

## The Challenge of Employment Creation in G20 countries: policy options

### An ILO contribution

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#### *Introduction*

1. All G20 countries face a serious challenge of employment creation in the aftermath of the Great Recession. The immediate challenge is to strengthen currently weak recoveries while also increasing the rate of employment creation in the process. Unemployment had risen significantly as a result of the crisis and still remains above pre-crisis levels. Policies to accelerate the recovery in output and, more importantly, that in employment creation are thus a major priority.
2. Coupled with this is the problem of improving the quality of employment. In the emerging countries, a significant proportion of workers are in informal, precarious and low paid jobs. Another pressing problem is that of combating the substantial rise of youth unemployment that has occurred in most countries. The problem is particularly acute in high income countries where it is imperative to prevent the emergence of a 'lost generation' of youth whose employment prospects have deteriorated drastically in the wake of the great recession.
3. In April 2010 the G20 Employment and Labour Ministers adopted a set of recommendations that provide insightful policy guidance to countries both in the immediate aftermaths of the recent crisis as well as in tackling the more deep seated challenges of achieving high levels of employment.
4. The general challenge of employment creation in fact predates the crisis. In the high income countries within the group there been a general improvement in the employment situation in the decade before the crisis but the margin of change was small. Unemployment rates were still significantly above the levels of full employment that had prevailed up till the early 1970s. In addition in European countries there was a recognition that employment rates needed to be increased through strengthening the incentive to work relative to dependence on welfare benefits.
5. In the emerging countries there is mounting evidence that the rate of employment creation has declined in the decade preceding the crisis as compared to earlier decades. This was true even in countries such as India and China which had experienced exceptionally high rates of economic growth. The reasons for this phenomenon are still not fully understood; several factors, some linked to initial conditions and policies in particular countries and some global in nature are probably at play. This is part of a wider picture for the developing world as a whole where the high

rates of open unemployment began to emerge in a growing number of countries.<sup>1</sup> This had hitherto been considered an unlikely outcome given the low levels of income and the lack of social protection in developing countries. People simply could not afford to remain unemployed and had to eke out an existence through creating some form of improvised livelihood in the rural or informal sectors. They would be poor and underemployed but this was not supposed to show up as open unemployment.

6. These facts suggest that there is a strong case for seeking to do better in terms of employment creation in the global economy as a whole. This would require a widening of the scope of policy options that are considered for addressing the challenge of employment creation. In all countries, it would appear necessary to go beyond the current focus on labour, social protection, and skill development policies to examine ways in which development strategies, macroeconomic, and structural policies could be harnessed to support the goal of increasing the rate of productive employment creation.

### ***The employment challenge in emerging countries***

7. A useful benchmark for evaluating employment performance in developing and emerging countries is the Lewisian two-sector model of economic development. This posits that starting from a position of surplus labour in the low-productivity agricultural sector and a small high-productivity modern sector the optimal growth path would be one of rapid and labour-intensive growth in the latter. This would raise income and productivity while also progressively reduce the extent of surplus labour in the economy through high labour-absorption into the modern sector. The latter should occur because growth, in line with underlying comparative advantage, should be labour-intensive in a labour-abundant economy. Within this framework real wages should remain constant until a 'turning point' when the labour surplus is exhausted is reached. This condition would allow for rapid capital accumulation that would propel high growth in the modern sector.

### *East Asian experience*

8. The successful development experience of the East Asian newly industrialized countries (Republic of Korea, Taiwan- China and Singapore) in the 1960s and early 1970s is widely held to have been in line with the Lewisian framework. Rapid growth was spearheaded by the rapid growth of an export-oriented and labour-intensive manufacturing sector. Rapid growth in output was thus accompanied by rapid growth in employment. This led to the swift elimination of surplus labour and the raising of incomes and productivity in both the modern and traditional sectors thereafter.

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<sup>1</sup> ILO *General survey concerning employment instruments* (ILO, Geneva, 2010) pp127-134

9. It is important to note that such a strategy is also one that can combine high growth with greater equity. High growth in productive employment is a powerful means of spreading the benefits of growth widely. When combined with policies to simultaneously raise agricultural productivity (as was done through land reform and strong rural development policies in Japan, the Republic of Korea, and Taiwan, China) and to support the growth of small and medium enterprises the positive impact of growth on equity is further strengthened.

*Persistent informal employment*

10. Since then, very few other developing countries have managed to achieve this benign combination of rapid growth in both output and employment. What has transpired instead has been either low growth of both output and employment in the modern sector or high growth of output but low growth of employment. In both cases the outcome has been, in addition to the surprising emergence of high open unemployment, the persistence of low-productivity employment and underemployment in the rural and informal sectors. In many such cases the main source of employment growth has been in the urban informal sector, running counter to the growth dynamics required by the Lewesian model. Attention has been drawn to this phenomenon since the late 1990s in the emerging literature on jobless growth, or less starkly, on the decline in the employment-intensity of growth in a growing number of countries.<sup>2</sup>

*Low and high unemployment*

11. Table 1 shows the available data on unemployment levels in emerging G20 countries for the period between 1997 and 2007, the year before the onset of the great recession. It will be seen that apart from China and India, the unemployment rate is above 5 percent. In South Africa the rate has been well above 20 percent over the period while it has been above 10 percent in all except one year in Argentina. In both Indonesia and Turkey it has been above 9 percent for the last five years of the period between 1997 and 2007. These are very high levels of unemployment in relation to what has previously been assumed should be the norm for developing countries.

