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## EMPLOYMENT CREATION, LABOR MARKETS AND GROWTH IN ASIA IN A GLOBAL ECONOMY

### Reforms for What?

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Abstract: This paper discusses several issues concerning the debate about the need to reform labor markets across Asia as part of the so-called second generation reform programs, viewed by many as a necessary condition to accelerate growth and to create employment in the region. It is argued that creating employment for those entering the labor market in the coming years is the most important challenge for most Asian developing countries. In the final analysis, unemployment and underemployment are the root cause of poverty. Therefore, though the objective of achieving a growth rate as high as possible is, and will continue being, important, governments in the region should seriously think about the achievement of *full employment*, not in the "Natural Rate" sense, as their prime objective. Labor market reforms might help, but they are very difficult to implement because the public associates them with reductions in benefits and firing. In any case, although some aspects of the labor markets of many developing countries should be reformed, to achieve full employment governments must look beyond piecemeal reforms in this market, and must think in terms of expansionary macroeconomic policies. This is of paramount importance in *wage-led* economies, i.e., those where an increase in the wage rate or in the labor share leads to increases in aggregate demand and employment. In these economies, however, labor-saving technical advances tend to create unemployment. The six-million dollar question of most developing countries is how to shift productivity gains to higher real wages and aggregate demand so as to achieve full employment.

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## EMPLOYMENT CREATION, LABOR MARKETS AND GROWTH IN ASIA IN A GLOBAL ECONOMY

### Reforms for What? For Full Employment !

“No society can surely be flourishing or happy, of which the far greater part of the members are poor and miserable”

Adam Smith, *The Wealth of Nations*

“Cutting wages means only the cutting of buying power and the curtailing of the home market ...most of the people of the country live on wages. The scale of their living - the rate of their wages – determines the prosperity of the country”

Henry Ford, 1922<sup>1</sup>

### 1. INTRODUCTION

Since the East Asian financial crisis erupted in 1997, most Asian countries in the region, have been immersed in a soul-searching exercise with a view to identifying what went wrong and which ultimately led to the financial crisis and to the slowdown in their GDP growth rates. In mainstream circles, the medicine recommended has been reform of almost everything. Countries not affected by the crisis, such as PRC and India, began undertaking much-needed reform programs years ago. They are still pushing for further reforms so as not to miss the train of the new economic order imposed by globalization. The objective is, ultimately, to try to attain growth rates as high as possible with a view to reducing poverty and catching up with the developed world. Growth is seen as the key to poverty-reduction and, ultimately, to the achievement of the *Millennium Development Goals*, and broad development. From the point of view of workers, one would hope for a growth regime that fostered both rapid real wage growth and low or declining unemployment. Recently, it has been observed that some Asian countries are achieving respectable rates of growth. However, as a consequence of their limited capacity to create jobs to match the increase in the labor supply, unemployment appears to be

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<sup>1</sup> As is well-known, one of Ford's “revolutions” was to double his workers' salary. In 1914, Ford offered to increase his employees' pay to \$5 a day. The day after the offer, more than 10,000 workers appeared at the gates of the Ford factories looking for jobs. According to Ford's human resources department, worker productivity went up by 51 percent in 1914. Absenteeism was reduced by half and workers became considerably more docile. However, Ford realized that doubling salaries was not enough to increase his workers' productivity. What mattered was whether workers were being paid twice as much as elsewhere.

increasing.<sup>2</sup> The question in every policymaker's mind is: *what sort of policies and institutional reforms should be implemented to achieve high and sustained growth and simultaneously generate enough employment?* And in particular: *do labor market policies hinder the creation of employment?*

One way or another developing countries have been asked (advised?) for a long time (more clearly since the 1980s) to reform (liberalize?) almost everything, à la Washington consensus:<sup>3</sup> trade, inward FDI, privatization, deregulation, property rights, tax reform, liberalization of interest rates, introduction of a competitive exchange rate, and fiscal discipline. This package could be labeled "first generation reforms." The three key underlying ideas are: (i) achieving macroeconomic discipline; (ii) putting in place a market economy; and (iii) opening to the world (at least with respect to trade and FDI). Extensions of this package in what could be called "second generation reforms" came later, and include labor market and institutional reforms. Other reforms being considered are: financial market reforms, education reforms, agriculture reforms, and reforms of the distribution system.<sup>4</sup>

In a nutshell, to become *more competitive* (the new buzzword), countries need to dismantle their trade barriers, abolish their legal monopolies, privatize their state-owned enterprises, and reduce overstaffing in their bloated bureaucracies. Reforms aim at achieving (or increasing) growth via efficiency gains. While these ideas have been accepted for quite some time by the developed countries (with different degrees), they are still sort of *anathema* to many developing countries. Many countries in this group have lived for a long time (with clear exceptions in Asia) in a world characterized by: (i) inflation; (ii) state-led industrialization; and (iii) import substitution.

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<sup>2</sup> I would not describe the situation as one of "jobless growth". Employments are indeed being created. The problem is that the influx of new workers into the labor market is so large that the economy cannot cope with it.

<sup>3</sup> The term Washington consensus was coined by John Williamson in 1989. It was presented as a reform agenda in the context of Latin America, encompassing: (i) fiscal discipline; (ii) reordering public expenditure priorities; (iii) tax reform; (iv) liberalization of interest rates; (v) implementation of a competitive exchange rate; (vi) trade liberalization; (vii) liberalization of inward foreign direct investment; (viii) privatization; (ix) deregulation; (x) property rights. On several occasions, John Williamson has complained that often his ideas have been misinterpreted because they have been taken to extremes (neoliberalism) that he never meant to, such as capital account liberalization, monetarism, supply-side economics, or a minimal state.

<sup>4</sup> In this vein, Ali (2003) has argued that in order to expand the Production Possibility Frontier in a world characterized by globalization, Asian countries must implement a broad reform package that addresses: (i) fiscal stability; (ii) financial sector problems; (iii) trade regime and exchange rates; (iv) labor market; and (v) education.

This paper argues that the objective of labor market, or any other, reforms in Asia should be the achievement of *full employment*. This objective will be achieved through the development of a labor market that is not only *well-functioning*, in the sense of efficient and fair, but also that is *inclusive*, in the sense that it provides employment opportunities. This will require finding a balance between labor flexibility and the implementation of a variety of policies to promote employment and social justice. This is because inequality fosters conflict, and the latter is costly to police and often precludes the cooperation needed for low-cost solutions to coordination problems. Since highly unequal societies are often incapable of or have little incentive to solve coordination problems, the result is a reduced capacity to attenuate market failures through public policy. Unemployment is a *collectively irrational outcome* (Bowles and Gintis 1995, p.410) that can be seen as the result of coordination failures. However, it must be pointed out that while some aspects of the labor market are in need of deep reform in a number of countries, perhaps inefficiencies in this market are not the binding constraint for faster growth and more employment. This is one of the most important challenges of the new millennium.

The rest of the paper is structured as follows. Section 2 summarizes the record of twenty years of reforms in developing countries in the context of globalization, technical change and intense competition. Section 3 discusses the nature of unemployment today and argues that the old Luddite argument, namely, that technical progress leads to unemployment is valid in the context of *wage-led* economies. Section 4 summarizes the so-called functions of the labor market, and offers a critical discussion of the neoclassical labor market model. Section 5 proposes full employment as the objective to pursue in the coming decades. Section 6 reviews the empirical evidence on the impact of labor market policies. The conclusion is that they cannot be blamed for the unemployment problem. Section 7 provides a summary and discussion labor market policies in Asia. Section 8 offers a brief discussion of urban and rural labor markets. Still today the most important feature of the labor market of most developing countries is their dualism. Section 9 discusses policies to promote employment. Section 10 concludes.

## **2. TWENTY YEARS OF REFORMS, GLOBALIZATION AND THE NEW WORLD ECONOMIC ORDER**

What does the record say about the success of the reforms in developing countries? Overall, results have disappointed. Although it is true that in some countries economic and social transformations over the last decade have put their economies on a higher and more sustainable growth path, in other cases these same transformations have led to higher unemployment, underemployment and inequality. A first reason that explains this undesired outcome is that a series of crises have occurred. Crisis avoidance was not emphasized as a key issue until the Mexican crisis of 1994 and the East Asian crisis of 1997-1998 occurred. Secondly, reforms were incomplete. As indicated above, labor market reforms, for example, were not part of the first generation reform package. It is clear now that a broad development strategy must integrate labor market issues with other factor and output market reforms and institutions. Indeed, reforming a distorted market will usually not lead to increased efficiency and growth. Opening up the economy to international trade is unlikely to attract significant investment if the physical infrastructure (e.g., roads and electric power), or the legal infrastructure (e.g., contract enforcement), are highly deficient.<sup>5</sup> Thirdly, the objective that underlay these reforms was, perhaps, excessively narrow. This consisted in accelerating growth without worsening income distribution. The record of the 1990s, however, is not too successful when it comes to poverty reduction and income distribution, across countries or within countries. If one regards poverty as an issue of human dignity, then it is imperative that we care about the distribution of income as a primary objective.<sup>6</sup>

The above, perhaps, does not call for a radical abandoning of the central ideas of the Washington consensus. What many developing countries have criticized is the fact that the Washington reform package, as initially stated by Williamson, was distorted and taken to the “extreme” by some by emphasizing issues such as capital account liberalization or supply-side economics, not included in the program (see footnote above). Likewise, many Western governments have used double standards when they have urged developing countries to liberalize while they keep trade restrictions on the specific

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<sup>5</sup> Likewise, the opening up of a product market to increase efficiency will generally have unsatisfactory results if existing laws and regulations make it very difficult to shed or relocate labor.

