



Job Creation in Mozambique: Is Labor Law Reform the Answer?

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SUMMARY

Labor-law reform has the potential to advance Mozambique's poverty reduction and growth strategy by increasing industrial output employment. In recent surveys firms have cited labor regulations as one of the most important obstacles which discourage expansion and investment, and this has been confirmed by outside analysis of Mozambique's legal framework for large scale private enterprise. In response, the Government, in consultation with key stakeholders developed a set of reforms which were placed before Parliament in August, 2006. If adopted, the proposed legislation would give small firms and medium firms greater freedom to hire and fire workers, would reduce the cost of severance pay and other benefits for all firms, and make various institutional changes to the system for resolving labor related disputes.

This report assesses the potential changes of the proposed draft labor law to increase output and employment in the private enterprise sector, and assess the possible poverty and social impacts. Based on an analysis of other countries' experience with similar reforms and the (limited) data on the private enterprise sector in Mozambique, we project the extent to which the proposed changes could be a factor in increasing competitiveness, investment, output, and employment in Mozambique's relatively small private enterprise sector.

Initial conditions and economic trends create a propitious base for the reform: sustained economic growth in the country has been marked by macroeconomic stability, a good resource base, continued improvements in the business climate, and large foreign investment projects. Other important initial conditions in Mozambique are the strong demand from private sector employers for change, and the scope of proposed reforms.

However, even with positive initial conditions, we project that the effect of the proposed changes on investment, competitiveness, and new private sector employment may be small and only materialize in a few years.

- ***Mozambique's private enterprise sector is still small*** (only 5% of total labor force) so any employment expansion should be small relative to the job creation problem.
- ***Increased private sector employment requires new investment***, which takes time.
- ***Although the reform is broad, potential international investors might still be dissuaded from investing.*** Mozambique's score on the international benchmarks of Doing Business would not show much movement. This is because while the reforms are substantial for Mozambique, the hiring and firing reforms proposed would still leave near the bottom compared to other countries. Additionally, these benchmarks do not capture some of the most important elements of the reform.

Additionally, our data do not allow us to identify the actual important binding constraints to private sector employment expansion (for example, are the obstacles the provisions of the law or are

they how the law is enforced). The involvement of the private sector in developing the new law does provide a strong basis for optimism however.

Therefore the pending legislation has only limited potential to make a deep dent in job creation and poverty, and may even make the situation worse in the short run. Households headed by wage and salary workers in the private sector are much less likely to be poor, so if new employment does take place (most likely in the cities where the firms are concentrated - Maputo, Beira, and Nampula) households in these cities should be winners from the reform. But under the new legislation, the reduction in severance pay takes effect immediately. This could set in motion major layoffs of long-time employees by larger firms, triggering an increase in poverty in these three cities. Most countries prevent this problem is to include transition arrangements in such legislation.

Mozambique will have to continue to focus policy attention on the range of factors that have allowed the non-agricultural sector to grow rapidly over the past decade. In addition, the spirit of the labor reform will need to be carried through in the implementing decrees and regulations. Once the new law has been implemented, an evaluation of its impact, relevance, and efficiency should be conducted. The data deficiencies which limited the scope and quality of this analysis imply that plan for the necessary policy-focused research should be put in place before any new law actually takes effect so that changes brought about by the reform can be assessed from the start.

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1 INTRODUCTION

Mozambique has achieved a high rate of economic growth over the past 10 years, thanks in large part to expansion in agriculture. Privatization and the consequent restructuring of the manufacturing sector also have contributed to growth, as have various “mega projects” (in aluminum, cement, and other plants financed by South African investors). But although this growth has reduced poverty substantially, it has not generated many new jobs in the formal sector, in part because local demand is so limited.¹ And the growth of nonagricultural exports has been slow.

Mozambique’s poverty reduction strategy calls for building employment by increasing exports. To do that, the country needs to strengthen its investment climate and become more competitive. The legal framework for labor relations is an element of the investment climate. Amending the labor law to decrease the costs of termination is a core policy measure of the Government in the PARPA II² and the 2006 PAF³.

Mozambique provides greater protection for employees of private firms than do other countries at a similar level of development (Coughlin 2004). For example, the cost of discharging an employee in Mozambique is among the highest in the world, according with indicators from *Doing Business*. The high level of protection is a source of concern for firms in the country. In a recent survey, labor regulation was seen as a major or severe obstacle to doing business by 49 percent of Mozambican businessmen, more than triple the Africa average of 15 percent. Employers wishing to dismiss a worker must provide three months’ notice and offer severance pay that is high even when compared to developed countries. Labor inspections are widely viewed as ineffective and subject to corruption. Resolution of labor disputes is very slow. In general, the structure of the country’s labor law reflects its socialist past.

In 2005, the government set up a tripartite commission (including representatives at the technical level from the Government, the employers association, and the unions) to draft new labor legislation. After a process of national consultations, the government submitted the draft to parliament, the goal being to have a new law in place by end of 2006. If adopted, the proposed legislation would change current law by giving firms greater freedom to hire and fire workers, reduce the cost of severance pay and other benefits, and make various institutional changes to the system for resolving labor conflicts.

¹ The “formal sector” refers to economic activity, public or private, regulated by government agencies. In this paper, we employ the term “private enterprise sector” to denote the activities of privately owned firms, large and small, that are regulated by the government and thus form part of the formal sector.

² PARPA is the Action Plan for the Reduction of Absolute Poverty (or Plano de Acção para a Redução da Pobreza Absoluta) administered by the Government of Mozambique. PARPA I extended from 2001 to 2005. PARPA II, the current plan, covers the period of 2006-09.

³ PAF (Performance Assessment Framework) is a set of key policies and actions based on the national poverty reduction strategy (PARPA)

This paper, a joint product of a technical team composed of staff from the Ministry of Planning and the World Bank, analyzes the potential economic impact of the changes to the labor legislation proposed in the summer of 2006.⁴ The paper was produced as a result of a request to the Government for such an analysis. The plan of the paper is as follows. Taking as the starting point the objectives of the Government in proposing a new law (increased employment in the private enterprise sector and poverty reduction) the economic logic behind the reforms is reviewed, and the conditions under which the reforms could be expected to have the maximum impact on employment are isolated. Next the experiences of selected developing countries which have undertaken similar reforms are reviewed, which showed the importance of initial conditions and economic trends outside of the labor market in ensuring a successful reform. Third, the main provisions of the proposed reforms are explained. Using this background information and descriptive information on Mozambique's economy and industrial structure, the probability that the reforms in the labor law proposed in July 2006 *could* actually increase employment is analyzed. Owing to data limitations, the analysis is not definitive, but a number of enabling initial conditions are identified. The aspects of the reform most important for increased investor confidence and employment creation are indicated.

The analysis concludes that given Mozambique's initial conditions, including the strong demand from private sector employers for change, the scope of proposed reforms, and the potential for continued economic growth, the reforms should increase firm's profit margins, and as a result, a positive employment effect is possible in the medium term. Owing to the small size of Mozambique's private enterprise sector (only 5% of the total labor force works there) the employment effect would have to be small relative to the scope of Mozambique's employment problem. The analysis also shows that although the reforms are deep compared with the starting point (the current law), even if the reforms are enacted, Mozambique's labor market would still be classified as rigid by international benchmarks. Thus the size of the competitiveness effect is unclear, and in any case, competitiveness depends on a host of factors, the labor law being only one. Improvements in competitiveness require a cohesive and sustained government effort.

The report concludes with a discussion of the possible social and poverty effect. If an employment effect occurs, this would produce a small but probably positive effect, mostly in Maputo, and in the medium term. But in the short run, there is a danger of layoffs in some of the larger firms which had previously reported being overstaffed. If this happens, the poverty effect would certainly be negative in the short run. The concluding section notes that other countries have avoided these types of layoffs by introducing transition arrangements.

⁴ This paper reviews the proposed legislation (in Portuguese, "anteprojecto") submitted to Parliament in July 2006 (any subsequent changes introduced by Parliament are not included). We refer to this document as "the draft law" or "the proposed new legislation". The legislation in force in the summer of 2006 is referred to as "the current law".

2 LABOR LEGISLATION AND EMPLOYMENT—INTERNATIONAL EXPERIENCE

When considering whether to hire an additional worker, profit-maximizing firms weigh the marginal value of the new hire in relation to its marginal cost (wages plus benefits). Generally, economists expect firms to hire additional labor if the value of production of the additional employee exceeds the increment in total costs. Labor-market regulations that increase the overall cost of labor will tend to reduce employment, especially if firms are able to relocate to escape the regulations.

In all countries, but particularly in the developing world, regulated economic activity, including a regulated labor market, coexists with unregulated activity known as the informal economy (or informal sector), where self-employment dominates. In Mozambique and many other developing countries the unregulated economy accounts for most non-agricultural economic activity.

Economists have argued that rigid regulation of the labor market can have the effect of reducing employment in the formal sector, notably in the privately owned firms, thus forcing more workers into the informal sector. Rigid regulation may also reduce private investment in the formal sector, as local and foreign investors may find investment too risky or conclude that they cannot afford the costs of regulated labor. As employment and investment in the formal sector fall, employment and output in the informal sector increase. Firm owners will be reluctant to increase firm size if doing so will subject them to additional regulation or if they will face additional pressure to comply with labor regulations. Taken together, individual decisions to keep employment and investment low have the effect of reducing economic growth and poverty reduction. In Africa, these decisions also depress average wages because formal-sector firms pay higher wages than informal-sector firms for the same skill level.