**Table 1 Unemployment Rate in Emerging G20 Countries 1997-2007**

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Argentina	14.9	12.8	14.1	15.0	18.3	17.9	16.1	12.6	10.6	10.1	8.5

<sup>2</sup> Rizwanul Islam *The Challenge of Jobless Growth in Developing Countries: An Analysis with Cross-country Data* (Bangladesh Institute of Development Studies, Occasional Paper No. 1, Dhaka, October, 2010)

Brazil	7.7	8.9	9.6	6.3	9.3	9.1	9.7	8.9	9.3	8.4	8.1
China	3.1	3.1	3.1	3.1	3.6	4.0	4.3	4.2	4.2	4.1	4.0
India	2.6	3.6		4.3	..	..	..	4.5	..	..	
Indonesia	4.7	5.5	6.3	6.1	8.1	9.1	9.5	9.9	11.2	10.3	9.1
Mexico	4.1	3.6	2.5	2.6	2.5	2.9	3.0	3.7	3.5	3.2	3.4
South Africa	n.a.	n.a.	n.a.	26.7	29.5	30.5	31.2	26.2	26.7	26.5	23.0
Turkey	6.8	6.9	7.7	6.5	8.4	10.4	10.5	10.8	10.6	10.2	10.3

Source: ILO Key Indicators of the Labour Market Data Base, online

12. Table 2 shows the annual change in total employment in the same countries. It should be noted that these figures of total employment constitute only a partial indicator of how well countries are performing in terms of employment creation. This is because they comprise increases in both productive employment in the modern sector and low-productivity employment growth in the informal sector. Thus a rise in total employment that merely reflects an increase in distress employment in the informal sector would not necessarily be an indicator of success in productive employment creation. Unfortunately the data necessary to distinguish between the two types of employment growth are scarce. Bearing this limitation in mind, it is still worth noting that Table 2 does show that in some countries there is significant variation in the rate of increase of employment from year to year. In China the increase in total employment is steady but at a low level of about 1 percent per year.

**Table 2**                    **Growth in Total Employment in Emerging G20 Countries**  
(Percentage change over previous year)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Argentina	6.7	5.1	0.0	0.0	-2.4	-1.2	11.2	5.6	2.1	4.2	1.0
Brazil	2.1	1.0	2.0	n.a.	n.a.	3.7	1.5	5.6	3.1	2.4	1.7
China	1.3	1.1	1.1	1.0	1.3	0.9	0.9	1.0	0.8	0.8	0.8
Indonesia	1.6	0.7	1.3	1.1	1.1	0.9	-0.9	3.2	0.2	1.7	4.6
Mexico	n.a.	n.a.	n.a.	n.a.	0.3	2.4	0.7	3.3	0.7	3.5	1.7
South Africa	n.a.	n.a.	n.a.	n.a.	-8.5	1.8	3.6	1.7	6.0	4.1	3.1
Turkey	0.0	2.5	2.4	0.9	-0.5	-0.5	-1.4	3.3	0.9	1.4	-7.2

Source: ILO Key Indicators of the Labour Market Data Base

13. There are several interrelated grounds for concern over these developments. Most importantly, high unemployment and the persistence of underemployment inflict high personal and societal

costs. In addition it retards progress towards poverty reduction and the wider sharing of the benefits of development. It is also a contributing factor to the rise in income inequality that has been observed in a growing number of developing countries. From a growth perspective it represents the underutilisation of a potentially valuable economic resource and strongly suggests that opportunities for a more equitable pattern of growth have been foregone. It is also a cause for concern from the standpoint of macroeconomic policy since low employment growth increases the demands on fiscal resources for the reduction of poverty and the provision and extension of social protection.

14. It is also important to note that raising the overall rate of employment growth is a prerequisite for improving the overall quality of employment and achieving decent work for all. In particular a high rate of growth in productive employment would offer expanding opportunities for workers in low productivity employment to move into better jobs. This would be the most effective means of countering the trend towards an increase in informal and precarious employment. It would also make a substantial contribution to the goal of extending social protection to all since modern sector jobs, in contrast to those in the informal sector, typically provide adequate social protection. Nevertheless, this does not obviate the need for complementary policies directed at raising productivity in agricultural and informal sectors and at extending social protection to workers in these sectors.
15. Before discussing a broader array of policy options that could be considered to improve upon past employment performance it would be useful to briefly review how broader economic policies may have contributed to relatively poor employment performance in a few emerging G20 countries where the relevant literature is available.

#### *Employment in India*

16. India is a striking case where in spite of an impressive acceleration of growth of GDP and output in the organized sector, employment in the latter has stagnated. 'Total private and public sector employment in the organized manufacturing sector has been stagnant for more than two decades, hovering between 6.0 and 6.4 million during 1981-2001 and then declining to 5.6 million in 2006. Thus the acceleration in real GDP growth since 1980-81 is not reflected in trends of employment in the organized sector.'<sup>3</sup> Capital-intensity in organized sector manufacturing industries increased significantly. The real capital stock per worker in 2004 was three times higher than in 1993.<sup>4</sup>

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<sup>3</sup> .N. Srinivasan 'Employment and India's development and reforms' *Journal of Comparative Economics* 38 (2010) 82-100

<sup>4</sup> Planning Commission *Towards Faster and More Inclusive Growth* (Government of India, 2006)

Various reasons have been advanced for these adverse developments. One view is that the strict employment protection laws that apply to only the organized sector has deterred hiring by firms in that sector and also made the choice of capital-intensive techniques of production more attractive.

17. Another view is that the 'lock-in effects of the past development strategy of assigning a key role to capital intensive industrialization still prevails in spite of substantial liberalization.<sup>5</sup> In spite of a decline since liberalization the share of public investment in total investments in the organized sector was still 25 percent in 2007-08 and may be crowding out private investment since it is largely funded by public sector borrowing.<sup>6</sup> The past industrialization strategy had also included the policy of reserving a set of consumer goods for production exclusively by labour-intensive small-scale industry. This was intended as the employment-generation arm of the industrialization strategy. However, the policy resulted in allowing many inefficient units to survive and pre-empt more efficient large firms from exploiting India's comparative advantage in labour-intensive goods in both domestic and world markets.<sup>7</sup> The lingering effects of this policy can also be detected in the fact that there is a 'missing middle' in the Indian industrial structure that is characterised by extreme dualism between a large-scale and a low-productivity small-scale sector.<sup>8</sup> This is seen to have retarded the emergence of more labour-intensive firms in the organized sector.
18. While the preceding view sees incomplete liberalization as a problem, others have seen the liberalization policies themselves as a major cause of low employment growth.<sup>9</sup> One view is that the increase in income inequality brought about by liberalization, coupled with the expansion of consumer finance, has shifted the pattern of domestic demand towards consumer durables and other products that are produced by capital-intensive industries.<sup>10</sup> Another is that the liberalization of FDI inflows has increased the import-intensity of the manufacturing sector and reduced domestic linkages within it. Another point that has been made is that financial liberalization has lowered the cost of capital and has hence made capital-intensive technologies more attractive.