<sup>6</sup> Birdsall and de la Torre (2001) have proposed a program that aims to complement the Washington consensus by listing a set of reforms intended to *improve income distribution and reduce poverty* without reducing growth. These include: (i) an income floor for workers and middle-class households during slumps; (ii) greater public spending on preschools; (iii) anti-tax evasion efforts; (iv) better worker protection; (v) rural land reform; and (vi) improvements in public health.

commodities that developing countries have a comparative advantage in, and which they can export successfully. This does not mean, however, that developing countries have to close their economies and go back to import substitution and industrial policy.

What has changed during the last two decades so that reforms are being pushed today more vigorously than before? A series of events (e.g., economic crises) and changes in the way of thinking of academics and policymakers took place during the 1970s. Their impact materialized in the 1980s and 1990s. The result was the end of the *golden age of egalitarian economic policy* (Bowles and Gintis 1995, p.408), which had expanded the first three decades following WWII. During this period, the belief was that wage increases and the expansion of publicly funded social services and transfers would promote growth. Under this view, policies to promote high employment or to expand unemployment insurance commanded wide support from workers and even from employers. However, the scenario began changing in the 1980s (e.g., due to heightened international competition), and the process accelerated during the 1990s. Today we live in a world characterized by the interplay of three factors, namely, *globalization*, *technical change* and *competition* (ADB 2003). Any analysis of the current economic situation starts with a reference to globalization, and takes technical change and competitiveness as policy-making variables. It is in this context that reforms are being pushed across countries in a race for it seems that the future of many developing countries depends on how far and how fast they go about with these reforms, since they are presented as the solution to their problems (e.g., unemployment, insufficient growth).

To the above is must be added that three changes in the past decade have produced a huge global oversupply of labor (Polaski 2004). First, the end of the Cold War threw hundreds of millions of workers who belonged to non-market economies (mostly in Russia, the People's Republic of China (PRC), Eastern Europe, and even India) onto the global labor market. Second, to the above it must be added that the significant increase in new entrants into the labor force due to the demographic transition in many Asian countries has compounded the problem. Third, the interaction of *globalization*, rapid *technical progress*, and intense *competition* has turned a segmented worldwide labor market into a very integrated market that permits, for example, outsourcing of a large number of manufacturing and service jobs.

The problem is that this magnificent increase in the labor force has not been accompanied by a concomitant increase in capital for investment. The consequence is

that jitters are being felt all over world because the combination of these changes has led to the so-called “race to the bottom” argument, according to which globalization is forcing workers to compete to attract capital by accepting lower wages. The fear of most Asian countries (and indeed all over the world) is that the PRC and India, which have slowly but fully integrated themselves into the global production system during the last decade, have the capacity to absorb much of this limited pool of capital available, which reduces the capacity of other economies to generate new employment to absorb their increasing labor supplies. Moreover, in some cases, the same process is probably leading to relocation of firms from some Asian countries, particularly to the PRC. And given that this process began at large scale only in the 1990s, perhaps what we are witnessing now is just the tip of the iceberg. The problem is compounded by the fact that technological changes have increased the productivity of labor enormously. Perhaps in the long-run this will lead to higher wages and income; in the short-run, on the other hand, this has led to a disequilibrium in supply and demand in the global labor market (shortage of jobs created), and to unemployment.

The result was the shake in the belief that government redistributive policies and wage increases can promote full employment and economic growth. Moreover, “attention has shifted from the effect of egalitarian policies on aggregate demand to their effect on “competitiveness” which is to say on costs and productivity [...] and the growing focus on questions of wages and productivity under the general rubric of competitiveness has supported a near consensus that wage restraint and the limitation of social expenditures are necessary conditions for adequate economic performance. Society might still opt for egalitarian measures on moral grounds, many now believe, but at a cost leaving even the poor to suffer in the long run ” (Bowles and Gintis 1995, pp.409-410).

## **2.1 The Pros and Cons of Globalization**

Globalization can be defined as the process through which goods and services, capital, people, information and ideas flow across borders leading to greater integration of economies and societies (Agénor 2002). It is undeniable that globalization has brought a series of worldwide scale benefits, mostly through trade and finance. To name a few: (i) openness to FDI can contribute to growth by increasing the available amount of investment resources; (ii) openness to capital flows may increase opportunities for

portfolio risk diversification and consumption smoothing through borrowing and lending; (iii) increased access to the domestic financial system by foreign banks may raise the efficiency of the intermediation process between savers and borrowers, thereby lowering mark-up rates in the banking system; (iv) financial openness helps mitigate asymmetric information problems and can improve the opportunities for the poor to access the formal financial system; (v) openness to trade leads to static and dynamic gains. The former refer to the gains derived from the fact that productive resources tend to be reallocated toward activities where they are used more efficiently and away from rent-seeking activities. Dynamic gains occur derive from the fact that trade openness may facilitate the acquisition of new inputs, less expensive or higher quality intermediate goods. Likewise, openness to trade facilitates the transmission of ideas. Overall, there seems to be empirical evidence that suggests that countries that have opened themselves the most to trade during the last two decades have grown on average the fastest. On the other hand, the empirical evidence regarding the benefits associated with financial integration are less clear.

Despite the benefits of globalization via trade and financial integration, it is being widely recognized and accepted that the process of globalization entails significant risks, and potentially large economic and social costs that might last for quite some time. Consequently, concerns about the negative effects of globalization have led to a polarized debate. For example, openness to global capital markets has brought greater volatility to the domestic financial markets. Large reversals in short-term capital flows have led to several financial crises and to sharp increases in unemployment and poverty in the short-run. Likewise, trade liberalization has led in some countries to reduced demand for unskilled labor and lower real wages in the short-run. Since often developing countries suffer from low degree of inter-sectoral labor mobility, job losses and declines in income have led to higher poverty rates.

Theoretically, the argument can be made that, in the long-run, globalization is a beneficial process that increases society's welfare. Concerns refer to the impact of globalization in the short-run. For instance, trade reforms (e.g., tariff reduction) may lead to higher unemployment and greater poverty as a result of pervasive labor market distortions (e.g., low degree of wage flexibility and imperfect labor mobility across sectors). It is important to consider as well the possibility that globalization may have negative effects that last for a significant number of periods (long-run). For example, trade openness tends to reduce the market power of domestic firms and to increase

competitive pressures on them, eventually forcing the least efficient ones out of business. In the long-run, the country may well become more efficient, and this efficiency may translate into higher growth rates, higher employment and lower poverty rates. In the short-term, on the other hand, the presence of labor market rigidities (e.g., segmentation due to minimum wage legislation or wage-setting behavior by firms or trade unions, and imperfect mobility across sectors) may make difficult the reallocation of labor that a tariff reduction program entails. This effect may persist over time and unemployment and poverty may not decrease.

Likewise, some new trade theories emphasize the effects of scale economies and learning-by-doing. Countries that lag behind technologically, and that have an initial advantage in a “non-dynamic” sector can see their growth rate reduced due to openness. For these countries, there may be a period during which globalization may have a negative impact on growth, employment and poverty before any positive effects materialize. Under these circumstances, trade restrictions may accelerate growth.

Trade liberalization may also lead to higher unemployment and poverty by reducing the demand for unskilled labor and by worsening income distribution. Trade liberalization may induce the introduction of advanced technology, which requires skilled labor. This may occur because a fall in tariffs often translates into a fall in the cost of capital. If skilled labor and capital are complimentary, and unskilled labor and capital can be easily substituted, there would be an increase in the demand for skilled labor that would widen the wage gap between skilled and unskilled labor. And the decrease in unskilled labor demand will translate into an increase in unskilled labor unemployment.

Regarding financial integration, it is recognized that a high degree of financial openness may entail important costs, especially in countries with imprudent sovereign debt management, improperly sequenced capital account liberalization, and poorly regulated domestic financial systems (e.g., East Asian financial crisis). An important problem associated with financial openness is that access to world capital markets is asymmetric: developing countries are able to borrow in “good” times, whereas in “bad” times they tend to face credit constraints. This pro-cyclicality in the access to world capital markets may have a perverse effect and increase macroeconomic stability. Periods of prosperity attract large capital flows and encourage consumption and spending levels that might be unsustainable in the long-run, forcing countries to over-adjust to adverse shocks as a result of adverse capital reversals. When this happens, output contracts, and unemployment and poverty increase.

A different channel through which financial liberalization can have a negative impact is via penetration of the domestic financial system by foreign banks. While this increases the quality of financial services and reduces risks of domestic financial instability, foreign penetration is usually accompanied by a greater concentration of credit flows towards large firms producing tradables. In general, access to loans by relatively more labor-intensive small and medium-size firms, is reduced. This may lead to a reduction in activity on the part of these firms and lower demand for labor.

What the above mechanisms indicate is that trade and financial liberalization and integration should be accompanied by adequate reforms of the domestic financial system to minimize the adverse effects of volatility on output, employment and poverty.