By and large, the experience of developing countries is that labor laws that increase costs in the formal sector have tended to reduce formal-sector employment. For example, Rauch (1991), focusing on the minimum wage, finds that higher minimum wages in the formal sector are associated with a higher level of informality. Loayza (1997), Carneiro (2003), and Botero and others (2003) broaden the focus to labor-market regulations in general. They find that such regulations can create incentives either to operate informally or to employ informally so as to avoid the costs of formal employment.

However, initial conditions are extremely important in determining the effects of labor regulations. In the next section, we analyze the conditions under which each principal part of Mozambique's draft labor law might have an impact on employment. Next, we analyze the experience of three countries—Brazil, Colombia, and India—where labor reforms have been

implemented in at least one of the areas that Mozambique is considering. In Brazil and Colombia, the legal structure is similar to Mozambique's. The review is based on existing analysis; we try to look for success factors that may be relevant for Mozambique.

Labor law and employment—theoretical perspectives

The effect of lower labor costs on employment

It is widely assumed that when the cost per worker is reduced, employment will go up.⁵ The assumption is not wrong, but it can take some time for the effect to be produced. Immediately after labor costs drop, for example, in response to a reform of labor legislation, firms may not have had time to make new investments. They will begin to hire more labor only once they have the capital in place (plant, machines, land, and so on) to employ the labor productively. Thus in predicting the employment effect of lower labor costs, it is important to know the capital/labor ratio of current firms. In a labor surplus economy with a low capital/labor ratio, less capital is required to increase output, especially where the elasticity of substitution between capital and labor is high, so if there is an adequate supply of labor at the skill level the firm requires, firms are likely to increase employment faster in response to a change in labor laws.

Over a longer period of time, if the major obstacle to expansion in labor-intensive industries had been high labor cost, even firms with a higher capital/labor ratio may increase employment in response to labor reform. This implies that labor costs must be a significant percentage in firms' total costs and must be perceived as a major impediment to investment, relative to other risks in the investment climate (such as other costs, poor infrastructure, an uncertain tax regime, and so on), such that a change in the law must lower them enough to alter firms' calculations of future risk-adjusted profits and thus induce to increase investment, especially in the production of labor-intensive goods and services. In short, labor-law reforms must give firms enough additional profits to stimulate further investment.

The structure of the goods market is also an important determinant of the effect of labor reforms. If the market for a given product is very concentrated because there are few sellers, a reduction in labor costs may be absorbed by those sellers in the form of high profits (IMF 2006).⁶ Thus regulations that reduce product market competition will tend to reduce the effects of labor-law reform.⁷ Strong labor unions, combined with weak competition, can erase the employment

⁵ Throughout this analysis, we concentrate on the industrial sector, including manufacturing, mining and construction. We would expect the results to be similar in other employment-intensive sectors such as plantation agriculture, tourism, and telecommunications.

⁶ As noted in IMF (2006): "In more regulated product markets, softer competition pressures may lead existing firms to expropriate a larger share of the cost reduction in the form of higher profits."

⁷ Blanchard and Giavazzi (2003) study the effects of product market competition under imperfectly competitive labor markets. They argue that greater competition in OECD countries would increase employment, and less

impact of a reform. Because unions are more interested in higher wages for their workers than increased employment, they usually force employers to share with workers the higher profits made possible by labor-law reform.

The effect on employment of an increase in hiring flexibility

The same factors apply to a reform that increases firms' flexibility in hiring and firing workers. Employers that were able to make use of more workers with their existing capital would hire a few workers immediately after the reform, especially if they were already considering expanding but had held back because of the risk of not being able to reduce employment later on. If an increase in flexibility is to boost employment in the medium term, the risk of being stuck with too much labor in case of an economic downturn or external shock must be prominent. If investors perceive other issues to be more crucial, such as the supply of educated workers or uncertainties in the tax regime, then a reform that makes the labor market less rigid may not lead to much increase in formal sector employment.

Compliance with existing legislation is also an important factor in determining the effect of this type of reform. If firms do not observe the current legislation, then increasing firms' flexibility to hire and fire will merely legalize their current behavior rather than increasing employment. But because international firms often are more likely than domestic firms to comply with the law, a more flexible labor law could make the market more attractive to international investors.

The employment impact of institutional changes

Institutional changes will increase employment if, as with increased flexibility, they decrease investment risk. Unpredictable institutions often are a major source of investment risk (Eifert and Ramachandran 2004). Improving speed and predictability in the resolution of disputes over contracts and industrial relations can reduce investment risk substantially, resulting in increased foreign and domestic investment, especially in high-wage sectors and firms.⁸ As with other labor law reforms, the time path is uncertain. Investors may wait to see how the changes actually work out before undertaking new investment.

competition would reduce it. Low competition in product markets is an important reason for Europe's high unemployment, they argue, warning focusing on labor regulations alone is not enough to solve the problem.

⁸ Powerful unions can exacerbate an unpredictable regulatory environment with complex procedures for settling disputes, especially where competition is weak (as in nontradable, capital-intensive industries such as utilities, and protected manufacturing sectors). This was the case in many Latin American countries before trade was liberalized. Unionization was often blamed for large gaps in earnings between formal and informal sectors, when, in fact, the differences were the result of a more complex set of factors (Berhman, Birdsall, and Székely 2001).

Our review of economic theory suggests that some increase in employment may follow labor reform in developing countries with dual labor markets⁹—if the initial conditions are favorable. We now review the outcomes of reforms in three countries.

Brazil: incomplete reforms and weak demand for labor

Since 1995, Brazil has been reforming its labor law and regulations with the objective of achieving greater flexibility. As in Mozambique, changes have focused on specific aspects of the law, as opposed to a wholesale reform. The main changes made in Brazil's labor legislation in the 1990s and the early 2000s are outlined below (Zylberstajn 2002).

Increase in hiring flexibility

- *Fixed-term contract.* Firms may hire employees for a fixed period of time, up to two years.
- *Part-time jobs.* Firms may hire employees to work part-time schedules, up to 25 hours a week.
- *Annual working schedule and “comp time.”* As in the Mozambican reform, firms may compensate overtime by adjusting workers' weekly schedule over a period of one year; that is, by allowing workers compensatory time off. (Requires collective contract with union.)
- *“Indirect workers.”* Creates a category of workers who are not represented by the union. Firms may use “indirect workers” only to perform tasks related to noncore business activities.
- *Layoffs.* Firms are allowed to lay off workers for up to five months. At the end of this period, the firm may either rehire the worker or fire him, in which case the firm must negotiate the firing with the union.

Institutional changes

- *“Conciliation tables.”* A conciliation table is a form of mediation undertaken as an alternative to judicial proceedings. Firms found in violation of health and safety rules may use the conciliation table to negotiate settlements with labor inspectors.
- *Rapid processing of grievances.* Rapid processing (scheduled within 90 days) is designed to settle grievances on the first hearing.

⁹ Dual labor markets refer to the segmentation of the economy into the formal and informal sectors

- *Prior conciliation.* An alternative to the labor tribunal, prior conciliation allows employers and workers to settle disputes through negotiation. As in binding arbitration, the negotiated settlement has the legal status of a decision by the labor tribunal. Conciliation may take place at the firm or industry level.

The changes in Brazil's labor regime, like those proposed in Mozambique's draft law, were designed to increase flexibility, lower labor costs, and improve the efficiency of labor-related institutions. In practice, however, many of the changes took effect only when included in collective bargaining contracts, thus reducing the scope of the reforms. It is also worth noting that Brazil's labor legislation, while rigid in some aspects was already flexible in hiring and firing. Employers are allowed to fire workers without cause. To ease the financial cost of separation, workers and employers contribute to a fund that provides financial assistance (unemployment compensation) to terminated workers to workers based on tenure (as reflected in the balance in their fund account).

Brazil's reforms occurred during a period of major change in the Brazilian economy following decades of high inflation and low growth. In the early 1990s, Brazil introduced a monetary reform that reduced inflation from more than 1,000 percent per year to nearly zero. Other reforms were aimed at improving competition in product markets; reducing government budgetary obligations (especially the implicit debt of public banks and other commercial institutions); reducing trade barriers; and privatizing banks, utilities, and other public and quasi-public enterprises.

Under the open economic environment created by the trade reforms, Brazilian firms were forced to raise their quality standards to compete with foreign firms in import and export markets. This involved new technology and production actually became more capital intensive, so the share of industrial employment *decreased*. Workers were obliged to migrate to other sectors, such as services and trade. After 1997, these sectors were no longer able to create jobs fast enough to absorb the migration from industry. This trend, combined with series of debt crises in developing countries, including Brazil which slowed economic growth in the region, caused unemployment to *increase*, not decrease.

The poor results from Brazil's labor reform can be attributed to two causes: (a) the economic environment was not conducive to an expansion in formal sector employment, and (b) the steps taken toward labor-market flexibility were relatively timid, given the scope of regulation in Brazil's labor market, and thus were insufficient to encourage new labor-intensive firms to enter the market or existing firms to shift to more labor-intensive production processes. This was especially true in the export sector, where capital-intensive technology was needed to improve quality and ensure competitiveness. Even with labor reforms, firms in the informal sector still faced huge obstacles to expansion, including high tax rates, poor access to credit, stiff competition (resulting in low prices), no access to technology, low levels of education among

firm owners, small-scale production, and low productivity. Because labor reform left unresolved so many other issues that informal businesses faced, it was not enough to induce firms to move to formal status and thus raise formal sector employment¹⁰.

