workers or workers that have recently left the formal sector. More effort is needed to target the messages to other workers and to the youth.

24. **Mexico has made less progress in improving access to the labor market.** Changing labor laws is always complicated there are often many who feel that their accumulated rights are in jeopardy. Reforms in the labor market must be built upon

³ The mandate to produce a national labor law was fulfilled in 1931 with the *Ley Federal del Trabajo* (National Labor Law, LFT), issued to "promote the betterment of the working conditions of the Mexican labor force." This law was substantially reformed in 1970 and, with some minor changes after that, is the regulatory framework in force today, more than 30 years later.

strong political support. The advocates need to explain how changes will benefit the country, particularly competitiveness and effective protection to the workers. They also need to develop a strategy to protect existing rights, through payments and “grandfathering.”

Recommendations made for labor reform in 2000 Policy Note.

Recommendation	Result
<i>Modernize industrial relations and collective bargaining</i>	
• Introduce firm-level, decentralized bargaining and discard obsolete rules regarding collective bargaining	No progress
• Encourage more flexible job ladders	No progress
• Move towards more cooperative work relationship with unions	No progress
• Reform profit sharing	No progress
• Reform and consolidate minimum wages	No progress
• Eliminate restrictions on the use of flexible, temporary or fixed-term contracts	No progress
<i>Urban informal market needs policies to stimulate growth and formal market participation</i>	
• Reduce cost of registration and the high cost of being formal	Some progress in reducing registration costs
• Reduce high cost of formal sector wages	Reform of the social security health insurance
• Raise the productivity of the formal sector	Little progress

Conclusions

25. Mexico faces many challenges in the upcoming six years. **Without changes in its education system and in the way that its labor markets work, Mexico will continue to lose its international competitiveness and its rate of growth will continue to stagnate.** Without faster growth, the high levels of inequality and poverty will continue.

26. **Improving education is important both in its own right and to increase Mexico’s competitiveness and future potential growth.** The Mexican education system faces challenges at all levels, including incomplete coverage of basic education and low quality of learning. The education system is complicated with both federal and state governments involved. This relationship should be addressed and updated as the government attempts to update the entire education system. Low levels of enrollment at the upper secondary and tertiary levels directly impact on the quality of the Mexican workforce. Likewise, the lower average level of education of workers has a similar impact. Going forward, Mexico should work to keep more students in school and improve the education and skill levels of adults already out of school.

27. **The economy is burdened by a labor system that offers limited protection to the worker while generating significant distortions and transaction costs.** Mexican workers are already at a disadvantage due to their education level. Current labor laws do not help. They raise the cost of employment and doing business in Mexico while providing limited tangible benefits to workers. Reforms should be centered around useful protections for workers that complement and not duplicate the social protection system.

28. **Mexico's reform agenda should be seen as a long term project.** It is neither possible nor desirable to introduce a radical reform in the short term. Rather the government should work with different elements of society to bring about change in a gradual fashion, fully protecting existing rights under current rules while introducing new systems. In the long term, Mexico will need to reform and it should be prepared to pay the long-term costs to increase its competitiveness. This note has proposed a number of reforms that are summarized in the table in Annex 1.