Finally, with globalization in the picture, how much bargaining power does labor have? Workers are greatly exposed to the uncertainties that come along with globalization, in particular the fear of immiserization, and the possibility of unemployment. The main difference between the current period of globalization and the earlier ones is that, before, both labor and capital were mobile, while now, *financial capital* is more mobile while labor is substantially less mobile.<sup>7</sup> This has brought in uncertainty to labor and plenty of voices have been raised against globalization, especially as this relates to the labor market. This has two logical implications: (i) the burden sharing of negative shocks between labor and capital is most likely unequal, with labor bearing the largest burden, since capital could threaten to flee unless it receives the international rate of return plus a risk premium; and (ii) in a world with higher mobility of capital, labor will have to compete harder to attract capital, leading to lower wages and a “race to the bottom”.<sup>8</sup>

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<sup>7</sup> Physical capital is hardly mobile and investments that are already in place cannot credibly threaten to flee abroad. When we speak of the mobility of capital we mean financial claims. These are the ones that would not be renewed if their returns were threatened to fall below international rates.

<sup>8</sup> In a neoclassical world with capital mobility one would expect that capital flows to the regions where unit labor costs are lower. The wage rate would increase in the capital scarce (poorer) economy, and presumably the labor share would move concomitantly. But at the same time, the labor share would also tend to fall in societies where labor is less efficient to start with, since domestic capital could move elsewhere in search of higher returns. This second argument, more classical in nature, underlies the “race to the bottom” argument. If it is indeed the dominant one, capital mobility would induce a decrease in wages in societies dominated by rent-seeking behavior, like the Philippines. It is perfectly possible that capital has benefited from all the political turmoil in the Philippines during the last two decades as well as from the process of globalization.

### **3. THE UNEMPLOYMENT PROBLEM TODAY**

As indicated above, the economic and social transformations that many Asian developing countries have undergone over the last decade have led them to higher growth paths. But at the same time, these changes have led, in some cases, to higher unemployment and underemployment. The problem that seems to be arising is that the growth rate of output is not enough to absorb the growth of the labor force. Moreover, in some cases, some of the newly created jobs are poorly paid and have led to high inequalities and social exclusion. There exists the perception that low-wage jobs are being created in some sectors, most of them in services, such as hotel room cleaners, nursing assistants, data-entry clerks, hamburger flippers, secretaries, childcare workers, cashiers, and tellers.<sup>9</sup> These jobs are not coming from old firms that have not caught up yet with globalization and technological progress. On the contrary, these jobs are being created by efficient, technologically-sophisticated firms.

It is worth noting that this is not an entirely new phenomenon. In the early 1970s, several missions of the International Labor Organization analyzed the employment situation in developing countries, and concluded that despite high rates of economic growth and industrialization, overt unemployment and underemployment were very high, of the order of 20 percent of the urban labor force (Emmerij 1986). Moreover, unemployment had increased with the process of industrialization. High rates of unemployment in turn induced a diverging process of economic growth: the owners of capital and the owners of skills complementary to government-sponsored, capital intensive development were growing richer, but the owners of unskilled labor were not benefiting proportionately. Skilled and semiskilled workers who had been absorbed into modern industry had joined the middle class, while unemployed and underemployed workers in low-productivity sectors and in low-productivity enterprises were increasingly falling behind.

From a theoretical point of view, the discussion of why unemployment exists, its relation with wage increases, and in general how one thinks about labor markets, depends on the model one uses and on one's beliefs about how the labor market works. Some of the early fathers of economics (e.g., Adam Smith, Karl Marx) thought that egalitarian economic policies deserved credit; and that increases in real wages

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<sup>9</sup> In countries like the Philippines or India, call centers and software development are also part of this new phenomenon. However, these are not low-wage jobs relative to the wages paid in these countries.

might promote employment and stimulate economic growth. If wage increases induce higher levels of employment, then the economic interests of the employed will coincide with those of the unemployed. But not all schools of thought see the issue from the same point of view.

The neoclassical school of thought argues that increases in real wages will cause employment to decline. This is because the aggregate demand curve for labor is downward sloping. Wage increase lead to reductions in employment for two reasons: (i) higher wages induce firms to substitute other inputs for labor; (ii) higher wages entail cost increases, which induce buyers to shift suppliers. From a policy perspective, it is argued that a competitive market has an internal mechanism that makes it eliminate unemployment very quickly. This mechanism is the flexibility of wages. The actions of rational optimizing individuals ensure that the labor market clears by a flexible wage rate. Thus, existing unemployment is the result of workers refusing to accept the equilibrium wage rate determined by the demand and supply of labor. The policy implication is that the solution to unemployment is more competition and less government intervention in market processes by, for example, setting minimum wages or ensuring job security, or so long as unions do not drive up wages excessively. In competitive markets, the law of demand and supply ensures that eventually, in the long-run, the demand for labor will equal the supply –there will be no unemployment.

In this framework, wage and employment levels are determined in the labor market as the result of an optimization process that determines both simultaneously. Often one hears references and proposals for making labor markets more *dynamic*, *flexible*, *efficient*, and *less rigid*. Greater wage and labor market flexibility, the argument goes, encourages employment. This policy recommendation has its origin in the belief that labor markets work as they are depicted by classical and neoclassical theories. In this world, a profit-maximizing firm sets its marginal revenue equal to its marginal cost of production. If a firm hires labor in a perfectly competitive labor market, a certain money wage ( $w$ ) must be paid to each extra worker hired. The additional cost of hiring an extra unit of labor ( $\Delta L$ ) will be  $w\Delta L$ . The extra revenue generated by an additional worker is the extra output produced ( $\Delta Q$ ) multiplied by the output price ( $P$ ), that is,  $P\Delta Q$ . It pays for a profit-maximizing firm to hire labor as long as  $w\Delta L < P\Delta Q$ . To maximize profits requires the equality between the two, which implies that  $(\Delta Q / \Delta L) = (w / P)$ . In other words, a firm should hire labor until the marginal product of labor ( $\Delta Q / \Delta L$ ) equals the

real wage rate ( $w/P$ ). This leads to the well-known result that the demand for labor is an inverse function of the real wage rate: the lower the real wage the more labor will be profitably employed.

On the other hand, the supply of labor is a positive function of the real wage rate, indicating that at higher wage rates, people will be willing to work more hours. A rise in the real wage rate makes leisure more expensive in terms of forgone income and will tend to increase the supply of labor. Under these circumstances, the level of employment in equilibrium represents 'full employment', that is, all those members of the labor force who desire to work at the equilibrium real wage can do so. Classical full employment equilibrium is compatible with the existence of voluntary unemployment, but does not admit the possibility of involuntary unemployment. What is the most important policy prescription of this paradigm to eliminate unemployment?: real wages should be reduced by cutting the money wage rate. This is what the theoretical and policy literatures mean by *efficient* and *fair* (sometimes referred to as a *well-functioning*; this is elaborated upon below in the context of the discussion of the functions of the labor market) labor market (i.e., are wages equal to the marginal productivity of labor). This question is elaborated upon below. This is simply the tip of the iceberg. Modern theories take these arguments as their starting point and have refined and extended them, e.g., the concept of Natural Rate of Unemployment, the policy message of which is that the unemployment rate should not be allowed to fall below the natural rate. Consequently, macroeconomic policy is rigidly bound by an inflation constraint.<sup>10</sup>

The Keynesian model, on the other hand, denies that market economies have such 'automatic' mechanisms to eliminate unemployment due to the existence of rigidities and market failures. In sum, markets do not work like the simple demand and supply model and unemployment is a natural consequence. There is no invisible hand channeling self-interest into some social optimum. In particular, involuntary unemployment is likely to be a feature of the labor market if money wages are rigid. But Keynes argued that flexibility of nominal wages would be unlikely to generate powerful enough forces that could lead the economy to full employment. The policy implication is

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<sup>10</sup> This is defined as the unemployment rate consistent with a steady rate of inflation. This implies that prices and wages tend to accelerate when unemployment is below the so-called natural rate. The argument behind this theory is that if unemployment falls below the natural rate, inflation will increase; moreover, inflation will accelerate as long as unemployment remains below the natural rate.

that government well-designed intervention to achieve full-employment is necessary via fiscal and monetary policies.

A third theoretical position is that unemployment is functional to capitalism. In the Marxian version, capitalism creates a *reserve army*. Marx pointed out that capitalist production always coexists with noncapitalist production such as domestic labor and subsistence agriculture, and draws part of its labor supply from these noncapitalist sectors through migration and the mobilization of female and child labor. Marx viewed these sectors as reserve armies of labor. When a capitalist economy is growing rapidly enough so that the reserve army of unemployed is depleted, then workers will utilize their increased bargaining power to raise wages and shift the distribution of income in their favor. Profits are correspondingly squeezed. As a result, capitalists' animal spirits are dampened and they reduce investment spending. This then leads to a fall in job creation, higher unemployment, and a replenishment of the Reserve Army. In other words, the reserve army is the instrument capitalists use to prevent significant wage increases and thereby maintain profitability.<sup>11</sup>

### **3.1 Wage-Led Economies**

What is happening today? In very simple terms, the argument is as follows. As a matter of definition, one can think of employment ( $L$ ) as the ratio of output ( $Y$ ) to labor productivity ( $y=Y/L$ ), that is,  $L=Y/y$ . And in growth rates,  $\hat{L} = \hat{Y} - \hat{y}$ . Detractors of globalization argue that, given a rate of growth of output, if productivity increases as a consequence of technological progress, then employment must go down. Indeed, under these circumstances, more rapid productivity growth will diminish the growth of employment and compound the unemployment problem. The argument is that if the workforce becomes more efficient, then fewer workers will be needed. Defenders of globalization, on the other hand, argue that this argument does not consider what happens after productivity improves and allows the economy to expand and create new jobs. The classic mechanism enabling real per capita demand to rise in market economies has been growth in real wages in line with productivity increases. However, this is not a law and can break down. The empirical evidence indicates that increasing returns to scale and technological progress have produced an adverse combination.