A third factor was also important. Prior to the reforms, most of the cost of labor-market regulations was reflected in the depressed wages of formal sector workers. But the introduction of more flexible regulations brought wage increases for existing workers, as unions bargained hard for these increases (supported by a system of labor relations that supports unions in the bargaining process). Firms were restructuring and introducing new technology so they needed the unions on their side. Because the increases partially offset the cost savings from the reform, the overall reduction in the cost of labor perceived by firms turned out to be small. Gruber (1995) found similar results in Chile following a reduction in payroll tax rates from 30 percent to 5 percent. The result was an increase in the salary of workers who were already employed—and no increase in employment.

A final factor was the lack of changes in the institutional environment. We noted earlier that many of the changes that would have increased labor-market flexibility in Brazil had to be embedded in firm-level collective bargaining agreements before taking effect. However, because few changes were made in the regime for collective bargaining or labor adjudication, the scope of the reforms was attenuated. The main institution for adjudicating labor and industrial relations issues remains the labor tribunals, which tend to favor workers (Zylberstajn 2002). Employers must prove that the accusations leveled against them are unfounded, and must pay most of the court costs. Union leaders retain a great deal of power, owing to a compulsory contribution to the union that firms are required to make. Because the union's earnings are guaranteed by the contribution and unions have a monopoly over a given geographic area, union leaders have little incentive to attend to the interests of existing formal sector workers, and no incentive at all to defend the interests of those outside the formal sector trying to get in.

Colombia: strong economy, weak unions, strong employment growth

In the early 1990s, Colombia went through a series of structural changes that included reforms in the areas of trade, finance, and labor. The labor reform had two main facets. The first was reform of the social protection system, including the pension and unemployment assistance systems, through the introduction of personal accounts. The second was reform of mandatory training programs. Both of these facets of reform lowered the cost of labor. Other reforms introduced greater flexibility in the length of workdays and reduced the cost of firing a worker. Overall the reforms decreased dismissal costs by 60–80 percent. Eslava and others (2004) find that the reform package “was associated with rising overall productivity that is largely driven by

¹⁰ IBGE (Instituto Brasileiro de Geografia e Estatística) survey from October 1997.

reallocation away from low- and towards high-productivity business.” Although labor market reforms started in 1990, they were fully implemented only in 2002/03.

The reforms took place in a favorable economic context. According to Núñez (2005):

The moment in which the [labor] reform was promoted was exceptionally positive: since the economy’s unemployment rate was higher than the natural unemployment rate, supply of labor into the formal sector was good and substantial underutilized plant capacity was available. The impact of the expansive fiscal policy that took place between 2002 and 2003 did not have inflationary effects. As a consequence of the expansion and greater flexibility, employment increased 5.2 percent during 2003 while GDP increased 3.9 percent.

Echeverry and Santamaría (2004) concur, noting that the private enterprise sector was the most dynamic in the economy; in the informal sector employment only rose by 2 percent.

Further evidence on the impact of the reforms is provided by a survey of 75 firms in the formal sector (DANE¹¹ cited in Echeverry and Santamaría (2004)). Forty-one percent of surveyed employers reported increasing the number of workers during 2002–03; half of those said they did so because of the labor reform introduced in 2002. This group considered the reduction in the cost of Sunday, holiday, and night-shift work important or very important. Also, 37 percent of the firms surveyed increased the number of apprentices in response to provisions of the labor reform. On the topic of unionization, Edwards (2001) finds that unions do not have significant power in most Colombian industries. Since the economic reforms of the 1990s and the labor reform implemented in 2002–03, union membership in Colombia nationwide has fallen from 12 percent of the workforce in the mid 1990s to only 3.5 percent today (Gill 2004).

India: institutional conditions

Because India’s labor regulations were reformed at the state level and overall economic conditions were roughly the same in all states, it is possible to isolate the effects of the reforms. Besley and Burgess (2002) look at state amendments to the Industrial Disputes Act¹² to establish the relationship of labor regulation, investment, and output growth in the manufacturing sector in India. The study covers 1958–1992, a period when manufacturing was still highly protected from international competition. During this period, India did not introduce reforms of goods markets. Changes in manufacturing output and employment could therefore be analyzed as a function of

¹¹ DANE (Departamento Administrativo Nacional de Estadística) , the National Statistics office in Bogotá, Colombia

¹² The Industrial Disputes Act “specifies the powers of government, courts and tribunals, unions and workers and the exact procedures that have to be followed in resolving industrial disputes. It defines the bargaining positions of the different parties involved in an industrial dispute.” Each state has the power to create amendments to the act. Some states established pro-worker procedures, others pro-employer procedures.

the level of rigidity of institutional conditions (the more pro-worker the amendment to the Industrial Disputes Act, the more rigid). States that applied a more flexible regulatory regime saw higher levels of investment, employment, productivity, and output in formal sector manufacturing. According to the authors, Andhra Pradesh was the most flexible state; West Bengal the most rigid. Andhra Pradesh, which grew at a rate of 6 percent per year between 1958 and 1992, would have grown by just 4.1 percent had it not passed pro-employer reforms. West Bengal, in which registered manufacturing output per capita declined 1.5 percent per annum, would have grown at a rate of 2.2 percent if its labor regulations had been more flexible. The authors also estimate that without pro-employer reforms, Andhra Pradesh's manufacturing output would have been 16 percent lower and manufacturing employment 6 percent lower than their 1990 level. If West Bengal had had more flexible labor regulations, manufacturing output would have been 14 percent higher and manufacturing employment 4 percent higher than their actual 1990 levels.

The Indian case is quite persuasive. It is important not to overstate the results, however. The analysis was quite careful, but, it is possible that the states that had regulatory regimes favorable to employers also had advantages not measured or controlled for in the study if the results are biased upward.

Are these international experiences relevant for Mozambique?

One must be cautious in extrapolating the experiences of one country onto another, since it is hard to isolate the effects of labor reforms. However, some lessons can be retrieved from these experiences.

- In Brazil, the economic climate did not favor expansion in formal sector jobs, especially lower skilled ones, so there was little job growth. In addition, although firms welcomed additional flexibility in hiring and firing workers and clearly exercised that flexibility, institutional reforms were incomplete, since many provisions could not be implemented in the absence of a collective bargaining agreement. As a result, many reform provisions were not implemented. Employers tended not to challenge the status quo because their options were few and expensive.
- In Colombia, where the reforms did not require ratification through collective bargaining and labor unions were in decline, the labor market was able to adjust better to reforms. The result was higher employment. High economic growth played the most important role, however.
- The case of India illustrates the important role of institutional conditions. States that granted high levels of bargaining power to organized labor created

an unfavorable business climate, resulting in reduced investment and investment.

Labor reforms by themselves are not likely to increase employment if the economy is not ready for job creation. The Latin American experience shows that in times of recession or slow economic growth, labor reforms have a neutral effect on employment. However, in times of strong economic growth, a more flexible labor market can boost employment and help the economy grow more than if the labor market were rigid, as firms can take advantage of lower costs and lower risk to increase investment even further.

3 LABOR-LAW REFORM IN MOZAMBIQUE

Proposed legislative changes, if enacted, are expected to affect the demand for labor in Mozambican firms in the short and medium term. Those changes can be grouped under three headings: increased flexibility, reduction in labor costs, and institutional changes, each of which is discussed below.¹³ Additional details are provided in annex 1. As important as the terms of the law itself are the decrees and regulations that will be developed to implement it. These are not yet available for analysis.

Increased flexibility

Length of fixed-term contract. The current law allows firms to hire workers under fixed-term contracts of up to two years, renewable once. The draft law would permit two renewals for the same job in large enterprises. Medium and small enterprises would be allowed an indefinite number of renewals during their first 10 years of operation.

Limits to the normal working period. The current law sets the work week at 48 hours, which would remain the under the draft law. However, the draft law would treat the 48 working period as an average. Thus, it would be possible to work more than 48 hours a week, but with a limit of 8 hours a day, extendable to 12 hours in exceptional cases. Time worked in excess of 48 hours would be deposited in a time bank from which the employee could withdraw leave over the next six months. Employee would not be allowed to work more than 70 extra hours per trimester, or to work extra hours in two consecutive trimesters.

Temporary agencies. The draft law would allow employment agencies to enter into provisional work contracts with workers and to supply those workers to third parties. The services rendered there could not be permanent or form part of the regular, permanent activities of the third-party firm. The fixed-term work contract regime would apply to provisional work contracts. No such provision exists in the current law.

Notice of dismissal. The current law requires firms to give workers 90 days' notice of termination. The draft law would cut the notice period to 30 days.

Contracting foreign workers. Under the current law, the contracting of foreigners requires authorization from the Ministry of Labor, which entails a case-by-case assessment and analysis. Under the draft law, firms could hire foreign workers without authorization but would have to notify the Ministry of Labor. Foreign workers could constitute no more than 5 percent of all workers in large firms, 8 percent in medium-size firms, and 10 percent in small firms.

¹³ In this analysis, the "current" law refers to the law in force in July, 2006. The "draft" law refers to the submitted by the Government to Parliament in August, 2006.

Changes in labor costs

Severance pay. Severance pay is due when an employer terminates a permanent, full-time employee for economic reasons. Employers may dismiss workers for the following economic reasons:

- *Structural reasons*, relating to reorganization or restructuring, a change in business activity, or a shortage of economic and financial resources that has the effect of causing labor redundancies
- *Technological reasons*, related to the introduction of new technology, new processes, or methods of work that may lead to labor redundancies
- *Market reasons* stemming from difficulties in placing goods or services in the market or from a reduction in the enterprise's activities.