#### *Employment in South Africa*

19. Turning to the case of South Africa, it should first be noted that it has had one of the highest rates of open unemployment in the developing world and that this has persisted since the end of

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<sup>5</sup> T. N. Srinivasan op.cit.

<sup>6</sup> Ibid.

<sup>7</sup> Ibid.

<sup>8</sup> Dipak Mazumdar *The Employment Problem in India and the Phenomenon of the Missing Middle* Paper for the Canadian Economic Conference 2008, Vancouver.

<sup>9</sup> Jayati Ghosh and C.P. Chandrasekhar *Economic Growth and employment generation in India: Old problems and new paradoxes*.

<sup>10</sup> K. P. Kannan 'Growth sans employment: A quarter century of jobless growth in India's organised manufacturing' *Economic and Political Weekly* Vol XLIV No.10 2009

Apartheid. As in the case of India the growth of employment in the modern sector has been extremely low in spite of a moderate growth rate in output and capital intensity has been increasing. 'A final trend worth emphasising is capital deepening. The process of substituting has been particularly marked in tradeable activities (including manufacturing)' <sup>11</sup>

20. As in the case of India various explanations have been advanced for the poor employment performance in South Africa. One on which most are agreed is that the residential patterns imposed under Apartheid is an important part of the explanation for South Africa's exceptionally high level of unemployment. <sup>12</sup>The system of Bantustans created a labour market that was highly segmented geographically. In addition labour mobility was further restricted by the system of pass laws. With the end of Apartheid legal restraints to labour mobility were removed and there was a huge surge in the number of job seekers. But the geographical constraints in terms of a residential pattern divorced from, and with poor transport links to areas where employment was to be found, was a severe obstacle to job-matching. In addition, the settlement pattern under Apartheid had also retarded the growth of an urban informal sector that is an important factor in keeping open unemployment low in most other developing countries. This continues to exert an influence that is reflected in the fact that informal sector employment is still relatively low.
21. Another explanation that has been advanced for the poor employment performance is that a non-competitive exchange rate deterred investments in labour-intensive and export-oriented manufacturing industries. Industrial policy also favoured capital-intensive industries. <sup>13</sup> This meant that insufficient new modern sector employment was being created when there were significant job losses in import-substitution industries as a result of trade liberalization. The industrial policy stance also foreclosed the seizing of the growing opportunities to participate in the rapidly expanding global production system in manufacturing in the same way that several Asian countries have successfully done. It has also been argued that another legacy of apartheid, the neglect of education for the black population, has resulted in the current problem of poor quality education and a shortage of skilled labour. At the same time trade and investment liberalization is raising the demand for skills through the increasing introduction of skill and capital-intensive production techniques by foreign as well as local firms.

### *Employment in China*

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<sup>11</sup> Dani Rodrik 'Understanding South Africa's Economic Puzzles' *Economics of Transition* Volume 16 Issue 4 October 2008

<sup>12</sup> Ibid.

<sup>13</sup> Rodrik (2008) op.cot.

22. The overriding aim of China's development strategy was to maximise the rate of economic growth. In this it succeeded spectacularly. In the process it also achieved a dramatic reduction in poverty. Yet the achievement in terms of employment creation was far less impressive. Net employment creation in the modern sector was low in spite of very high rates of growth in output and exports. In part this outcome was a reflection of the significant job losses that occurred in the process of restructuring State Owned Enterprises. At the outset of the reform process the SOE sector had significant underemployment or disguised unemployment. However, even if we separate out this dampening effect of SOE job losses on total employment growth, the employment elasticity of output growth in the new manufacturing industries was still exceptionally low.<sup>14</sup>
23. The main reason for this was that the growth maximization strategy took the form of maximizing the rate of savings and investment. A key enabling factor was the exceptionally high rate of domestic saving in both the household and corporate sectors.<sup>15</sup> High household savings were largely the result of the slow development of a comprehensive social protection system to take the place of the system that had prevailed under Communism. The precautionary motive to save for contingencies such as unemployment, illness as well as for investments in education was thus very strong.<sup>16</sup> At the same time corporate savings were also very high due to the lack of alternative mechanisms for financing investment projects. The financial system was dominated by state-owned banks that provided capital at low real interest rates to favoured firms.<sup>17</sup> In addition there were subsidies on land and energy to enterprises. The combination of cheap capital and subsidies ensured very high levels of profits which were largely reinvested. It should also be noted that cheap capital also favoured the choice of capital-intensive techniques of production.<sup>18</sup>

*Employment and economic policy: a comprehensive approach*

24. The upshot of this strategy was, not surprisingly, a highly capital-intensive growth path with a low rate of employment creation. This growth path also generated growing income inequalities driven by a fall in the share of wages in the functional distribution of income, a rise in wage inequality and growing rural-urban and regional income gaps.<sup>19</sup> At the same time real wages increased only modestly until recently and the share of household consumption in GDP was extraordinarily low.

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<sup>14</sup> Jayati Ghosh 'Jobless Growth in China' *Frontline* Volume 24 Issue 07 April 2007

<sup>15</sup> Eswar S. Prasad *Rebalancing Growth in China* (National Bureau of Economic Research, Working Paper 15169, July 2009)

<sup>16</sup> *Ibid.*

<sup>17</sup> *Ibid.*

<sup>18</sup> *Ibid.*

<sup>19</sup> A. R. Khan *An Evaluation of China's Experience in Poverty Reduction in the light of Successful Methods Elsewhere* presentation at the Poverty Reduction and Development Forum, Beijing, 16-17 October 2010.