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<sup>11</sup> At the microeconomic level, there is probably a connection between certain labor market policies and growth. Most likely some countries have implemented a series of policies that do not favor job creation. This could be the case of policies that prevent competition (Lewis 2004).

Indeed, a faster rate of technical change, if it does not lead to a fast growth of output, may actually lead to increasing unemployment. Under these circumstances, a faster growth of output does not require a proportionate growth of employment (the situation is such that the growth of output is too low to absorb all the growth in the labor force).<sup>12</sup> Even if wages do go up as productivity increases, the latter does not necessarily lead to higher output and employment.

As is well known, this possibility originated with the Luddite movement and David Ricardo. Ricardo (1821, p.392) argued that the opinion prevailing in “the labouring class, that the employment of machinery is frequently detrimental to their interests, is not founded on prejudice and error, but is conformable to the correct principles of political economy.”<sup>13</sup> Most contemporary and subsequent economists until today have disagreed with this view. However, Luddite arguments can be valid if an economy with less than full employment is *wage-led*, that is, if following an exogenous increase in the real wage or in the labor share consumer demand increases and so does overall demand. On the other hand, if the corresponding reduction in the capital share results in a reduction in investment that dominates the increase in consumption, the economy will be said to be *profit-led*. In general, we define a *wage-led employment regime* as an “institutional structure within which an exogenous wage increase induces an increase in employment [...] under a wage-led aggregate demand regime an exogenous increase in the real wage increases the level of aggregate demand” (Bowles and Boyer 1995, p.145). The converse regimes are referred to as profit-led employment and profit-led aggregate demand, respectively. A necessary condition for a wage-led employment regime is that the aggregate demand regime be wage-led. From the policy perspective, *wage-led* employment strategies focus on the likely positive effects of the wage on aggregate demand and employment. These will take place if income distribution affects the demand for consumer goods; or, stated in different terms, if a larger wage share will support a higher level of demand for consumer goods. On the other hand, *wage-led* productivity growth strategies advocate wage increases as a means of sustaining a higher level of output per unit of input. But if productivity growth is strongly *wage-led*, it is

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<sup>12</sup> Perhaps paradoxically, with constant returns to scale, the same growth of output would require a faster growth of employment.

<sup>13</sup> Ricardo added the chapter “On Machinery” to the third (1821) edition of the *Principles of Political Economy and Taxation*.

unlikely that wage increases will lead to the creation of employment. This is the strategy unions and in general labor advocate groups fear and oppose.<sup>14</sup>

How can it be determined if an economy exhibits a wage-led regime? Following Bowles and Boyer (1995), the market clearing condition  $D(w, h) = I(w, h) - S(w, h) = 0$ , where  $D$  denotes excess aggregate demand,  $I$  is investment and  $S$  is savings, all three written as functions of the wage rate ( $w$ ) and employment ( $h$ ). It is assumed that  $I_w < 0$ ,  $I_h > 0$ ,  $S_w < 0$  and  $S_h > 0$ . The effect of a

wage change on employment equals  $\frac{dh}{dw} = -\frac{D_w}{D_h} = \frac{S_w - I_w}{I_h - S_h}$ . A wage-led aggregate

demand regime requires that  $\frac{dh}{dw} > 0$ . Given the assumption that  $(I_h - S_h) < 0$ , that is,

that savings responds more to the employment level than does investment, and hence an increase in employment will reduce excess demand, the requirement for a wage-led regime is that  $(S_w - I_w) < 0$ , that is, a wage increase reduces savings more than it reduces investment. This will lead to an increase in aggregate demand and employment. Given appropriate savings and investment functions, empirically, an economy will be wage-led if  $(s_r - s_w) > i_r$ , where  $s_r$  is the savings propensities out of profits,  $s_w$  is the savings propensity out of wages, and  $i_r$  is the effect on investment of a change in the profit rate, holding the employment rate constant.<sup>15</sup>

An important question to discuss is that of how wage-led economies react to productivity improvements. In the short-run, higher productivity is unlikely to lead immediately to real wage increases, especially in the face of unemployment. Following the elimination of jobs, total wage payments decline. Then consumer demand will decline too. Eventually, investment and new capacity formation will also fall. The important question, then, is whether the unemployment that potentially results in a wage-led economy from increases in productivity is a reason to prevent or control the diffusion of labor saving techniques (Dutt 1984, Taylor 1991). The increase in productivity will

<sup>14</sup> There is also the possibility of *wage-led growth* (Foley and Michl 1999, chapter 10). This occurs if the impact of investment on profits is negligible; then an increase in the wage share leads to an increase in the equilibrium capacity utilization rate, which leads to an increase in the growth rate of the capital stock. Wage-led growth occurs because the increase in consumption demand has a positive feedback effect on investment through raising the capacity utilization rate. Since by assumption investment is insensitive to profits, there is no dampening effect through changes in profitability from the labor share increase.

<sup>15</sup> The model can be easily extended to incorporate net exports and government borrowing into the excess aggregate demand function.

eventually lead to increases in wages, leading to a new situation with lower unit labor costs (the labor share), which causes aggregate demand to drop. This will lead to reductions in capacity utilization and the employment rate.<sup>16</sup> The result is that, in general, *wage-led* economies are not well prepared to absorb technical change.

To get the complete picture of how the economy reacts to increases in productivity, we have to analyze how the economy evolves in the long-run and thus see what happens to the growth rate of the capital stock in the new equilibrium. To this purpose, assume that investment in this *wage-led economy* responds negatively but weakly to higher unit labor costs (labor share) and positively to capacity utilization. Under these circumstances, the lower capacity utilization effect dominates the higher investment due to lower unit labor costs (higher capital share). Hence, the overall result is a reduction in capital and output growth, and consequently in employment. The conclusion is that, in a *wage-led* economy, the Luddite arguments also apply to the long-run, a problem that is magnified in the context of globalization, where labor-saving technological advances are constantly being implemented. The implication is that in this type of economies arguments in favor of limiting labor-saving technical progress seem to make sense.

The “problem” with this conclusion is that it poses an interesting paradox, namely, that growth in real wages and income per capita are impossible without productivity gains, themselves the result of technical change. The six-million dollar question, therefore, is not how to impede productivity gains, but how to shift them to higher real wages and aggregate demand. This is addressed in a later section.

#### **4. FUNCTIONS OF THE LABOR MARKET**

The labor market is one of the main channels through which globalization is affecting the developing countries (Rama 203a). First, because, as hinted above, employment shocks resulting from structural reforms are dealt with in the labor market. Second, because a labor market that makes possible job creation and leads to increases in productivity is a key element of the development of a business climate where new firms are created and

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<sup>16</sup> The econometric evidence showing that developing countries are *wage-led* is not fully available. However, this seems to be the case. Think, for example, that in developing countries, exchange rate devaluations, which induce real wage reductions, often lead to reductions in output. This is because many developing countries tend to have a relatively price-inelastic export mix. Preliminary work of this author on the Philippines indicates that  $s_r \cong 0.8$  and  $s_r \cong 0$ , i.e., most likely it is a wage-led economy.

where innovation is fostered. Third, labor is often the only asset poor people have. And finally, a labor market that facilitates job creation and leads to increases in productivity is a key ingredient of a business climate where new firms are created and private agents find the proper incentives to invest and innovate.

A labor market is said to perform 'well' if it achieves the two primary objectives of *efficiency* and *fairness*. If these two objectives are achieved, the labor market will perform adequately three major functions: (i) allocate resources; (ii) allocate incomes; and (iii) allocate risks. In what follows we review each of them:

*(i) Resource Allocation:* An important role of the job market is to match workers with jobs. In an efficient labor market, all workers willing to work should find jobs that match their skills, and no vacancies should be left unfilled. Moreover, workers should have the right jobs given their education, skills, experience, and needs of the marketplace. Finally, in an efficient labor market workers should be able to find employment fast.

*(ii) Income Allocation:* This objective responds to the question of whether workers are paid a fair wage. There is the tendency to argue that when wages are low, they are not fair. However, it is important to clarify what a fair wage rate is. For economists fairness is measured in terms of whether a worker is paid what he/she is worth, and this is measured in terms of a worker's productivity. At the most intuitive level, the statement that wages cannot outstrip labor productivity (at least for a significant amount of time) is a very general economic principle; otherwise no firm will survive. Fundamental to the process of growth of any economic unit is the concept of an economic surplus, and the use to which such a surplus is put in allocating resources over time. The surplus can be defined as the difference between the value of output ( $Q$ ) and its cost of production, measured at constant prices. Labor is often the primary input in the process. The cost of labor is the total wage bill ( $W$ ). In per capita terms, the surplus is the difference between the productivity of labor ( $Q/L$ ) and its real wage rate ( $w/P$ ). Hence, the survival of the firm requires that  $(Q/L) > (w/P)$ .