In case of termination for any of the above reasons, the draft law would set severance pay at 20 days per year of service. The present law requires employers to pay terminated employees with more than three years of service severance pay equal to three months' salary for every two years of service. Employees with from six months to three years of service receive three months' severance pay. Employees with as little as three months of service receive 45 days' pay under the current law.

Under the current law, when a permanent employee is terminated and the employer is not able to demonstrate the reason was structural, technological or market related or if the employer violates the legal rights of the worker, the amount of severance pay is doubled. Under the draft law, the amount of severance payable under such circumstances would be 45 days per year of service.

When the employer terminates a fixed-term contract for just cause¹⁴, the employer now must pay the employee for the unused portion of the contract. This requirement would not change under the draft law. In case no just cause is proven by the employer, the amount of severance doubles only under the present law, but not in the draft law.

Leave. Under current law, permanent employees enjoy 21 days' of annual leave (paid vacation) after completing one first year of service and 30 days thereafter. The draft law would change those amounts to one day per month of work in the first year, two days per month of work in the second year, and 30 days in the third year. Thus the change would affect only first- and second-year employees. Workers on fixed-term contracts between the duration of 3 months and one year would receive one day of paid leave for every month of service.

¹⁴ Just cause by the employer implies that reasons for termination of contract were of structural, technological or market nature. Inaptitude of the worker is also considered just cause, but in this case, no severance is paid. Just cause by the worker implies rights violation by the employer and the worker receives severance. It also includes the worker's duty to fulfill legal obligation, but in this case no severance is paid.

Under the current law, employees should notify their employer with 5 days in advance before taking unscheduled leave that have been justified¹⁵. An extensive number of days is allowed. Under the draft law, employees must provide their employer with at least two days' notice before taking leave. The draft law would impose limits on justified absences and require employees to obtain permission from their employers before taking leave for cultural and sports activities (annex 1).

Institutional changes

Strikes in export zones. Current law prohibits strikes in export zones. The draft law would submit strikes in duty free zones to the same treatment as strikes affecting essential services and activities.

Term for claiming workers' rights. Under current law workers must assert claims for employment-related benefits and redress within one year. The draft law would cut that period in half.

Conflict resolution. The current law provides that conflicts may be solved by mediation, arbitration, or judicial process. Mediation is voluntary. The draft law would provide a new, alternative extrajudicial mechanism for resolving collective and individual conflicts. Public and private entities, for-profit or nonprofit, would be licensed to offer mediation services; both parties would be required to make use of them. The draft law would also make binding the decisions of arbitration panels. Grievances would have to be filed within six months of the disputed event.

Collective bargaining. Under current law, firms with more than 10 workers must engage in collective bargaining at the firm level. The draft law sets negotiations between the firm and workers' representatives as the fundamental basis for collective bargaining. It would extend the collective-bargaining system to all enterprises, including small ones.

Size of enterprises. The draft law classifies enterprises based on the number of workers. Large enterprises are those with more than 100 workers. Medium enterprises employ between 11 and 100 workers. Small enterprises employ up to 10 workers.

¹⁵ For a description of justified leave see Annex 1, "Other leave"

4 ANALYSIS OF THE PROPOSED LABOR-LAW REFORM

Current conditions in Mozambique

As seen in section 2, macroeconomic conditions and the structure of the economy are important in determining whether a given set of labor-market reforms will have the desired effect on employment. In this section we analyze economic conditions in Mozambique, asking whether they are likely to increase or decrease the employment impact of the proposed changes to the country's labor law.

Mozambique's overall macroeconomic conditions have been excellent in recent years, and this is expected to continue. Macroeconomic stability (as indicated primarily by a low fiscal deficit and inflation in single digits for the past few years), a good resource base, continued improvements in the business climate, and large foreign investment projects have combined to produce a growth rate averaging in excess of 7 percent per year for the last 10 years. During that time, Mozambique has undertaken reforms to improve the business climate—strengthening and deepening the financial system and replacing an antiquated commercial code and business registration procedures with simpler and more up-to-date versions. Thus, the climate for a labor-law reform would seem excellent.

On the other hand, the country's private sector is small, and formal employment is concentrated in large firms. According to a survey of enterprises performed in 2002 by INE, Mozambique had just over 30,000 firms, 80 percent of which employed fewer than five people (including the owner) and employed just under 16 percent of the labor force in the private enterprise sector. It is probable that such firms, most of which are family businesses, are not greatly influenced by labor regulations. Large firms (those with more than 100 employees) constitute just 1.5 percent of total firms but employ 60 percent of the private sector workforce and account for 58.4 percent of production (table 1). Mozambique has 31 firms that employ more than 1,000 people; these firms alone account for 26 percent of all private sector jobs. Because larger firms are subject to a wider array of labor regulations, the proposed changes in the labor law will have the greatest effect on them and their employees.

Table 1 Number of firms, workers in service, and business volume by firm size, 2002

Number of workers	Percent of firms	Percent of workers in service	Percent of business volume
> 100	1.4	57.1	58.5
10–99	9.1	22.9	17.5
1–9	89.5	20.0	24.0
TOTAL	100.0	100.0	100.0

Source: INE (*Instituto Nacional de Estatística*) 2002.

Note: In 2002, Mozambique had 28,870 private firms that employed 301,145 workers and generated sales of 66,444, 254 (10⁶ Mt)

Surveys of manufacturing firms have shown that labor regulation is an important constraint on the growth of businesses in Mozambique—but by no means the only one. To better understand the dynamics of organizational performance, the World Bank and CTA (2002) and the Ministry of Planning and Development of Mozambique, the University of Copenhagen, and CTA (2006) conducted a series of surveys of entrepreneurs that uncovered the sources of economic inefficiency. Chief among them were:

- Procedures related to clearance of goods through customs and to the processing of refunds of value-added tax (VAT).
- Corruption and sluggish performance of government institutions that delayed the resolution of issues.
- Poor infrastructure, including roads, railways, and ports that slow the circulation of raw materials and merchandise. Unreliable electricity was also considered as a serious obstacle to the business performance.
- Limited access to credit and high interest rates.

Sarkar 2000 and USAID 2004 have cited additional factors that impede business development in Mozambique (see also PARPA II):

- The lack of a culture of entrepreneurship and a shortage of business management skills.
- A shortage of workers having the technical skills needed to enhance quality and productivity.
- Limited capacity for market research.
- Weak linkages with markets.
- Low levels of innovation and poor operational practices.

A panel of manufacturing firms rated the severity of these conditions, generating the results shown in table 2. Perhaps the most interesting point is that while most conditions are deemed to have improved as a result of the government's reform program, labor regulations are now seen as a more serious constraint than they were previously. In a list of 18 obstacles, labor regulations rose from thirteenth place in 2002 to fourth place in 2006, tied with tax rates and unpredictability of policies.

While Mozambique's current labor law offers strong employment security for those in permanent jobs, it does have one loophole—the fixed-term contract. Workers hired under this contract can be let go with no recourse and no severance pay once their contract expires. Contracts may last up to two years and be renewed once. The law specifies that fixed contracts are to be used only for certain types of jobs and for a maximum of four years.

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Table 2 Private sector's perception of key constraints to investment

Item	2002	2006
Telecommunications	1.4	0.8
Electricity	2.7	2.0
Transportation	1.4	1.4
Access to land	1.3	0.7
Tax rates	2.5	2.2
Tax administration	2.3	1.8
Customs and trade regulation	2.1	1.9
Labor regulations	1.8	2.2
Skills and education of workers	1.7	1.8
Business licensing and registration	1.4	0.9
Access to domestic credit	3.2	2.5
Access to foreign credit	3.1	1.8
Cost of credit/financing investments	3.3	3.1
Unpredictability of policies	2.6	2.2
Macroeconomic instability	2.9	2.8
General corruption	2.8	2.0
Crime, theft, and disorder	2.4	1.8
Anticompetitive practices	2.5	1.5

Source: Data from firm surveys collected under the auspices of the CTA(Confederação das Associações Económicas de Moçambique)¹⁶, unweighted sample.

Note: Scale = 1 (slight constraint) to 4 (serious constraint).

Under both current law and the draft law, fixed-term contracts can be used to staff “temporary activities” for a period that is necessary for the completion of the activity. Temporary activities include the following:

- Substitution of a worker temporarily unable to perform the task
- Tasks requiring an unusual increase in production, as well as seasonal activities
- Tasks not included in the permanent activities of the employer
- Discrete projects of a temporary nature, including plant repairs and construction projects performed under contract to the state

Workers under the fixed-term contract are entitled to a different form of severance compensation than permanent workers. If an employer terminates fixed-term contract

¹⁶ Panel sample of manufacturing firms survey conducted jointly by the CTA and World Bank in 2002 and by CTA and University of Copenhagen in 2006.

prematurely it must pay the worker for the unused time in the contract. Annex 1 contains further details.

Firms are making increasing use of fixed-term contracts. A recent survey shows that large enterprises already have 25 percent of their workforce on such contracts (figure 1). The larger the firm, the use greater the use of fixed-term contracts.¹⁷ Overall, however, the number of workers on fixed-term contracts remains a minority of total workers, even in the larger firms, indicating that the level of compliance with the law is substantial.