25. The above review of country experiences suggests that employment outcomes are heavily influenced by general economic policies such as the choice of an overall development strategy, industrial policy, the functioning of financial systems and monetary policy, public investment policies, and the pace at which economic reforms are implemented. The goal of increasing productive employment creation is thus unlikely to be achieved through focussing on labour market and social policies alone. A more comprehensive policy approach is clearly required.
26. Such an approach is in fact in keeping with what the ILO has long advocated. It is in fact incorporated in ILO convention No 122 on Employment Policy adopted in 1964.<sup>20</sup> This Convention has been ratified by a large number of G20 countries. It would be apposite to recall that the Convention calls ratifying States to commit themselves to attain the objective of full, productive and freely chosen employment and to make the best possible effort to achieve and maintain full employment. This includes ensuring that macroeconomic, trade, investment and industrial promotion policies take into account the objective of full employment and that they mutually support it.
27. In this context it is interesting to note that there is growing advocacy of precisely such an approach in both the academic literature and the publications of international organizations.

*Mutually supportive employment and growth policies*

28. One important strand of this new thinking is an improved recognition of the mutually supportive roles of employment promotion and growth policies. Employment growth is conventionally seen as an automatic outcome of economic growth. On this view the best means of dealing with the employment issue is to focus on the maximization of economic growth. Yet we have seen there is no guarantee this will deliver adequate employment growth. This is because different patterns of growth yield different rates of employment creation. Thus to the extent that policies can choose between alternative growth paths there should be a bias towards a more employment-intensive growth path. But conventional policy has been wary of exploring this dimension of choice since there is a widely held presumption that there is a substantial conflict between the maximization of employment and output growth.

*The experience of the 1950s and 1960s*

29. In contrast to this, the new thinking emphasises the fact that there are in fact important synergies between a higher level of employment growth and the attainment of higher growth in output. A higher level of employment supports growth through generating a higher level of effective

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<sup>20</sup> Employment Policy Convention, 1964 (No.122)

demand.<sup>21</sup>This positive effect on growth would be amplified if real wages are allowed to rise in line with the growth in labour productivity. This was in fact a central element in the model of high growth with full employment that was pursued by the high-income countries in the 'Golden Age' of capitalism that spanned the period from the end of World War II to 1973.<sup>22</sup>Government policies fostered a high rate of capital accumulation which generated high growth in both employment and productivity. This was combined with strong tripartite institutions that, inter alia, ensured that real wages rose in line with productivity growth. This generated a virtuous circle between rising effective demand, continued incentives to further capital accumulation, and further rises in employment, productivity and wages.

30. In the context of developing countries this effective demand effect is also vital for sustaining a high level of investment since it raises the inducement to invest.<sup>23</sup>The force of this argument is increased when we recall that the low growth in both employment and real wages associated with past policies have generated substantial problems of growing income and wage inequalities and in cases have not even delivered a high and sustained rate of economic growth.

#### *Domestic demand as a source of growth*

31. This consideration has of course also gained considerable currency during and in the aftermath of the global economic crisis. Policies to sustain effective demand were crucial for staving off a Great Depression and promoting recovery. There is also the fact that from the standpoint of developing countries there is less scope for relying on external demand from the advanced countries given the slow recovery in these countries and the need for rebalancing in deficit countries especially in the U.S. , hitherto the largest market for developing country exports. Although there will be partial compensation for this in the form of rapid growth of South-South trade, the fact remains that many developing countries will have to look more towards domestic demand as a source of growth.<sup>24</sup>

#### *Expanding social protection coverage*

32. Where domestic demand has been repressed through keeping real wages below productivity growth then there is scope for increasing domestic demand through upward adjustments in wages. Similarly, necessary increases in social spending such as the extension of social protection and of access to health and education will also contribute to an increase in domestic demand. An increase in social spending will also reduce the need for precautionary savings and boost household

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<sup>21</sup> UNCTAD *Trade and Development Report 2010* (Geneva, 2010)

<sup>22</sup> Ajit Singh ' Historical Examination of the Golden Age of Full Employment in Western Europe' in Arestis, P and McCombie, J *Missing Links in the Unemployment Relationships* ( Palgrave Macmillan, Basingstoke, 2009)

<sup>23</sup> UNCTAD op.cit.

<sup>24</sup> Ibid.

consumption through this route. In turn a rise in domestic demand would also make a contribution to raising the rate of output and employment growth.

*Broader macroeconomic policy objectives*

33. Planning for this shift towards domestic demand will also be the occasion to consider new ways of making development strategy more supportive of a higher rate of employment creation. One set of proposals argue that the objectives of macroeconomic policies should be broadened beyond their current focus on inflation targeting and ensuring fiscal balance.<sup>25</sup> The critique of this policy stance is that this has often led to over-restrictive macroeconomic policies that have also been, perversely, pro- instead of counter-cyclical. Especially in the context of liberalized capital flows, real interest rates have been kept high to the detriment of investment, growth and employment creation. Public investments with high potential social returns have also often been unnecessarily restrained by fiscal conservatism.

*Avoiding exchange rate volatility*

34. In addition exchange rate policies have often not been supportive of employment growth. Exchange rate volatility deters investment through the uncertainty that it generates. Abrupt devaluations such as those under structural adjustment programmes have also resulted in severe economic contractions, large losses in employment and sharp declines in real wages. In addition over-valued exchange rates caused by capital inflows induced by financial liberalization have deterred productive investments in the tradeable sector and the growth of labour-intensive exports. Prolonged over-valuation of the exchange rate also tends to increase the capital-intensity of production since capital goods are typically imported. For all these reasons it has been argued that maintaining a stable and competitive exchange rate is an important part of any policy package for supporting employment growth.<sup>26</sup>
35. It is also important to note that the problem of maintaining a stable and competitive exchange rate is closely linked to the issue of capital account liberalization and short-term capital inflows. Volatility in short-term inflows has posed a problem not only for the management of exchange rates but has also been responsible for diverting capital into fuelling asset bubbles. Much of this represents unproductive and speculative use of resources that displaces productive real investment, the prime requirement for sustainable growth in output and employment. Such activity also increases the risk of financial crises that have caused devastating setbacks in development in

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<sup>25</sup> Deepak Nayyar ' The Financial Crisis, the Great Recession, and the Developing World ' *Global Policy* Volume 2 Issue 1 January 2011

<sup>26</sup> R. Frankel *Real Exchange Rate and Employment in Argentina, Brazil, Chile and Mexico* Paper prepared for the G24, August 2004

affected countries. From this perspective, therefore, the issue of reform of the global financial system to achieve greater stability is important for the growth and employment creation prospects of emerging and developing countries.