As summarized before, in the classical and neoclassical models the idea of fairness is presented in slightly different terms. The neoclassical conceptualization of the labor market, in particular, is very problematic at the theoretical level. The standard notions of labor demand and supply curves are not straightforward concepts (Keen 2001, chapter 5). It must be remembered that Fisher (1969) showed that aggregate

production functions can be derived theoretically only under very stringent conditions. The aggregate demand for labor curve, however, is derived assuming that an aggregate production exists. Despite this important shortcoming, orthodox analyses proceed under the premise that wage increases entail reductions in employment (Heckman and Pagés 2003, pp.32-38). The argument is that higher wages induce firms to substitute other inputs for labor; moreover, higher wages entail cost increases, which induce buyers to buy goods from other producers, including imports. These lead to reductions in employment. In the standard neoclassical model, this is the result of an optimization process that extends from the firm to the aggregate economy.

However, as indicated above, this may be incorrect. Keynesian macroeconomics challenged this view on the grounds that although a wage increase will discourage employment, it may also promote employment by supporting a higher level of demand. The implication is that while it may be true that at the individual level labor demand curves slope downward, at the aggregate level this need not be the case, so that a wage increase *may* led to an increase in demand and employment. On the one hand, a wage increase will increase the demand for consumer goods. On the other, it may reduce the expected future profit rate so as to negatively affect the demand for investment goods. The result is that the effect of wage variations on aggregate demand depends on which effect dominates.<sup>17</sup>

The notion of labor supply is also problematic. Long ago, Joan Robinson put it as follows: “The orthodox conception of wages tending to the *marginal disutility of labour*, which has its origins in the picture of a peasant farmer leaning on his hoe in the evening and deciding whether the extra product of another hour’s work will repay the extra backache, is projected into the modern labour market, where the individual worker has no opportunity to decide anything except whether it is better to work or starve” (Robinson 1942, pp.2-3; italics original). Reviving this view, Keen (2001, pp.124-125) has argued: “The vision of a worker deciding how many hours to work on the basis of his/her preferences between income and leisure, and offering more labour as the wage rate rises is, like so much else of economic theory, superficially appealing. But [...] how can one enjoy leisure time without income?” In real life, most leisure activities cost money, hence there cannot be such a trade-off between work and leisure (i.e., no work no leisure).

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<sup>17</sup> And at the empirical level, Felipe and McCombie (2004) have shown that a negative employment elasticity is the only possible result when estimating the so-called labor demand function. The reason is that it is an algebraic tautology.

Finally, it is difficult to use the marginal productivity theory of factor pricing at the empirical level. As Thurow (1975, pp.211-230) argues, the theory could exist at different levels. As indicated above, the theory shows that a profit maximizing firm should hire labor up to the point where the marginal product of labor equals the real wage rate. But what does this mean and how does one test it? Does it mean that if the real wage rate is above the marginal product labor is “expensive”? Thurow argues that “In its most rigorous form, marginal productivity states that each individual factor of production is paid his, her, or its marginal product at each instant in time. From this position there exists a continuum of possibilities where individual factors are paid their marginal products but only over longer periods of time. At the other end of this continuum, factors are paid their marginal products, but only over the course of their entire lifetimes” (Thurow 1975, p.212). He concludes: “Fortunately or unfortunately, each reader is going to have to construct his or her own marginal-productivity model [...] As long as marginal productivity is left as a general amorphous theory, it can neither be used nor criticized” (Thurow 1975, p.230).<sup>18</sup>

Nevertheless, this standard conceptualization of the labor market has often translated into reforms and policies in three areas:

- (i) *wage-setting practices*: these directly affect labor costs and consequently decisions of firms on the best combination of factor inputs, adoption of new technologies and ultimately output growth. Some governments are trying to eliminate minimum wages.
- (ii) *regulations affecting hiring and firing*: these provide job security for covered workers but overly strict regulations tend to raise the cost of workforce reorganization which is often required when adopting growth-enhancing new technologies. Moreover, overly strict regulations tend to tilt incentives for firms towards the informal sector.
- (iii) *taxes on labor and social security contributions*: unless these taxes are fully shifted onto wages (which, in turn depends on wage-setting practices), they raise labor costs and tend to reduce labor demand. This has led to the reduction of labor benefits (e.g., unemployment subsidies).

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<sup>18</sup> In the pages referred to, Thurow develops his argument about the possibility of testing the marginal productivity theory in terms of a series of questions which he tries to answer. After reading the pages, the reader ends up with the feeling that the marginal productivity theory of factor pricing is almost useless, not because there is anything wrong with it, but simply because its testing is a futile exercise. The problem with Thurow’s recommendation (i.e., construct it your self) is that it is scientifically unsound.

It is argued that while these policies may have perverse effects for growth in some countries, the lack of basic labor market institutions in the poorer ones not only tends to raise inequalities (e.g., public *versus* private workers; formal *versus* informal workers) but also has negative growth effects. The lack of basic rules of the game in the labor market (or the lack of enforcement of such rules) may indeed raise uncertainties for both entrepreneurs and workers, thereby reducing incentives for investment in new firms or in new technologies and human capital.

*(iii) Risk Allocation:* The third major function of the labor market is to allocate risks, mostly that of losing one's job. A well-performing market protects workers against the risk of income loss. If workers can find a new job quickly (first function), this income loss is kept to a minimum. On the other hand, for those who end up unemployed, unemployment insurance provides a temporary solution.

Finally, it must be added that the product market (i.e., market where goods and services are bought and sold) also has important effects on the functioning and final outcomes in the labor market. For example, large-scale privatization programs often result in major restructuring and layoffs. In this context, whether dismissed workers quickly find jobs depends not only on a labor market functioning efficiently but also on the existence of appropriate product market regulations that promote competition and output growth amongst privatized and newly-created companies. More generally, entry restrictions in (otherwise) competitive markets, by reducing product market competition and international technology spillovers, are likely to result in lower output growth and negatively affect long-run employment levels (Lewis 2004).

The bottom line is that deregulation of the labor and capital markets alone might not work. This is because industry-level restrictions governing the conduct of individual businesses determine the nature of competition. For example, the development of the retailing and hotel sectors can be severely constrained by planning regulations. Some evidence on how labor market policies and institutions affect output and productivity growth exists for some countries. However, much less is known about how product market conditions -- and regulatory reforms therein -- affect labor market outcomes, and the interactions of regulatory settings in the two markets.

Nevertheless, it is important to understand how labor markets work in the context of globalization. To this purpose, research on the type of reforms that lead to creation of a labor market that favors the creation of employment is very important.<sup>19</sup>

## **5. FULL EMPLOYMENT AS THE OBJECTIVE OF LABOR MARKET REFORMS IN DEVELOPING ASIA**

It was argued above that in an efficient labor market *all* workers willing to work should be able to find jobs. However, also as noted above, Keynes argued that the virtues of the price mechanism advocated by mainstream economists (e.g., flexibility of wages to market conditions) have various limitations. Keynes argued that a feature of the labor market is *involuntary unemployment*, something denied by the classical school. Unless the authorities take a positive action to eliminate involuntary unemployment, Keynes argued, the system could end caught up in a situation of *underemployment equilibrium*.

The above can be particularly important in the specific context of developing the countries, whose labor markets are dualistic. Unemployment, underemployment, and surplus labor are permanent features of the labor markets of many Asian countries. Typists in government offices playing cards during working hours, members of large families laboring at snail's pace on tiny plots of land, maids and drivers, Arthur Lewis' "messengers" employed by most businesses in underdeveloped countries but who make an almost negligible contribution (Lewis 1954, p.142), are all employed in a conventional sense but are actually expressions of the same phenomenon. One implication of such manifestations of excess labor supply is that official unemployment statistics are often quite misleading. In the words of Amartya Sen, the figures can be "low enough to put many advanced countries to shame" (Sen 1975, p.119).

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<sup>19</sup> It must be argued that the argument that reforms aim at increasing efficiency suffers from a theoretical deficiency. This is that Marshallian neoclassical economics, the theory underpinning the call for labor market reforms, was never intended to be a growth theory; only a theory of static resource allocation. It therefore must be supplemented by a theory of accumulation and growth. Moreover, the postulates of neoclassical economics, which are needed to ensure the efficiency of neoclassical market equilibrium, are not applicable to developing countries. The latter are hardly characterized by smoothly mobile factors, complete and well-functioning markets, comprehensive information and perfect foresight. In short, the institutional bases for a neoclassical economy are missing in most developing countries. The absence of any of these characteristics implies that market equilibrium cannot be proven to be Pareto-optimal, and hence even statically efficient. Moreover, market equilibria depend on the initial distribution of wealth. If that distribution is not optimal the Pareto optimality of a neoclassical economy will not maximize even static social welfare. Finally, mainstream advocates often forget the theory of second best. Since it is impossible to remove all regulatory constraints on markets, it is quite feasible that, even when all neoclassical postulates hold, adding further constraints on markets will improve, rather than reduce, market efficiency.

All these characteristics reflect an underlying problem: an acute inadequacy in the economy's capacity to employ its labor force. This is just a piece of the *poverty-trap* puzzle in which many developing countries, or at least some groups within countries, are immersed. In the words of Meier: "The need to create jobs will be especially pressing, given that the world's labor force will increase by 40 percent over the next two decades, with 95 percent of the increase in developing countries, where less than 15 percent of the world's capital investment will occur. To reduce poverty by increasing productivity and earnings, governments will have to devise appropriate policies in four crucial sectors of the economy: the rural sector, the urban informal sector, the export sector, and the social sector" (Meier 2001, p.25). For this reason, there is a need for finding a balance between labor flexibility and the implementation of policies that promote employment.