The political and economic conditions which shape the effect of reform on employment

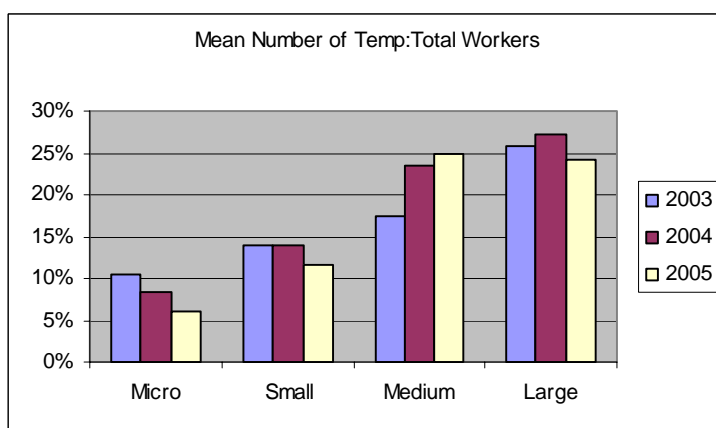
Specific conditions in Mozambique determine the degree to which the proposed reform can be expected to raise employment the private enterprise sector. Those conditions are reviewed here. Conditions are graded according to whether their employment effect is likely to be significant, moderate, or limited. We then

reverse the analysis in section 4.3, taking current conditions as given, and rank the provisions of the draft law in terms of their likely impact on employment. The data bases we are using to conduct these analyses—the CEMPRE data base and the panel survey of manufacturing enterprises—are both new surveys in Mozambique.¹⁸ As a result, the quality of the data in some areas is poor, so conclusions may be difficult to reach at this time.

Conditions likely to maximize the reform’s effect on employment

Broad scope of reforms. As suggested by Brazil’s experience, limited reforms that fail to address one or more of the bottlenecks reducing labor demand (such as the legal regime governing labor relations) are unlikely to have a significant impact on employment. In Mozambique, the proposed reforms are substantial and would not require further steps (such as ratification in collective-bargaining agreements) before taking effect. In addition, the initial steps in the system of conflict resolution would be substantially simplified.

Figure 1 Temporary workers as a share of total workers, by firm size, 2006



Source: CTA/DNEAP/University of Copenhagen, 2006 (see footnote 17)

¹⁷ Only seven enterprises in the sample employ more than 300 workers.

¹⁸ At the time of preparation of this note, the labor force survey was not yet available for analysis. The new labor force survey, should increase the data available for analysis of labor and economic growth issues in Mozambique.

Low capital intensity of production (capital/labor ratio). Mozambique's capital/labor ratio is very low (table 3). Intensive use of labor is a common practice in micro and small enterprises. Medium-size firms have only half the capital per worker as large firms. The country's overall capital/labor ratio should allow even large firms to add labor fairly cheaply. As a result, the lowering of labor costs expected from passage of the draft law should create an incentive for firms to decrease the capital/labor ratio even further in the short run, and to finance expansion in the medium term, which would generate significant new employment.

Table 3 Capital/ labor ratio by industry in Mozambique, 2001

Industry	Capital labor ratio
Food	1.8
Wood and furniture	1.05
Textiles	0.38
Metal	0.98

Source: CTA/World Bank 2003 (see footnote 17)

Diversified market structure (competition in the goods markets). The level of firm concentration in Mozambique is low, indicating the presence

Table 4 Product diversity of Mozambican firms, 2002 and 2006

Percent	2002	2006	Average
One product	11.1	34.9	23.0
2–5 products	47.6	59.5	53.6
More than 5 products	37.3	3.2	20.2
Omitted	4.0	2.4	3.2
Total	100.0	100.0	

Source: CTA/DNEAP/University of Copenhagen 2006 (see footnote 17)

of competition in the domestic market. Firms that export participate in world trade, and thus face significant competition. Both of these factors suggest that firms would be unlikely to keep as profits, rather than to reinvest, the windfall resulting from lower labor costs (table 4).

Investor perceptions. As noted earlier, domestic investors perceive that labor regulation is a growing obstacle to enterprise growth. The average perception for all firms is that labor regulations are still only a moderate constraint, but for larger firms they are of greater concern. In 2006, most the enterprises with fewer than 50 workers believed labor regulations to be at worst a minor obstacle to firm operation and growth, whereas firms with 50 or more workers were more likely to take a gloomier view (table 5). Changing the regulatory regime should give investors in large-scale manufacturing subsectors a better perception of the Mozambican environment. New investment in large-scale production should raise employment substantially (from a low base though).

Table 5 Labor regulation as an obstacle to operation and growth as perceived by firms, 2006

Number of employees	No obstacle	Significant obstacle	Total
0–9	67	33	100
10–49	44	56	100
50–299	19	81	100
>300	14	86	100
Total	39	61	100

Source: CTA/DNEAP/University of Copenhagen 2006. (see footnote 17)

Note: The sample of firms is not nationally representative.

Conditions likely to moderate the effect of reform on employment

Size of formal sector. As noted above, Mozambique’s private enterprise sector is limited, so in the aggregate even a major expansion in investment would not produce many new jobs. Because nearly 80 percent of the country’s enterprises are found in Maputo province (table 6), the employment effect of the proposed labor reform is expected to be regionally concentrated.

Table 6 Concentration of firms by location, 2002

Location	Firm units		Workers in service	
	Number	Percent	Number	Percent
Maputo Province and Maputo City	11,578	36.5	173,133	55.6
Manica and Sofala	7,705	24.3	31,393	13
Gaza	3,154	9.9	22,644	7.3
Nampula	2,505	7.9	17,993	5.8
Other provinces	6,793	21.4	66,105	21.2
Total	31,735	100	311,268	100

Source: INE 2002.

Cost structure. Labor represented about 25 percent of the total cost of goods sold in the manufacturing sector in Mozambique in 2003 (Eifert and others 2005a). Indirect costs, including energy, transport, and other non-inputs, total about 33 percent. This high percentage of indirect cost, a result of poor and unreliable infrastructure, is higher than the African average for indirect costs, which is 20–30 percent, which suggests that indirect costs are the biggest burden for enterprises in Mozambique (Eifert and others 2005b). Even if labor-law reforms reduce labor costs by 20 percent, total costs would fall by just 5 percent. The paramount importance of infrastructure improvements does not mean that lower average labor costs would have no impact as all. For firms that export, lower labor costs have to translate into at least a marginal increase the rate of return on capital, so they should affect investors that have a choice of locations.

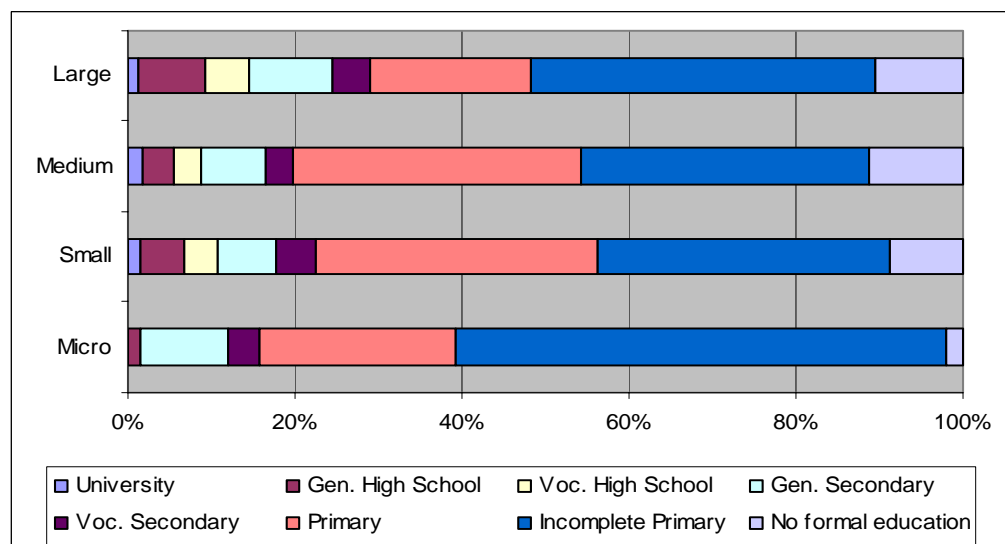
Where labor costs are already competitive, improvements in other aspects of labor regulation can affect the bottom line positively.¹⁹ For example, seasonality is important for some Mozambican firms (for example, in tourism and agro-processing); for these firms, more flexibility to hire and fire workers may be even more important than wage levels.

Compliance. If compliance with the current law is poor, changes cannot be expected to have much impact on employment. Although firms appear to be complying with the law in their use of fixed-term contracts, we have little evidence about overall compliance. The fact that large firms are more likely than smaller firms to see the current regulations as an obstacle suggests that the smaller firms may not be bothering to comply with those regulations. If that is true, then liberalizing the rules for these enterprises may not make much difference. With regard to fixed-term contracts, firms still face limits on the number of hours that may be worked and on the type of work that may be done under such contracts.

Labor supply. Roughly 50 percent of the employees of Mozambique's large firms are unskilled (figure 2). This is good news to the extent it indicates healthy demand for the type of labor that Mozambique has in greatest supply. (By contrast, about a third of managers at large firms in 2006 had some university-level education.) If growth in the private enterprise sector occurs mostly in low-tech areas, the country's labor supply should be ample. The three cities in which most of Mozambique's firms are located have a large workforce in the informal sector who would be willing to take formal sector jobs. Yet new investors still might encounter shortages of skilled labor. Only 16 percent of informal workers in Maputo Province have more than a primary education. Nationally, the figure is 5 percent (table 7). If the supply of qualified labor is very low, the ample supply of unskilled labor may not be enough to attract investors, especially those that make use of higher levels of technology.

¹⁹ We suspect that the costs of inflexibility and unpredictability are not included in labor costs, but show up elsewhere, for example, in investors' reluctance to invest in lines of business that require flexible working hours.