36. The alternative policy stance that has been proposed is that employment creation should be installed as an important co-objective of macroeconomic policies. This had indeed been the norm in most industrialised countries during the 'Golden Age' of full employment. Including employment as an objective would open a new agenda beyond the current preoccupation with short-term macroeconomic stabilization. It will be necessary to also consider ways in which macroeconomic policy could be more supportive of economic growth and employment creation.

#### *Monetary and fiscal policy*

37. A key issue would be how private fixed capital formation can be stimulated, especially in sectors that are either employment-intensive or have large employment multipliers. With respect to monetary policy this will require an examination of questions such as whether real interest rates could be lowered, whether the exchange rate is being maintained at a competitive level, and whether short-term capital inflows are having a detrimental impact on growth and employment creation. On the fiscal policy side it will be necessary to consider whether the existing structure of fiscal incentives is consistent with the goal of increasing employment creation, including ways in which special incentives could be extended to sectors that can contribute most to boosting employment creation. It will also be necessary to consider ways in which income inequality could be reduced given the fact that rising inequalities had been associated with a shift in demand away from labour-intensive goods. In addition, public investments in infrastructure and social protection need to be given high priority.

#### *Industrial policies*

38. Structural policies will then need to be aligned with this broader agenda for macroeconomic policy. Industrial policy in particular has a potentially important role to play in overcoming often severe market failure in developing countries.<sup>27</sup> A major problem is that the incentives for entrepreneurs to enter into new lines of activity are typically weak. This arises from the fact that successful pioneers will see their returns eroded by subsequent entrants who do not have to bear the same risk because these activities have now been demonstrated to be profitable. To overcome this problem it will be necessary for governments to promote, including through subsidies, pioneering entry into new activities. Industrial policy will also need to consider possible measures such as

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<sup>27</sup> R. Hausmann and D. Rodrik "Economic Development as self-discovery" in *Journal of Development Economics*, 2003, Vol. 72 pp603-633 and D. Rodrik *Doomed to choose: Industrial policy as predicament* (mimeo. John F. Kennedy School of Government, Harvard University, Sept. 2006)

credit support to sectors that are likely to contribute significantly to employment creation, the strengthening of comprehensive support to small and medium enterprises, and reforms to increase the competitiveness of product markets.

*Labour market and social protection policies*

39. In countries that still have a significant dependence on primary commodity exports and have experienced slow growth in the manufacturing sector, industrial policies to kick-start rapid industrialization should also be given serious consideration. This arises from the fact that heavy dependence on primary commodity exports makes growth more volatile due to the price instability in global commodity markets. Growth is also likely to be lower because such countries are foregoing the potential benefits from industrial growth such as increasing returns to scale, knowledge spillovers, learning-by-doing, and stronger incentive to invest in human resource development. These benefits will also be increasing as countries upgrade their production structure towards higher value-added products in the industrialization process.
40. Active consideration should be given to comprehensive reforms to labour market and social protection policies that will support the employment creation strategy and advance the extension of social protection. In designing these policies it is important to exploit the potential synergies between employment and social protection policies. The development of sound institutions for collective bargaining and social dialogue also needs to be emphasised. Such institutions are indispensable for ensuring that reforms are efficient, equitable and widely supported. They can also be an important mechanism for reversing the trend towards increasing inequality and for supporting a shift in macroeconomic policies towards a greater reliance on domestic demand. It should also be noted that shifts in the structure of production (and consequently of employment) are an inherent part of a change in development strategy. The development of labour market policies to facilitate the redeployment of labour from declining to emerging economic activities is thus an important part of overall employment promotion policies.

*Raising the productivity of informal employment*

41. It is important to note, however, that mobilizing all feasible policy instruments to raise the overall rate of productive employment creation will not in itself be sufficient to solve the problem of low-productivity employment and underemployment in the rural and informal sectors. Although raising the rate of growth of productive employment is the most powerful means available to deal with the problem in a sustainable way, the process is likely to be a slow one. It therefore needs to be complemented by a second prong of employment policy that is directed at raising productivity and incomes in the rural and informal sectors. Such policies are also important from the standpoint of

the goal of poverty reduction and the attainment of the Millennium Development Goals to which all countries are committed.

42. In the case of agriculture and rural development there will be a need to focus on improving access to productive assets especially land, increase investments in infrastructure and in public services that support increased production such as agricultural extension, and credit. Similar action is required to support small and micro enterprises in the urban informal sector. It will also be important to consolidate initiatives to extend access to health and education services and social protection to the population dependent on the rural and informal sectors for their livelihoods.
43. Such social expenditures are important not only as instruments for the relief of poverty but are also essential for enhancing the ability of workers from these sectors to gain access to higher productivity jobs. In addition direct employment creation programmes are an important additional tool that can be deployed to provide work and incomes to the poor while also generating improvements in infrastructure and public amenities. It is important to recognise that such direct employment creation programmes and other programmes to support productive activities among the poor are also a strategic part of policies to extend social protection to all.<sup>28</sup> The greater the extent to which the incomes of the poor can be increased through such productive programmes the lesser would be the need for passive income support through means such as cash transfer programmes.
44. It is also worth underlining the fact that there is no simple solution to the problem of the informal sector through such means as regulatory reforms. While reforms to reduce the incentives for small and medium enterprises to remain informal have an important role to play, their potential impact is limited to the upper end of the wide array of productive units that constitute the informal sector. In other words it applies to small and medium enterprises on the margin between informality and formality but has little relevance to large numbers of individuals who are in precarious and low-productivity self-employment activities. For this group it is programmes to increase their productivity and incomes that are the paramount requirement. In this sense, therefore, such programmes are the prerequisite for a durable solution to the problem of the poor quality of employment in developing countries.
45. The ILO Declaration on Fundamental Principles and Rights at Work adopted in 1998 is also a highly relevant part of the solution to the problem of low quality employment in developing countries. Effective enforcement of the parts of this Declaration relating to child and forced labour will be