In the industrialized world, excess supply manifests itself mostly in open unemployment. Most developed countries have developed different degrees of safety networks to take care of the unemployed. In most LDCs no such institutionalized system of support for the unemployed exists, with the consequence that all forms of underemployment are, in part, society's attempt to insure against widespread poverty and also the vicissitudes of markets.

A sector is characterized by surplus labor (or disguised unemployment) if it is possible to remove a fraction of the labor force without causing any reduction in output. In other words: a part of the employed population is redundant. However, the persistence of surplus labor is a source of puzzlement to many economists. The standard view is that in many developing countries, and for many reasons, the marginal productivity of labor is zero over certain ranges. As a result, the withdrawal of part of the labor force has no effect on output. This argument, therefore, raises doubts about the rationality of workers and the firms that employ them. Think, for example, of a farm: why do workers work so much if their efforts are not so productive? Or, why do their employers employ them at all and pay them? Sen (1975) addressed the issue and showed that a zero marginal product is neither necessary nor sufficient for the existence of surplus labor.

It is in this context that the paper argues that the most important problem developing countries face, and the major objective of any reform of the labor market, is the achievement of *full employment*. What does this term mean? The term full employment has different meanings for different people, and it should not be taken for granted what it means. The first issue concerns the resources the term refers to, all

resources or just labor? Although there is a relation between the employment of labor and the employment of other resources, here I shall use it to refer only to labor. There are three important issues to take into account: (i) that the set of policies necessary to achieve full employment of labor and full employment of all resources are different; (ii) that full employment of labor may be brought about through economic policy. However, it is doubtful that full employment of all resources (as opposed to a high level of utilization) can be attained; and (iii) that it is not clear that full employment of all resources is desirable. Likely, some degree of unused capacity of some resources is desirable and can play an important role even while eliminating unemployment of labor.

A related issue is that of the level of employment that the term “full” refers to. While the “common-sense” meaning of the term is zero unemployment, most economists do not use it with that sense today, and look at it from the point of view of the Natural Rate of Unemployment.<sup>20</sup> From this point of view, full employment indicates that level of employment associated with price stability even if that means that many individuals are out of work. This usage obviously places fighting inflation as a priority above combating unemployment. Economists like Pasinetti (1993), however, reject the notion of natural rate of unemployment and thus, for him, full employment refers to zero involuntary unemployment. Full employment means that no one who is ready and willing to work full time (thus, this also refers to zero involuntary part-time employment) for an appropriate wage is jobless.

As indicated above, under the notion of the Natural Rate, macroeconomic policy is bound by an inflation constraint. Indeed, as we know, the prime objective of most governments today, including those of developing countries, is to fight inflation. Thus, although there are serious concerns in many countries with the level of unemployment (or with their lack of capacity to create employment), the inflation constraint imposed by the notion of Natural rate impedes the implementation of active policies: expansionary fiscal policies lead to budget deficits (in many developing countries already a problem), and expansionary monetary policies lead to inflation with no impact on output and employment (Palley 1996). This is the case because in the theory of the Natural Rate, economies adjust instantaneously to shocks. Under these circumstances, of course, monetary policy is useless (it might disrupt the workings of the market system). However, in a world were prices adjust slowly to equilibrium following a shock (due to

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<sup>20</sup> Beveridge (1944) defined full employment as a situation in which the number of job vacancies is greater than or equal to the number of unemployed workers.

uncertainty and incomplete information), the previous conclusion about the ineffectiveness of economic policy need not be true, especially in an economy with unemployment. This slow-adjustment scenario is particularly realistic in the labor market due to the conflict between firms and workers over the distribution of income.<sup>21</sup>

Technically, the condition for full employment can be stated as  $\sum c_i d_i = 1$ , where  $c$  denotes consumption per employee, and  $d$  is the labor-output ratio. The summation runs across the  $N$  products that an economy produces. This means that labor per unit of output and demand per unit of labor must be in balance if demand is to support a full-employment output (Taylor 1994a).<sup>22</sup>

Should governments pursue economic growth first and foremost, or should they focus on full employment (or more precisely, policies to increase the absorption of labor)? It seems that supporters of the globalization movement argue that economic growth is the key. They argue that expanded trade and higher economic growth are the best way to reduce poverty and, by implication, unemployment. The link from labor markets to growth is likely to occur through the allocation functions of the labor market and through their role in supporting the production and efficient use of human capital. The link from growth to labor markets, on the other hand, is likely to occur through the build up of infrastructure as a result of economic growth. On the other hand, critics of globalization point out that there need not be a negative relationship between the efficiency and equality objectives. Moreover, if employment creation is a paramount objective, then full employment should take the center stage. In the final analysis, a growth process that is not associated with job creation will fail to reduce poverty and will not be inclusive. According to Bowles and Gintis (1995, pp.409-414; italics original) “the relationship between inequality and economic performance is mediated by the structure of economic governance: *inequality impedes economic performance in part by obstructing the evolution of productivity-enhancing governance structures.*” They offer three arguments in support of a positive relationship between efficiency and equity, and a source of equality-productivity complementarity: (i) institutional structures supporting high levels of inequality often prove costly to maintain; (ii) more equal societies may be capable of supporting levels of cooperation and trust unavailable in more economically

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<sup>21</sup> Monetary policy can be used to speed up the adjustment process by causing nominal demand to grow. Certainly this causes inflation in sectors at full employment.

<sup>22</sup> Moreover, due to the importance of the agricultural sector in some Asian developing countries (e.g., two-thirds of the Indian workforce is in agriculture (Nagaraj 2002)), special reference has to be given to this sector.

divided societies; and (iii) economies with highly unequal asset distributions face more inefficient incentive structures.

For Pasinetti (1993), achieving full employment must be *the* paramount objective of economic policy. In fact, this was the objective of economic policy at some point in time, during the 1960s and 1970s, in developed countries. During the last twenty-five years, however, full-employment as the prime objective of economic policy has been abandoned by central banks, governments, and international organizations. Achieving full employment requires activist policies on the part of the government. However, the policy consensus of the 1980s led to the idea that government is an obstacle to economic growth. In particular: (i) government budget deficits are detrimental to the economy, (ii) government intervention in product, financial, and labor markets is economically inefficient; and (iii) government ought not to interfere with international product and financial movements.

What are the arguments for full employment? The first one is that the economic and social costs of unemployment and/or underemployment are staggering. Unemployment causes permanent losses in potential output of goods and services, not to mention the misery and social injustice that it causes, in particular in developing countries, as well as the myriad of related problems that derive from it (e.g., crime and social instability, psychological problems; deterioration of skills). The second argument is that the right to employment is part of the 'Universal Declaration of Human Rights'. Therefore, ensuring employment to all those willing to work, is a government's responsibility. The third argument is that countries like the US require by law the promotion and achievement of full employment. The fourth and final argument is that full employment is an ethical imperative in today's developing capitalist economies, where unemployment and underemployment are endemic. In societies characterized by this problem, public inaction constitutes social assignment of workers and their families to poverty.

As indicated by Mazumdar (1999), the meaning of full employment in developing countries is different from that in the context of developed market economies. In the latter case, where there exists an integrated labor market, and where employed workers and job-seekers work for a wage determined in the labor market, the idea of full employment consists in minimizing the number of unemployed in the labor force, either in the context of the natural rate, or in the sense of Pasinetti. In developing countries, on the other hand, an important proportion of the labor force is not in the formal wage labor

market; self-employed earners and unpaid family workers constitute a substantial part of the labor market. The wage differential between the wage and non-wage groups can be quite large. For this reason, the notion and objective of full employment cannot be the same. Thus, the notion of full employment applicable to developing countries must acknowledge that there is a hierarchy of earnings. Here, full employment consists in maximizing the absorption of labor. However, the latter is not just about maximizing employment, but about *creating the conditions* under which the high-wage segments of the economy generate more jobs. The key, therefore, is how to expand the demand for labor in the wage sectors outside agriculture so that these sectors can draw labor from agriculture. If labor surplus exists, this will lead to an increase in productivity in the economy without a fall in agricultural output.<sup>23</sup>

The policy of full employment described above encourages the transfer of workers from the non-wage sectors of the economy to the wage sectors of the economy, where the 'good job' exist. 'Bad jobs' are associated with low wages and little opportunity to accumulate human capital. 'Good jobs', on the other hand, are the ones that demand higher skills and command higher wages (Snower 1996).

For some time now it has been documented that the demand for unskilled labor is falling. The phenomenon began being documented in the 1980s in the developed countries, but now a similar phenomenon seems to be taking place in developing countries: the *employment crisis* of developing countries should be seen as reflecting a shortage of demand for unskilled labor. There are two reasons why joblessness would affect unskilled workers more than skilled workers. The first is an obvious asymmetry: an unskilled worker can in most cases perform the job of an unskilled worker, while the opposite is not true. The second reason can be posed in the form of a question: has education become an instrument for creating better jobs, or is it a mechanism for promoting some individuals in a job market that is to a large extent intangible. On this issue, Michael Spence (1974) argued that education functions only as a "signal for employers" during the hiring process (i.e., an instrument to discriminate). The implication of this argument is that the particular subject taught (be it poetry or mathematics) in school does not matter much. All that counts is the individual's aptitude for learning and for reacting to competitive circumstances. Baudelot and Glaude (1989) seem to have verified empirically this hypothesis. At the international level, education is clearly a

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<sup>23</sup> One of Kaldor laws is that there is no correlation between GDP growth and the growth of agricultural output.

determining factor of prosperity (e.g., the experience of the East Asian countries). At the domestic level, on the other hand, it functions as an instrument of differentiation of the labor force as well as an element of qualification.