Figure 2 Educational background of workers in the private enterprise sector, by firm size, 2006



Source: CTA/DNEAP/University of Copenhagen 2006. (see footnote 17)

Table 7 Education of urban workers aged 15 and older, by sector, 2002

Education Level	Formal (national)	Formal (Maputo Province)	Informal (national)	Informal (Maputo Province)
No education, or literate	17.2	24.5	50.4	26.8
Primary education	48.0	57.0	44.8	56.2
Secondary education	28.0	14.7	4.3	13.6
Technical training	5.0	2.8	0.5	2.4
Tertiary	1.8	1.0	0.0	1.0
Total	100	100	100	100

Source: Authors' calculation based on IAF 2002/3.

Note: This table refers to the highest completed educational level.

Conditions likely to prevent the reform from raising employment

Labor inspections. Nontransparent labor inspections often are perceived as a significant constraint to enterprise formation and development, one that firms take into account when assessing the risks posed by business environment. Labor inspections are not transparent in Mozambique in part because inspectors are granted wide discretion in the timing of inspections. Inspectors also receive part of the fine imposed as a bonus, an added incentive for imposing fines. Changes in the labor law would not address these issues; complementary reforms would be needed.

Expected impact of the draft law given current conditions

Economic conditions in Mozambique are such that a positive employment impact could be expected from reform of the country's labor regime, but which aspects of the proposed changes in the law are likely to have the greatest impact on employment? The expected impact of key provisions of the draft law are summarized in table 8. Our survey data do not tell us which aspects of the current labor regime are most important to investors, but, as suggested by our review of recent international experience, the institutional changes proposed in the draft law would seem to be good candidates. A more efficient system of dispute resolution would reduce both cost and risk especially important for larger firms, which have the worst perception of the current labor regime.

Table 8 Projected employment impact of key provisions of the draft law

Provision of draft law	Expected effect on employment
Flexibility	
Fixed-term contracts	<i>Significant impact.</i> Firms already use these contracts, but extension of the time limit will allow employers to keep fixed-term workers employed longer; especially beneficial for small firms (who can use the contracts without limit) and start-ups.
Length of work week	<i>No impact.</i>
Temporary agencies	<i>Moderate impact.</i> The option of obtaining manpower from temporary agencies increases flexibility in labor management and reduces labor costs.
Notice period	<i>Significant impact.</i> The significant reduction in the notice period required before termination increases firing flexibility, putting Mozambique in a better competitive position.
Contracting foreign workers	<i>Limited impact.</i> The simplification of entry into the country is not a major change from the previous provision.
Reduction in labor costs	
Severance pay for dismissal without cause and layoffs for economic reasons.	<i>Moderate impact.</i> This is one of the major changes in the law, and it affects an area where Mozambique is an outlier among direct competitors. Since investors' perception of Mozambique's labor regime has worsened since 2002, this change could have a positive impact, although severance pay will remain high even if the draft law is enacted.
Annual leave (vacation)	<i>Limited impact.</i> The leave period would remain essentially the same. Reductions in the draft law affect only workers employed for less than two years.
Other leave (sick leave, family leave, etc.)	<i>Limited impact.</i> New limits on absences should reduce workplace absenteeism, but should not have a significant impact on job creation.
Institutional changes	
Dispute resolution (mediation)	<i>Significant impact.</i> Conflict mediation and the creation of extrajudicial mediation mechanisms will simplify and shorten dispute resolution, reducing uncertainty and management costs.
Collective bargaining	<i>Limited impact.</i>
Deadline for asserting worker's rights	<i>Moderate impact.</i> This measure reduces the firm's obligations and thus reduces risk. Like the item above, this provision will be more significant for large enterprises, since small and medium enterprises do not perceive labor regulations as a major impediment.
Strikes in duty-free zones	<i>Limited impact.</i> The proposal to classify strikes in duty-free zones with strikes affecting essential services and activities offers workers in duty-free zones a limited amount of new bargaining power, as currently they are forbidden to strike.

The proposed reductions in severance pay and in the length of the notice period required before termination should have a moderate impact on labor costs. In theory, such changes should encourage a major increase in employment in the medium term, as firms invest in riskier

activities and in activities that require hiring flexibility (for example, to respond to seasonal or market cycles). The changes proposed in unscheduled leave allow firms to plan their workload more efficiently..

Fixed-term contracts give firms much more flexibility to adjust the size of their workforce. Therefore, the proposed increase in the degree to which small and medium-size firms can use such contracts is expected to have a significant positive effect on employment. Indeed, to avoid severance costs, firms may make growing use of temporary workers hired through temporary agencies established under the new law.

In sum, available evidence suggests that the proposed reforms should result in modest increase in firm profits, especially in those firms which need flexibility in hiring and firing owing to the nature of their business. Economic analysis indicates that this should encourage firms to invest and increase employment in the medium term. Uncertainties on this outcome stem from the lack of evidence on the importance of these as the binding constraint versus other factors in the labor market, such as the problem of the labor inspection program or the skill deficit.

Competitiveness and the *Doing Business* ratings

Economies perform better when laws are respected, property rights are secure, taxes and fees are predictable, and contracts can be enforced—in short, where the business climate is good. Improving Mozambique’s business climate, and thus its international competitiveness, is one reason for the proposed labor-law reform, as specified in Mozambique’s poverty reduction plan. (PARPA). Since 2000, the World Bank has ranked the business climate in the countries of the world in a publication entitled *Doing Business*.²⁰ *Doing Business* measures the impact on business of each country’s laws and regulations using 10 indicators of regulatory climate. Countries are assessed and compared not only against each indicator, but also against an aggregate of all 10. One of the indicators (“Employing Workers”) measures the ease of hiring and firing workers.

Although *Doing Business* is one of the World Bank’s most popular publications, the application of its methodology to low-income countries has been criticized. Blanchet (2006), using cross-country data to examine the explanatory power of the *Doing Business* indicators, finds that a country’s general score (ranking) explains little of the variance in macroeconomic variables between countries, such as the rate of growth of GDP per capita, rates of foreign direct investment, investment rates, and the human development index.²¹ The subindicator for ease of hiring and firing did not explain any of the changes in any variable (it was not significant). The

²⁰ An Internet version of *Doing Business* is available at: <http://www.doingbusiness.org>.

²¹ The level of significance was higher for the human development index, indicating a possible relationship between poverty and business climate.

relationship between the hiring and firing subindicator and employment outcomes in African countries has not been studied so it is unclear if the indicator on its own has any predictive power in terms of outcomes such as employment or poverty reduction.

Blanchet argues that composite indicators can be misleading. Using a similar set of composite indicators, Gregoir et Manuel (2003) find that reweighting can produce important changes in ranking, implying that the ranking obtained by using composite indicators, as in *Doing Business*, may be less a reflection of reality and more an artifact of the weights assigned to various indicators. As the indicator “Employing workers” (on the rigidity of hiring and firing), is a simple arithmetic average index, it is subject to exactly this problem, and therefore any changes should be interpreted with particular care. Finally, the authors of *Doing Business* have themselves stated that using their indicators on ease of hiring and firing workers to justify a relaxation of labor regulations may constitute a misuse of the data (Bakvis 2006).

When interpreting the *Doing Business* results for Mozambique, the following aspects of the methodology should be taken into account:

- The standard company is defined as a manufacturing company that has operated for 20 years and employs 200 workers—a very rare entity in the low-income countries of Sub-Saharan Africa. Many firms in Mozambique are start-ups or small businesses who would, under the proposals, have the right to use fixed term contracts extensively. By making these assumptions, the methodology does not pick-up this major change.
- A standard worker is defined as a man who (i) has worked for 20 years in the same company; (ii) has a full-time, permanent employment contract; (iii) earns the median wage for the country; (iv) works as a laborer; and (v) is not a member of a trade union. As a result, the index item “cost of severance” thus overestimates the extent of severance costs the average Mozambican firm would have to pay the average worker.
- In addition, the *Doing Business* indicators do not include any information on corruption or bribes, which are also relevant in assessing the regulatory climate of many countries in Africa.

Despite doubts about the applicability of the *Doing Business* methodology to low-income countries, the rankings appear to affect investors’ perceptions.²² To determine whether the proposed changes in Mozambique’s labor law would make its labor market more flexible relative to those of other African countries, we compared the actual *Doing Business* results (based on the current law) with a hypothetical set of results based on the changes proposed in the draft law (annex 2). The indicator that measures the difficulty of hiring workers dropped from the

²² *Doing Business* is one of the bestselling books the World Bank produces.

published level of 83 to 67 (the higher the indicator, the more rigid the system), because the maximum length of a fixed-term contract in the draft law is six years, rather than the four years permitted by the current law. The indicators measuring the difficulty of dismissing workers and the rigidity of working hours remained unchanged. The overall indicator of employment rigidity—the arithmetic average of the three subindicators—fell from 54 to 49. The indicator of the cost of dismissing a worker dropped from 143 to 84, thanks to substantial reduction in the indemnities payable upon termination.

Can such changes be expected to affect Mozambique’s competitiveness in the African context? Table 9 reports Mozambique’s rank among 37 countries in Sub-Saharan Africa on each of the *Doing Business* indicators under the current law and draft law. In the overall employment rigidity index, the draft law would bring Mozambique from 19th position to 17th position among the 37 countries, signaling to investors that the country’s Mozambique was slightly less rigid and thus somewhat more attractive to foreign investment.