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<sup>28</sup> Eddy Lee *Employment and Social Protection in Developing countries: A Framework for Policy Integration* ( mimeo. ILO Geneva, 2010)

important for eliminating some of the most glaring forms of exploitation that still shamefully exist in the 21<sup>st</sup> century. At the same time the parts of the Declaration relating to Freedom of Association and the Right to Collective Bargaining are important tools for the empowerment of both wage and self-employed workers in the formal and informal sectors. Enabling workers to claim freely a fair share of the wealth which they have helped to generate, as stated in the Declaration, is a sound means of ensuring more balanced and sustainable economic growth.

#### *Emerging policy shifts*

46. It is interesting to note that the broader approach to employment policy that was discussed above is being adopted in some countries. The most notable example is South Africa which has recently unveiled a New Growth Path that puts the creation of decent work at the centre of its economic policies. The new growth strategy 'will be founded on a restructuring of the South African economy to improve its performance in terms of labour absorption as well as the composition and the rate of growth.'<sup>29</sup>
47. A wide range of policy instruments have been identified to achieve this. A key one is for the government to 'provide effective inducements to private investment in targeted areas principally by prioritising labour-absorbing activities for the provision of appropriate and cost effective infrastructure, regulatory interventions that effectively address market and state failure, measures to improve skill systems and in some cases subsidies to production and innovation.'<sup>30</sup> In terms of macroeconomic policy it is stated that 'the monetary policy stance will continue to support a more competitive exchange rate and reduced investment costs through lower real interest rates.'<sup>31</sup> The plan also aims to increase savings through discouraging unnecessary consumption by means such as introducing disincentives to 'high personal debt, especially luxury items and high-end property.'<sup>32</sup> Other proposed measures include 'targeted export promotion and other support for employment opportunities identified in the New Growth Path, particularly in agriculture, light industry and services.'<sup>33</sup> There will also be an important role for extensive social dialogue to ensure, inter alia, 'that wage moderation and measure to support competitiveness lead to a measurable increase in employment creation.'<sup>34</sup> There are also proposals to overcome the constraints posed to employment creation by the segmented settlement pattern inherited from the Apartheid era.

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<sup>29</sup> Government of South Africa *The New Growth Path: The Framework (2011)* p.1

<sup>30</sup> *Ibid.* p. 7

<sup>31</sup> *Ibid.* p.16

<sup>32</sup> *Ibid.* p. 27

<sup>33</sup> *Ibid.* p.24

<sup>34</sup> *Ibid.* p. 26

48. It will be thus seen that a very comprehensive approach to employment promotion is being launched. The package of policies spans macroeconomic, industrial and trade policies in addition to the traditional focus on labour market and social policies. It is likely that there will be important policy lessons to be learned by other developing countries from the outcomes of this policy experiment.
49. There have also been signs of a policy change in India where the Approach Paper to the 11<sup>th</sup> 5-year Plan 2007-12 stressed the importance of 'robust growth in organized sector. In other words a massive reversal is required from the negative employment growth during the last decade.'<sup>35</sup> It also highlighted the fact that 'measures would need to be taken in the 11<sup>th</sup> Plan to boost, in particular, labour intensive manufacturing sectors.'<sup>36</sup> The paper also notes that the fiscal incentives for corporate investment all encourage capital use and none relates to labour. It suggests that the incentives be restructured to include 'at least one simple employment-related incentive (e.g. a corporate tax deduction at a flat rate per worker based on the number of workers on permanent payroll).'<sup>37</sup>
50. In China there have been the beginnings of a rebalancing away from export-led growth towards a greater reliance on domestic demand. Measures to spur domestic demand include boosting employment, promoting the urbanisation process, readjusting income distribution, improving social security and raising consumer demand.<sup>38</sup> This is likely to raise overall employment growth once the short-run problems of shifting labour to new jobs in the non-tradeable sector are overcome. If the economic rebalancing also involves a fall in the savings rate from the very high levels of the past then the overall employment outcome is likely to be even more positive.<sup>39</sup>

### ***Employment policies in high income countries***

51. In contrast to the emerging countries, the high-income countries share a more settled body of policy views on the measures required to meet their employment challenges. Employment policy is regularly discussed within the ILO, the OECD, and in the case of the European countries, also within the European Union. The OECD formulated a Jobs Strategy in 1994 which was subsequently

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<sup>35</sup> Planning Commission, Government of India *Towards Faster and More Inclusive Growth* (November, 2006) p. 77

<sup>36</sup> *Ibid.* p. 77

<sup>37</sup> *Ibid.* p. 80

<sup>38</sup> Zhang Ping, Minister of National Development, in a speech to the China Development Forum 2011

<sup>39</sup> Kai Guo and Papa N'Diaye *Employment Effects of Rebalancing Growth in China* (IMF, Working Paper WP-09-169, August 2009)



updated in the form of the Restated Jobs Strategy in 2006.<sup>40</sup> Similarly the European Union adopted the Lisbon Strategy for Growth and Jobs in 2000.