## **6. LABOR MARKET POLICIES AND REGULATIONS: ARE THEY THE EVIL?**

At the theoretical level, the idea of many mainstream models is that wages determine employment and that there exists an equilibrium wage for which all those wishing to be hired will indeed be hired at the market wage rate. This, however, does not seem to correspond to the reality, much less to that of the developing countries, where unemployment is a constant feature. Critics of labor market regulations claim that the collective bargaining institutions, employment regulations and income security measures reduce employment growth. If collective bargaining institutions keep wages above what the market would indicate, then they would depress employment. And if employment protection increases the cost of laying off workers in the future, then employers will be more reluctant to hire today. Moreover, the argument goes, increasing workers' rights (e.g., right to strike) undermines the business climate, raises labor costs and reduces employment growth.<sup>24</sup>

However, and contrary to common perception, a protective labor market policy, measured in terms of greater labor market regulations and standards, has not resulted in poor economic and employment conditions (Freeman 1993). Also, Buchele and Christiansen (1992, 1995, 1999a, 1999b) have found that workers' rights have a generally positive effect on the growth of output per hour worked. Their argument is that all the basic determinants of productivity growth (e.g., pace of innovation in technology, rate of growth of the capital-labor ratio, development of human capital) depend crucially on the *cooperation and effective participation of workers*. The reason is that workers hold the key to the success of the production process (they carry it out!), so they are in a unique position to contribute improvements in technology and work organization that increase labor productivity. When will they cooperate the most? When they feel that they have a secure stake in the long-run success of the company they work for; when they feel that they are treated fairly and trust that their employer will continue to treat them

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<sup>24</sup> Indeed, Besley and Burges (...) investigated whether the industrial relations climate in Indian states has affected the pattern of manufacturing growth. They conclude that states that amended the Industrial Disputes Act of 1947 in a pro-worker direction experienced lower output, employment, investment and productivity in formal manufacturing. However, output in the informal manufacturing sector increased. They also conclude that regulating in a pro-worker direction was also associated with increases in urban poverty.

fairly in the future. How is this accomplished? By guaranteeing workers' rights, including collective bargaining, and by implementing measures with a view to reducing workers' vulnerability against the loss of their jobs. The result, Buchele and Christensen argue, is that strengthening workers' rights encourages labor-management cooperation and workers' active involvement in improving productivity and product quality. Also, studying the effect of wages on labor motivation, Bowles et al. (1983) have documented the existence of a positive relationship between wages and productivity.

These empirical findings are very much in line with the work of Bewley (1999), who, during 1990-91, interviewed 336 managers, labor leaders and employment counselors, on the subject of why, when unemployed workers are available, firms don't cut wages until the excess supply is eliminated.<sup>25</sup> The answer that came out of the interviews was one that conventional theory has not considered, namely, that the most important factor preventing nominal wage cuts was the psychological factor of morale.<sup>26</sup> Good morale among a firm's workforce has a positive effect on the firm's profits by increasing workers' productivity, effort, creativity, and cooperativeness, and by reducing absenteeism and turnover. Likewise, well-motivated employees tend to provide good customer service. Workers would perceive a cut in nominal wages as a hostile act.<sup>27</sup>

In a widely cited article about unemployment in Europe, Bean (1994) dismissed many *clichés* about unemployment in the continent. For example, he argued that the hypothesis that unemployment results from unionization was rather unconvincing; that American salaries do not decline much in response to unemployment; that the welfare state was not a source of unemployment; and that the evidence available did not show that the existence of generous unemployment benefits was the cause of persistent unemployment.

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<sup>25</sup> Bewley conducted most of his interviews in Connecticut (USA). Unless someone argues to the contrary, I see no reason not to believe that his findings need to be restricted to the small US state.

<sup>26</sup> Bewley (1999) indicates that the economic theories he wanted to discuss seemed ridiculously naïve to those he was interviewing.

<sup>27</sup> Edralin (2001) shows, in the context of the Philippines, that a majority of management and labor groups are in favor of what is known as the "social clause", which refers to the incorporation of various social provisions into the labor relations. These provisions include freedom of association and the right to organize. Reasons cited in favor of this clause are: (i) to enhance and improve the quality and productivity of workers; (ii) to boost benefits for better competition; and (iii) to serve as guide or protection for both union and management. Edralin also stresses that despite the general agreement about the benefits of a social clause, a number of industries have found it very difficult to comply with such standards, and stresses the inflexibility of institutions in relation to worker benefits, despite the benefits brought in by globalization. She argues that firms can very well be willing to provide such rights and protection to workers as long as the costs of doing so are not too prohibitive and the productivity of workers is improved.

Nickel (1997) argues that higher unemployment in Europe vis-à-vis North America is often attributed to more rigid labor institutions in the former. However, the empirical evidence linking labor market rigidities and unemployment is weak. Nickel and Layard (2000) argue that labor market institutions such as unions and social security systems are important drivers of economic performance with strict labor market regulations, employment protection and minimum wages playing a lesser role.

Finally, Rama (2003b) finds that social protection programs are effective in reducing inequality. On the other hand, minimum wages, public sector employment and core labor standards are not.

Labor market reforms tend to be a thorny issue. In fact, they are more difficult to implement than reforms in any other economic areas. It is possible that the reason why this happens is that trade unions oppose them. However, there is another reason worth considering. This is the existing public perception about their effects, for they are associated with deregulation and a tendency towards “free markets” and a laissez-faire view of the economy. Convincing the public that reducing labor security and facilitating the firing process will improve labor market conditions is not easy. This is because the direct impact on those directly affected is very transparent and immediate. “Selling” a labor market reform on the grounds that it will benefit the economy is a much more difficult task than selling reforms in areas such as trade or taxes.

## **7. LABOR MARKET POLICIES IN ASIA**

The analysis in this section is based on the work by Botero et al. (2003). They have constructed an extensive data set covering employment, collective relations and social security laws for 85 countries as of 1997. Employment laws govern individual employment contracts; industrial and collective relations laws regulate the bargaining; and finally, social security laws govern the social response to needs and conditions that have a significant impact on the quality of life (e.g., unemployment, maternity). The authors have codified these data and come up with measures of worker protection. In essence, for each law in each country, the authors identify the government regulation of each specific area, and assign a higher score when a regulation is more protective of a worker.<sup>28</sup> The Tables with the data are presented in the Appendix. Table 1 provides a description of the subset of variables that I have taken from Botero et al. (2003). Table 2

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<sup>28</sup> The employment laws of most countries are available on line in the NATLEX database of the ILO. The authors also indicate that the main secondary sources are the *International Encyclopaedia for Labour Law and Industrial Relations*.

provides the scores of these variables for all the Asian developing countries that the database covers, a total of 15. The scores are of two types. Some variables are dummies, i.e., 1, 0. The other variables are continuous. Finally, Table 3 provides a regional summary. This includes data for Asia, the developed countries, Latin American and Africa. For the dummy variables, the regional summary statistic used is the mode, while for the continuous variables it is the average. The three tables in the Appendix provide the disaggregated information for the developed countries, Latin American countries and African countries.

Regarding table 2, given that there are 45 variables, it impossible to summarize and compare the scores for the 15 Asian countries considered. This information is provided for the reader to analyze a particular country or set of countries.

On the other hand, Table 3, which provides regional summaries, provides interesting information. One can ask the following question: is Asia different in terms of labor market policies? Regarding the employment laws, the answer is a clear no. In the case of the dummy variables, the mode is the same as in the rest of at least two other regions (i.e., one of the other three regions is the different one). In the case of the averages, a cursory look at the data indicates that Asia does not stand out. Asia, for example, has fewer days of annual leave with pay in manufacturing; the number of paid mandatory holidays is slightly higher than in the developed world and Africa, but the same as in Latin America; the cost of increasing hours worked is similar in the three developing regions, and substantially lower than in the developed countries; the legally mandated severance pay is substantially higher than in the developed countries and Africa, but about the same as in Latin America; finally, the cost of firing workers is also higher in Asia than in the developed countries and Africa, and about the same as in Latin America. It therefore seems that there could be two areas where Asia may be labeled as different in the sense of having a restrictive legal system that may affect the creation of employment. These are legally mandated severance pay and the cost of firing workers. If we now go to Table 1, we can see that there are two countries that stand out in terms of legally mandated severance pay. These are Indonesia and Thailand, with 25 weeks of pay. In the case of the cost of firing workers, except in Hong Kong, all the other Asian countries truly have a high cost.

Regarding the collective bargaining laws, once again the overall picture is not altogether different from that of the rest of the world. In this case, all scores displayed are modes. In Asia, workers councils are mandated by law, the same as in the

developed world. In Asia the law does not allow sympathy, solidarity or secondary strikes. These are allowed in the other three regions. On the other hand, Asia is the only of the four regions considered where a strike is not illegal even if there is a collective agreement in force. This is the only industrial relations aspect where Asia seems to be different and which may affect employment creation.