Table 9 Position of Mozambique among 37 Sub-Saharan African countries for various Doing Business indicators

Current position and simulation of position under draft law

Index	Current law	Draft law
Overall employment rigidity	19	17
Difficulty of hiring	30 ^a	24 ^b
Work hours rigidity	9 ^c	9 ^c
Difficulty of firing	4 ^d	4 ^d
Costs of firing	35	33

Source: Doing Business. *Note:* The higher the position, the more rigid the labor market. a. Tied with one country b. Tied with four countries c. Tied with 15 countries d. Tied with seven countries

We conducted the same simulation using only Mozambique’s immediate neighbors. Botswana, Lesotho, Malawi, Mauritius, South Africa, Tanzania, Zambia, and Zimbabwe can be regarded Mozambique’s direct regional competitors in attracting foreign investment (table 10). Although the draft law would improve the indicators, especially dismissal costs, and move Mozambique up from eighth to seventh place, its labor market would remain one of the most rigid in the region.

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Table 10 *Doing Business* indicators for Mozambique and eight neighboring countries

Current position and simulation with draft law

Index	Lesotho	Malawi	Mauritius	Mozambique		South Africa	Tanzania	Zambia	Zimbabwe
				Current law	Draft law				
Rigidity of employment	42	21	37	54	49	52	69	10	24
Difficulty of hiring	56	22	0	83	67	56	67	0	11
Rigidity of hours	60	20	60	60	60	40	80	20	40
Difficulty of firing	10	20	50	20	20	60	60	10	20
Firing costs (weeks of wages)	47	90	15.2	143	84	37.5	38.4	176	29.2

Source: *Doing Business*. Note: The higher the score, the more rigid the labor market.

Competitiveness is a multi-faceted concept, involving much more than labor regulations. It involves many other policy areas, such as logistics, the time and cost of transactions with the government, skills of the labor force, the potential for local adaptation, the structure of other factor markets, etc. It is unrealistic to expect one change, such as a new labor law, to have a dramatic effect. And even in the area of labor market flexibility, the *Doing Business* indicator does not capture many of the changes which have been proposed by the Government. Bearing these caveats in mind, the conclusion of this analysis is that although the proposed changes to the law are substantial in the Mozambican context, according to the only available global ranking, Mozambique's labor market would remain rigid even if the changes contained in the draft law are implemented.

5 POVERTY AND SOCIAL IMPACT

Poverty

The government's overall goal in reforming the country's labor legislation is to increase the incomes of the poorest households by increasing employment opportunities. We predict that over the PARPA period (until 2010), the reforms could indeed increase employment. But what would be the linkages between greater employment and poverty reduction? Two channels can be identified: (a) the direct effect of employment creation and (b) the indirect effect produced by linkages from employment and growth in the formal sector back to the agricultural sector and nonagricultural informal sectors.

Analysis of data from the IAF²³ (reveal that in Mozambique households headed by a wage earner are less likely to be poor than those headed by a casual worker, a self-employed person, or a farmer—only 40 percent of such households are poor (Fox and others 2005). Households headed by a wage earner are also overwhelmingly urban (85 percent), as most employment in the private enterprises sector is located in three cities: Maputo, Beira, and Nampula.. Overall, the private enterprise sector is a small fraction of total employment, numbering only 300,000 workers in a labor force of 8.5 million. Therefore, we can expect that the boost in employment stemming reform of the country's labor law will have a direct positive effect on poverty in those three cities, but not elsewhere around Mozambique, except to the extent that urban wage-earners send money home to their villages of origin.

Experience in other African countries shows that when wage employment in the private enterprise sector expands, so too do the earnings of informal businesses in that location. This effect is produced through increased demand for informal-sector goods and services from urban households enjoying higher earnings from formal sector employment.²⁴ In Tanzania in the late 1990s, for example, informal sector employment and earnings grew with the expansion of formal sector employment; this tandem growth had a strong effect on poverty. Where informal sector output and employment expanded without concurrent expansion of formal sector employment, there was little or no increase in income and very limited poverty reduction (World Bank 2006). Other transmission channels are possible as well. In Mozambique between 1996 and 2002, growth in informal sector employment and earnings allowed agriculture to shed labor (through migration of workers into nonagricultural activity), increasing agricultural productivity and incomes.

²³ IAF (*Inquérito aos Agregados Familiares*) is a nationally representative household survey on employment and consumption in Mozambique conducted by the national statistical agency.

²⁴ It is very difficult to trace the linkages between the formal sector and the informal sector. We do not know, for example, if the linkages are on the production side or the consumption side, but the nature of the expansion of the informal sector (primarily small-scale services) suggests that the linkage occurs on the consumption side.

In sum, depending on how other sectors of the economy perform, an increase in employment in the private enterprise sector (as a share of the labor force) may contribute to poverty reduction over the next 5–10 years in the large urban areas. These households will be the winners in the reform, especially those which actually get the new jobs created. But the reforms can not be expected to have an immediate or even short run impact – indeed as discussed in the next section, the short run impact could be negative.

Social impact - potential losers in the reform

Despite the rosy prediction for the medium term, not everyone stands to win from the reform. The potential winners are those who would not otherwise get jobs; the losers are those who presently have jobs but can expect to see their total compensation reduced through a reduction in benefits, the most significant being the reduction in leave and severance pay. For long-tenure employees the draft law proposes no reduction in leave, but the reduction in severance pay is very large. For an employee with 10 years of service, for example, severance pay would fall from 15 months to 9.2 months. Nevertheless, the severance provisions of the draft law, and its other provisions, are consistent with the International Labour Organization's Convention on Termination of Employment (annex 3)

The intent behind the decrease in severance pay is to encourage employers to take the risk of employing more workers. The design of the proposed law will achieve the opposite effect in the short run—that is soon after the legislation would come into force, if firms react by shedding workers. In the 2002 enterprise survey, about one-third of responding firms asserted that they had more workers than they wanted. Foreign-owned firms were 2.5 times more likely to have a large workforce, and formerly state-owned firms were much more likely to report a larger than optimal workforce.²⁵ It is possible that such firms would use the large reduction in severance pay to shed long-tenure workers. The resulting layoffs in large firms could be serious, because long-tenure workers would be expected to have higher salaries, so the impact on their households would be large. A worst-case scenario might involve as much as 10 percent of the labor force in the sector, or about 30,000 layoffs.²⁶

The draft law does not include transitional provisions, so the changes would take effect immediately. The standard way of preventing this type of shock is to include transition provisions, which phase in the provisions of the law. This creates a transition period to allow workers to adjust. Transition provisions would be especially important for the severance pay

²⁵ This question was not repeated in the 2006 questionnaire.

²⁶ We do not have enough information to predict firms' responses, so we do not know what firms would do if the draft law were enacted. However, we assume that many large firms would lay off workers, because they reported being overstaffed in the 2002 enterprise survey. About 43 percent of all employees in the private enterprise sector work in large firms on permanent contracts (table 2). Assuming firms might lay-off 25% their permanent workers, we arrive at the "educated guess" that 10% (that is, 25% of 43%) of the formal sector labor force might be laid-off.

rights accrued under superseded employment contracts. A recent analysis of developing-country experiences documented several cases in which workers' rights were protected following restructuring and privatization (World Bank 2004). For example:

- In Tanzania and Nepal workers were guaranteed continuity in their terms of employment after privatization.
- In Malaysia, employers were prohibited from modifying workers' terms of service for five years.

Transition provisions reduce the social costs associated with introduction of the new law. They can be justified in other ways as well. Investors in firms recently privatized or recently acquired presumably understood and accepted the terms of the labor contract at the time they acquired the firm.²⁷ Indeed, the cost of the labor contract would have been reflected in the selling price of the firm. Not providing a transition for workers of long tenure (for example, 10 years or more) has the effect of creating a windfall gain for the current owner of the firm at the expense of workers and their families.²⁸ This is particularly true of large firms and formerly public companies.

New employees who are offered fixed-term contracts instead of permanent jobs may also be considered losers. Because the draft law would keep severance pay relatively high, Mozambique has, in effect, chosen to increase employment, but possibly a higher share of which would be temporary over perhaps less employment, but more permanent employment, if the provisions in the proposed legislation become law. This result has been observed in other countries with strict permanent employee regimes but lax regulations (or lots of loopholes) on the creation of temporary jobs. Once the draft law is enacted, it will be important to monitor its effects not only on income, but also on worker security.

²⁷ Even under the draft law, severance costs are high. For example, a worker with 16 years of service and dismissed for economic reasons would be entitled to 320 days of severance pay.

²⁸ This argument does not apply to the grandfathering of other provisions, such as annual leave, notice, and so on.

6 CONCLUSIONS

This report assessed the principal legislative changes proposed in the draft labor law which was pending before the Mozambican parliament in the fall of 2006. Those changes include provisions relating to hiring and firing workers, severance pay and other indemnities related to dismissal, types of work contracts, and institutions for the resolution of labor-related disputes. Based on an analysis of international experience and current conditions in Mozambique, we projected the extent to which the proposed changes might serve to increase competitiveness, investment, output, and employment in Mozambique's private enterprise sector.

Generally speaking, the changes proposed in the draft law, if enacted, would make the labor market more flexible at a time when private firms, especially the larger ones, perceive labor regulation to be a major obstacle to expansion. The changes would come at a time of overall economic expansion and after complementary measures to remove or reduce other major obstacles. However, even though the draft law would improve the functioning of the labor market, Mozambique would remain one of the least flexible countries in the region.

The importance of reforming Mozambique's labor law is widely recognized. At the same time, it is recognized that the pending legislation has only limited potential to promote investment, competitiveness, and new employment. Nor could the new law be expected to make a deep dent in poverty. Mozambique will have to continue to focus policy attention on the range of factors that have allowed the country to grow rapidly and reduce poverty over the past decade. In addition, the spirit of the labor reform will need to be carried through in the implementing decrees and regulations.