### *Labour market policies*

52. There are broad similarities in these strategies in terms of their focus on increasing the employment rate through reforms to labour and social policies in order to make work more attractive as compared to remaining on social benefits. There is also a similar emphasis on education and training policies to increase the employability and adaptability of the workforce. A significant difference is seen in the central importance that the Lisbon Strategy attaches to innovation and increased competitiveness as the main driver of higher growth and employment creation. A key instrument for achieving this is increased spending on Research and Development and a target of devoting 3 percent of GDP for these expenditures was set. The rationale is that this stepped up R and D effort will produce new products and services to fuel both output and employment growth.
53. It is of interest to note that the central challenges of employment are both different and similar from what was discussed in the case of emerging countries. In the latter the central problem stems from the continuing dualistic structure of the economy and the consequent imperative to maximise the rate of growth of modern sector jobs in order to absorb a growing proportion of the labour into higher productivity jobs and hence escape from poverty. This is also the desired path to higher incomes and eventual convergence towards the living standards of the advanced countries. In contrast in the high-income countries employment policy challenges are linked to a changing sectoral composition of output and a rising and heterogeneous services sector, including on the backdrop of accelerated demographic change. The labour market is far more integrated and there is quasi universal access to social protection. Although the attainment of key objectives such as raising the employment rate is seen to depend mainly on labour market and social protection policies, these countries also need to find ways to make employment policy and macroeconomic policy mutually supportive. The argument made earlier on raising the priority given to employment in policy making, especially in broadening the objectives of macro-economic policy beyond inflation and fiscal balances, apply here as well. In short these countries need to define policy mixes that combine employment objectives as well as objectives of price stability and fiscal balances. Too often these objectives are seen in terms of tradeoffs, rather than as complementary and mutually supportive. Again the experience of the 1950s and 1960s is relevant here, when growth, productivity employment and wages were all moving in mutually compatible ways.

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<sup>40</sup> OECD *Boosting Jobs and Income-Policy Lessons from Reassessing the OECD Jobs Strategy* ( OECD, Paris, 2006

### *Hiring subsidies*

54. The current focus of policy is on engineering a quicker recovery in employment growth in the aftermath of the financial crisis. As of late 2010, there is less scope for macroeconomic stimulus given the shift towards fiscal consolidation so the focus has been on other measures to stimulate a higher demand for labour. A principal instrument is some form of temporary subsidy to hiring workers with the preferred option being a marginal employment subsidy to encourage new hiring.<sup>41</sup> In addition active labour market policies are being stepped up to prevent the emergence of long term detachment from the labour market as a result of the crisis. In countries that experienced a severe banking crisis measure are also being adopted to counteract the sharp contraction in bank lending to small enterprises.

### *Export promotion policies*

55. In countries with large trade deficits export promotion has become a priority both as a means for rebalancing the economy as well as for boosting employment creation. In this context global rebalancing involving a shift towards domestic demand in surplus countries is a significant influence on the prospects for employment growth in deficit countries. This process will involve structural shifts in employment that have to be facilitated by labour market policies in both sets of countries. A similar process of managing structural shifts in employment will also be required in countries where sectors such as construction and financial services which boomed prior to the crisis have faced severe retrenchment and have limited growth prospects in the medium-term. Another structural shift in employment that has received increased attention in the context of stimulus programmes in response to the crisis is the shift towards green jobs. This is seen as a source of future job growth as countries move towards a low-carbon economy.

56. In the aftermath of the crisis regional bodies have expressed no indications that there is any need to revise the basic settings of employment policy. A recent report to the European Commission on 'Medium-Term Employment Challenges' basically reaffirms the thrust of the Lisbon Strategy.<sup>42</sup> The OECD has reviewed the relative importance of the pillars of its Restated Jobs Strategy in the light of the crisis.

57. The employment challenge is thus defined in terms of how well countries do in implementing the agreed agenda of structural reforms in order to put in place the structural prerequisites for strong economic performance coupled with employment growth. The backdrop to this is the need to maintain competitiveness in the context of the resumption of rapid globalization, the continued

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<sup>41</sup> OECD *Employment Outlook 2010* (OECD, Paris, 2010)

<sup>42</sup> I. Begg, C. Erhel, and J. Mortensen *Medium-term Employment Challenges* Centre for European Policy Studies, 2010.

rise of emerging economies and a continuation of rapid technological change. It is appropriate to recall that the employment performance across high income countries varies significantly with persistent differences in the levels of the unemployment rate, before, during and after the recent crisis.

58. There appears to be less concern than in the recent past about the loss of jobs to developing countries through industrial relocation and the off-shoring of some service sector jobs. This may reflect a growing acceptance of the fact that the shift in manufacturing activity to emerging and developing countries will continue unabated. This probably accounts for the priority given to technological innovation and the development of high-level skills as a means of maintaining a leading role in the global economy.

#### *Competitiveness and unit labour costs*

59. In this context it is relevant to note that in addition to seeking to upgrade the structure of production towards higher productivity sectors in the face of increasing competition from emerging countries it is also important to align wages more closely to changes in productivity. For example, divergent trends in relative unit labour costs have been one of the underlying problems brought to the fore by the ongoing sovereign debt crisis on the Euro Zone.<sup>43</sup> Allowing wages to rise faster than increases in productivity courts the risk of a loss of competitiveness and painful subsequent adjustments through cuts in wages. Equally, however, a policy of wage compression in order to increase competitiveness entails costs in terms of a lower level of effective demand and an adverse shift in the functional distribution of income. These considerations underscore the importance of effective institutions of social dialogue and collective bargaining for ensuring stable growth in output and employment.