We have flagged here the risk of negative social consequences, including increased poverty, if the law is enacted without transition provisions. This is because firms may take advantage of the reduced severance pay to restructure their own labor force. This problem is solvable.

Once the new law has been implemented, an evaluation of its impact, relevance, and efficiency should be conducted. Monitoring and evaluation are too often neglected, despite their importance (World Bank 2004). Evaluation can reduce risk and provide valuable guidance for future action. The framework for the necessary policy-focused research should be put in place before any new law actually takes effect so that changes brought about by the reform can be assessed from the start.

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JOB CREATION IN MOZAMBIQUE

Annex 1 Comparison of provisions of current labor law and proposed changes

Subject	Current law	Draft law
Fixed-term contracts		
Length	2 years, renewable once, for a total of 4 years. Article 9	2 years, renewable twice, for a total of 6 years. Article 42
Exceptions	None	Small (up to 10 workers) and medium-size firms (11–100) may use fixed-term contracts up to their tenth year of operation. Article 42
Severance pay when employment is terminated by employer		
Termination of permanent employee for “economic” reasons (structural, technological, or market reasons)	45 days, for employees with 3–6 months of service 3 months, for employees with 6 months to 3 years of service 3 months for every two years of service, for employees with more than 3 years of service. Article 68	20 days per year of work Article 130
Termination of permanent employee for other reasons (indefinite term contract).	Twice the amount shown above unless employers can prove just cause Article 68	45 days per year of work Article 128
Compensation for termination of fixed-term contract	If before contract end date, worker is paid for the period between the termination of contract and end date in the contract. After contract end date, no severance pay is due. Article 68	No change Article 131
Notice of termination (all reasons)	90 days for employees with more than 1 year of service. Article 68	30 days Article 131
Severance pay when employment is terminated by employee or for cause		
Termination of permanent employee for cause	45 days, for employees with 3–6 months of service 3 months, for employees with 6 months to 3 years of service 3 months for every two years of service after the third year of service Article 68	45 days per year of service Article 128
Termination of fixed-term contract	If before contract end date, worker is paid for the period between the termination of contract and the end date of the contract. After contract end date, no severance pay is due. Article 68	No change Article 131
Advance notice	1 month and a half, if time of service is between 3 months and 3 years. 1 months for every two years if time of service exceeds 3 years. Article 67	7 days Article 128
Leave		
Annual leave (paid vacation), permanent employees	21 days in first year; 30 days in subsequent years. Article 39	1 day per month of work in first year 2 days per month of work in second year 30 days per year after third year Article 99
Annual leave, fixed-term employees	For service between 3 months and 1 year, 2 days per month. Article 39	For service between 3 months and 1 year, 1 day per month. Article 99
Other leave (sick leave, family leave, etc.)	6 days for wedding 6 days for death of spouse, parent, son/daughter, sibling, uncle, stepmother/father, stepson/daughter.	5 days for wedding 5 days for death of spouse, parent, son/daughter, sibling, grandparent, stepmother/father,

JOB CREATION IN MOZAMBIQUE

Annex 1 Comparison of provisions of current labor law and proposed changes

Subject	Current law	Draft law
	3 days for death of mother- or father-in-law, daughter- or son-in-law, grandparent, grandson/daughter, and brother-sister-in-law. 2 days—cousins, niece and nephew, only for first level of association. 5 days' notice (if possible) but no permission required, for mandatory exams, participation in cultural and athletic activities, illnesses, and accidents.	stepson/daughter. 2 days for death of mother- or father-in-law, uncle, cousin, niece/nephew, daughter- or son-in-law, grandson/daughter, and brother- sister-in-law. 2 days' notice (if possible) and employer permission for mandatory exams, participation in cultural and athletic activities, illnesses, and accidents must be authorized by employer.
	Article 43	Article 103
Dispute resolution		
Dispute resolution	Collective disputes resolved by mediation, arbitration, or courts. Mediation is voluntary. Article 116	Mandatory mediation by new, extrajudicial, licensed firms. If mediation fails, binding arbitration is required. The arbitration committee has 30 days from the day of the last hearing to provide a written decision. Article 184
Collective bargaining	Negotiation at the firm level in firms with more than 10 workers. Article 108	Negotiation in firms of all sizes. Article 166
Deadline for claiming worker's rights	Claims must be filed within 1 year. Article 13	Claims must be filed within 6 months. Article 69
Strike in export processing zones	No provision	Allowed, handled using rules governing strikes affecting essential services and activities. Article 206
Other provisions		
Work week	Maximum of 48 hours a week, maximum of 6 days. Employees may not work more than 100 extra hours per year and no more than 2 extra hours a day. Waivers granted in exceptional cases. Articles 28 and 33	Maximum 48 hours a week, 6 days a week on average over a 6-month period. Employees may not work more than 70 hours per trimester. They may not work extra hours in 2 consecutive semesters, or work more than 8 extra hours per week. They may not work more than 12 hours per day. Articles 85 and 90
Foreign workers	Requires authorization from Ministry of Labor Articles 170-171	Firm must report hiring of foreign workers to Ministry of Labor' Foreign workers may not exceed the following quotas: 5 % of total workers for large firms 8 % of total workers for medium-size firms. 10 % of total workers for small firms Article 31
Temporary agencies	No provision	Temporary agencies may supply workers to private firms under fixed-term contracts for commonly outsourced services, such as cleaning, security, catering, and maintenance. Article 79

JOB CREATION IN MOZAMBIQUE

Annex 2 Impact of draft law on *Doing Business* indicators

	Current law		Draft law	
	Answer	Count (score)	Answer (score)	Count (score)
Hiring and firing indicators (2005)				
Difficulty of hiring index		83		67
Can term contracts be used only for term tasks?	Yes	1	Yes	1
What is the maximum duration of term contracts? (in months)	48	0.5	72	0
What is the ratio of mandated minimum wage to the average value added per worker?	1.17	1	NA	1
Work hour rigidity index		60		60
Can the workweek extend to 50 hours for 2 months per year?	Yes	0	Yes	0
What is the maximum number of working days per week?	6	0	6	0
Are there restrictions on night work?	Yes	1	Yes	1
Are there restrictions on "weekly holiday" work?	Yes	1	Yes	1
What is the annual leave for an employee with 20 years of seniority? (in business days)	22	1	22	1
Difficulty of firing index		20		20
Is termination on the basis of redundancy legally authorized?	Yes	0	Yes	0
Must the employer notify a third party before dismissing one redundant employee?	Yes	1	Yes	1
Must the employer obtain an approval of a third party to dismiss one redundant worker?	No	0	No	0
Must the employer notify a third party prior to a collective dismissal?	Yes	1	Yes	1
Must the employer obtain an approval of a third party prior to a collective dismissal?	No	0	No	0
Does the law mandate retraining or replacement prior to dismissal?	No	0	No	0
Are there priority rules applying to dismissal or lay-offs?	No	0	No	0
Are there priority rules applying to re-employment?	No	0	No	0
Overall employment rigidity index		54		49
Other indicators				
What is the notice period for redundancy dismissal after 20 years of continuous employment?		90 days		30 days
What is the severance pay for redundancy dismissal after 20 years of employment? (months of salary)		30		18.5
Firing cost (weeks of salary)		143		84

Source: Doing Business indicators, <http://www.doingbusiness.org/ExploreTopics/HiringFiringWorkers/>

Note: Higher index numbers indicate greater rigidity of labor market.

Annex 3 Does Mozambique's draft labor law follow the ILO 158 Convention on Termination of Employment?

What the convention says

Conditions for fair dismissal

The employment of a worker shall not be terminated unless there is a valid reason for such termination connected with the capacity or conduct of the worker or based on the operational requirements of the undertaking, establishment or service.

Period of notice

A worker whose employment is to be terminated shall be entitled to a reasonable period of notice or compensation in lieu thereof, unless he is guilty of serious misconduct, that is, misconduct of such a nature that it would be unreasonable to require the employer to continue his employment during the notice period. Employers shall give a written notice to the competent authority when contemplating terminations for reasons of an economic, technological, structural or similar nature.

Severance pay

1. A worker whose employment has been terminated shall be entitled, in accordance with national law and practice, to-

- (a) a severance allowance or other separation benefits, the amount of which shall be based inter alia on length of service and the level of wages, and paid directly by the employer or by a fund constituted by employers' contributions; or
- (b) benefits from unemployment insurance or assistance or other forms of social security, such as old-age or invalidity benefits, under the normal conditions to which such benefits are subject; or
- (c) a combination of such allowance and benefits.

Dismissal procedures

When the employer contemplates terminations for reasons of an economic, technological, structural or similar nature, he shall notify, in accordance with national law and practice, the competent authority thereof as early as possible, giving relevant information, including a written statement of the reasons for the terminations, the number and categories of workers likely to be affected and the period over which the terminations are intended to be carried out.

Remedies for unjustified dismissal

Employee can appeal to a court, labor tribunal, or arbitration panel, and these bodies can order reinstatement or payment of adequate compensation.

Does the draft law measure up?

Yes. Just cause for dismissal is incompetence, criminal activity, or structural, technological or market reasons.

Yes. Workers must be given advance notice of termination.

Yes. Workers are entitled to severance pay based on their length of service.

Yes. Employer must notify authorities in writing.

Yes. Employers must demonstrate the reasons for dismissal, and workers may appeal to a court.

Note: Mozambique has not ratified the ILO 158 convention.