#### *Employment options for the Euro Zone*

60. The sovereign debt crisis in the Euro Zone has also highlighted the need for mechanisms for coordinating wage policy across countries in order to prevent the emergence of the misalignments in unit labour costs that emerged in the lead up to the crisis. Apart from helping to contain the emergence of macroeconomic imbalances, such a coordination mechanism will also serve to prevent the use of 'social dumping' as a tool for increasing a country's competitive position.<sup>44</sup> It is also relevant to note a high level of social protection in the form of employment protection laws, collective wage agreements, and unemployment insurance has played a significant role in

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<sup>43</sup> J. Filipe and U. Kumar 'Unit Labour Costs in the Eurozone: The competitiveness debate again' Working Paper No 651, Levy Economics Institute, February 2011

<sup>44</sup> Klaus Busch *European Economic Government and Wage Policy Coordination: The European Crisis Calls for Structural Reforms* (Friederich Ebert Stiftung, May 2010)

dampening the extent of contraction of effective demand in the aftermath of the financial crisis.<sup>45</sup> The problem of preventing social dumping from being used as a tool for increasing competitiveness is of course also of wider significance for the world economy as a whole.<sup>46</sup>

61. The adjustment required in highly indebted countries will inevitably involve significant social pain. But the extent of this pain can be mitigated if governments give high priority to employment and social justice in the design and implementation of adjustment programmes rather than focus exclusively on fiscal consolidation. All margins for manoeuvre to reduce the social cost of adjustment need to be explored.
62. For example a more gradual programme of fiscal consolidation that is still sufficiently credible to satisfy financial markets will clearly be preferable to one that involves abrupt and drastic cuts. Such an approach is also likely to reduce the risk of falling into a deflationary spiral since the 'impact multipliers for government spending on goods and services are usually quite low in normal circumstances but they become high during financial and banking crises'<sup>47</sup>In this context it is important not to overlook the fact that revitalizing growth is the ultimate objective of the adjustment process. As such adjustment programmes should also include strong measures to promote growth. Another example would be to maintain expenditures on active labour market and other programmes to boost employment. Such programmes are important not only for preventing a rise in long-term unemployment but also for facilitating the structural shifts in the economy that are required as part of the adjustment process. In addition ensuring that the burden of adjustment is fairly distributed across all income groups can do a great deal to lessen the hardship faced by the poor. This will also be important for building broad social support for the adjustment programme.

#### *Job polarization in services*

63. From the perspective of employment it has been observed that innovative and high-tech sectors are unlikely to generate much direct employment creation. But by driving overall growth they will stimulate employment growth in other sectors, particularly in services.<sup>48</sup> One reason for this is the elasticity of demand for services is very high (more than unitary) and thus there will be growing demand for services as incomes continue to rise in high-income countries. This effect becomes stronger when income inequality rises at the same time (as has occurred in many high-income countries) since high income households have a high demand for personal services.

<sup>45</sup> Paul De Grauwe *Flexibility is out : now we see rigidity's virtues* Centre for European Policy Studies, February 2009

<sup>46</sup> World Commission on the Social Dimension of Globalization *A Fair Globalization: Creating Opportunities for All* (ILO, Geneva, 2004)

<sup>47</sup> Giancarlo Corsetti *Fiscal consolidation as a policy to exit the global crises* in Richard Baldwin and Daniel Gros *Completing the Eurozone rescue: what more needs to be done* Centre for Economic Policy Studies, June 2010

<sup>48</sup> Christopher Pissarides *Lisbon five years later: what for European employment and growth?* (London School of Economics, LSE Research Online, March 2008)

64. Much of future employment growth is thus likely to come from service activities. This ongoing trend has given rise to concerns about the emerging problem of job polarization that has been observed in a growing number of high income countries.<sup>49</sup> An important underlying cause is believed to be the impact of technical progress, especially computerization, on the demand for different skills and tasks. Skill-Biased Technical Progress has increased the relative demand for skilled labour and has led to increasing inequality between the wages of skilled and unskilled labour. At the same time technical change has favoured non-routinized jobs over jobs which are largely routinized and can hence be replaced by computers. This has caused a fall in demand for middle-level jobs such as those in manufacturing and clerical services.<sup>50</sup> At the same time it has raised the demand for non-routinized low skilled service jobs such as transport and distribution, retail trade, community services and health and personal care. Such jobs are also immune from the threat of off-shoring. The result has been an increase in employment in both the high-skilled and low-skilled end of the labour market and a shrinking of middle-level jobs. It has also been argued that rising wage inequality has made it more attractive for women to enter the labour market and substitute market provided services for those previously self-provided at home such domestic work and child care.<sup>51</sup>
65. These inter-related problems of rising wage-inequality and job polarization demand a response in terms of both institutional and policy change. In terms of institutions these will need to adapt to the fact that many low-wage service jobs are temporary, part-time, and employ a high proportion of women. Employment security and social security arrangements have to be developed to provide adequate protection to workers in this sector of the labour market. Minimum wage policy and policies to facilitate the extent of unionisation will also be important. Since a significant proportion of these jobs are in the public sector, public sector employment and wage policies can also play a leading role in improving the quality of employment. Similarly, policies to improve the incentives to take up these jobs and to provide the supporting services to enable workers, especially women, to do so will remain a cornerstone of employment policy.

### **Conclusions**

66. In responding to the employment challenges that lie ahead it will be essential for policymakers to keep an open mind on the scope and combination of policies that may be required for achieving

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<sup>49</sup> Maarten Goos, Alan Manning, Anna Salomons 'Job Polarization in Europe' *American Economic Review Papers and Proceedings*, 99 (2)2009

<sup>50</sup> David H. Autor, and David Dorn *Inequality and Specialization: the growth of low-skill service jobs in the United States*. NBER Working Paper 15150, July 2009

<sup>51</sup> Pissarides op.cit.

this. Viable solutions are not likely to be found through an exclusive reliance on the old orthodoxies, based on a dichotomy between economic and social policies, which took hold in the pre-crisis period. The crisis has demonstrated that macroeconomic policies can have a large impact on employment, both when they go wrong and when they are deployed as the solution. Similarly, the crisis has shown that an exclusive reliance on policies directed at increasing market deregulation and a diminishing role for government is a highly risky path to follow. Some rebalancing is clearly required.

67. Against this background it is essential to reinstate employment as a major objective of macroeconomic policies. This will set a new agenda that will evoke creative responses from academics and policymakers on what the best policy packages and institutional arrangements should consist of in the light of this. Similarly, with employment as a major policy objective structural policies will be pushed to adapt creatively to this new reality. Labour market and social policies will also have to be viewed as a part of an overall economic and employment strategy. Finally, this entire set of policies to meet the employment challenge has to be skilfully orchestrated to ensure that inherent synergies between them are fully realised.

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