Regarding the social security laws, the evidence is once again clear: Asia is not particularly different for the other regions in terms of disability and death benefits and sickness and health benefits. Moreover, the social security system does not cover the risk of unemployment.

Finally, most Asian countries have mandatory minimum wages, the same as in the other two developing regions. Only Honk Hong, China, Malaysia and Singapore do not have mandatory minimum wages. This is not, however, the case of the developed countries, which are split on this issue. Lastly, Asia has the same union density (% of workers affiliated) as the other developing regions, about half that of the developed countries.

The conclusion of this brief analysis is that, probably, some labor market practices impose restrictions and impediments to the creation of employment. These are the ones that should be removed. But this does not mean that an overwhelming labor market reform is needed. On the contrary, this calls for detailed country analyses with a view to identifying the particular labor market policy (e.g., minimum wages, unemployment benefits) that is the source of controversy and, ultimately, prevents the creation of employment.

In recent work, Hausman et al. (2004a), analyzing episodes of acceleration in economic growth, argue that large-scale institutional transformation is not, in most cases, a prerequisite for take off. In other words, the initial growth stimulus can be achieved with minimal changes in institutional arrangements. Across-the board reform packages have often failed to get countries growing. On the other hand, sustained economic growth does require high-quality institutions so that, once growth is set in motion, rapid growth and institutional transformations generate a virtuous circle. The authors also conclude that good institutions can be acquired, but doing so requires experimentation, willingness to depart from orthodoxy, and attention to local conditions. Hausman et. al. (2004b) argue that the trick for policymakers is to identify the binding constraints on economic growth, and how these differ from setting to setting.

The above conclusions apply to the case at hand. The set of labor market policies of a country constitute an institution. If any of its pieces is preventing the development of an environment more conducive to the creation of employment, the solution consists in simply removing or reforming that piece.

## **8. RURAL AND URBAN LABOR MARKETS<sup>29</sup>**

As indicated above, if there is something that characterizes the labor market of most developing countries is their dualism (mostly in the urban areas) and the existence of surplus labor (mostly in the rural areas). Although the literature has interpreted the term surplus labor in slightly different ways, in general it is used to describe the rural sector. In the words of Mazumdar (1999): “With pressure of population on land, the marginal product of labor falls well below any positive return to a unit of labor which can sustain the working strength of a worker –the level which provides the floor to the wage level in the wage sub-sector of the rural economy.” The important point is that this “surplus” labor is not openly unemployed, but absorbed in the family farm. Most often, work and income are shared among the members of the family, so that the income of an adult worker in the family farm would approximate the average rather than the marginal product of labor in such farms. Moreover, empirical studies have shown that surplus labor does not imply that workers are idle. Rather, it entails a multiplicity of occupations for a typical worker, and a hierarchy of earnings per unit of time in the different activities. In this sense, it could be said that surplus labor describes a situation where a great deal of time is devoted to the marginal activities with low earnings. These marginal activities in the rural labor market are referred to as Z-goods (Mazumdar 1999).

Within Asia, one could expect the incidence of surplus labor to be higher in South Asia than in Southeast Asia because of the higher population pressure. However, in countries like Thailand it might exist due to the strong seasonality in the demand for labor due to the way the Thai agricultural system has existed. And second, due to the severe difference in income per worker between the poorer and the richer regions, which internal migration has not solved.

The urban labor market works in an entirely different fashion. Here there are two sectors, the formal, or high-wage sector, and the informal. They are separated by the level of earnings, unrelated to the human capital of the workers in each group. The former is dominated by large firms or government employment and is characterized by

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<sup>29</sup> This section follows Mazumdar (1999) closely.

the existence of well-defined wage and employment contracts. The latter, on the other hand, is characterized by more informal and flexible work arrangements. This sector includes household work (mostly maids, drivers, gardeners), self-employed petty traders and businesses, and casual day labor and wage-workers in small enterprises, usually not subject to legal registration. Given this dualism, there are two questions of relevance. First, is the differential in earnings between the formal and the informal sectors artificially maintained by institutional mechanisms like minimum wages, government regulation, etc.? Recently, it has been argued that the urban labor market is *segmented* due to economic forces. Research in countries like India has shown that substantial wage differences between large and small factories existed before trade unions and labor laws were set up. This wage difference can be traced to the higher productivity of factories with modern technology and are maintained by efficiency-wage considerations.

The second question refers to the degree of mobility from the informal to the formal sectors. Entering the informal sector is very easy; however, transferring to the formal sector proves to be very complicated for many workers who get stuck in this low wage-low productivity sector. One factor that inhibits this mobility is the operation of internal labor markets in establishments (especially the large ones) in the formal sector. This is sort of *insider-outsider* problem. For example, firms that encourage a lifetime commitment, typically recruit workers at a young age at a relatively low point of the career structure. Vacancies higher up the structure are filled by promoting workers internally rather than by recruiting older workers from outside. Thus, the opportunity to move into a formal sector job decreases with the years spent in the informal sector. The only way to eradicate this is by fighting against the whole panoply of regulations and entitlements that allow insiders to protect themselves against outsiders, the rivals. Finally, segmentation also occurs due to supply-side factors like sex and education.

Self-employed one-man businesses as well as owners of small establishments who contribute their family labor (and perhaps employ somebody else) are also part of this informal sector. Workers in this group also face lack of upward mobility due to their lack of access to capital.

## **9. POLICIES TO PROMOTE FULL EMPLOYMENT IN DEVELOPING COUNTRIES**

Given the definition of full employment provided above, i.e., that labor per unit of output and demand per person be in balance, the relevant question to ask is whether, in the

context of a growing economy with sectors expanding at different rates and productivity also increasing at different rates, full employment can be achieved.

It was argued above that the problem of many developing economies is how to translate productivity increases, the key to prosperity, into higher real wages and aggregate demand, so as to achieve full employment. However, the condition for full employment is not easy to satisfy in a dynamic context. This is because  $d$  (the inverse of labor productivity) tends to decrease over time. At the same time,  $c$  may be rising for some products, while declining for others. If both  $c$  and  $d$  are decreasing for a given sector, then employment will decrease. On the other hand, it is possible to find sectors where  $d$  is decreasing, but this decrease is compensated by an increase in  $c$ . This could lead to employment growth. But, in general, there is no automatic mechanism that makes the full employment condition be satisfied, in which case the full employment objective may not be achieved, i.e.,  $cd < 1$ . Achieving and maintaining full employment is very difficult.

Even in case jobs were available, changes in demand and productivity across sectors may require substantial labor force reallocations, if full employment is to be maintained. This is socially a complicated issue, and a reason why implementing labor market reforms that, on paper, would tend to make the full employment condition hold, is difficult.

As indicated above, the concept of full employment in developing countries should be understood in terms of maximizing the absorption of labor, which is not just about maximizing employment, but about *creating the conditions* under which more jobs are created in the high-wage segments of the economy. In the context of the developing countries, where an important proportion of the labor force is not in the formal wage labor market, a strategy towards full employment should contemplate the implementation of an effective policy that aims at: (i) increasing income in the non-wage sector (self-employed workers, unpaid family workers, informal sector); (ii) reducing the gap between the formal and informal sectors; and (iii) increasing the proportion of workers in the wage (formal) sector.

What are the limitations of pursuing a package of policies directed at expanding the demand for labor in the wage (formal) sector? It all depends on how large the surplus labor pool is. If it is very large (think of India, for example) it is unlikely that the non-subsistence sector of the economy will be able to absorb it to the point that wages in the former sector will increase significantly. For this reason, it is necessary to pursue a

complementary policy of increasing the supply price of labor directly in the subsistence sector by increasing the productivity in agriculture. When a large portion of the labor force is employed in the primary sector, it is the productivity of this sector that sets the supply price of labor in the rest of the economy, and unless the external sector of the economy is large relative to GDP, wages in the economy will not increase unless the supply price increases through an increase in physical productivity in agriculture. This calls for investment in rural infrastructure and better supply of farm inputs.

Recall that the general problem of developing countries is how to translate productivity increases into demand and employment increases. There are several possibilities. The first one is to increase public investments in infrastructure. A second option is to invest in training. A third one is an export push induced by lower unit labor costs. This can be done in two ways: (i) lower wages; or (ii) higher productivity. The first option is extremely difficult for the obvious reason that workers are not willing to accept lower wages. Moreover, countries that try to exploit their comparative advantages based on low labor costs by restricting wages end up getting stuck into a vicious circle of low productivity, deficient training, and a lack of skilled jobs, preventing the sector in question from competing effectively in the markets for skill-intensive products. This situation is referred to as a “low-skill, bad-job trap” (Snower 1996). ‘Bad jobs’ are associated with low wages and little opportunity to accumulate human capital. ‘Good jobs’, on the other hand, are the ones that demand higher skills and command higher wages. A second trap derives from the complementarities between capital and labor. The problem is referred to as a “low-skill, low-tech trap.” If workers have insufficient skills to operate modern machines, the latter will be underutilized. Consequently, firms will have little incentive to invest in the latest technology. This reduces workers’ productivity even more. A third problem emerges from the interaction between innovation and skills. Innovating is crucial for developing technological capabilities, but it requires well-trained workers. Economies can get caught in a vicious circle in which firms do not innovate because the labor force is insufficiently skilled; and workers do not have incentives to invest in knowledge because there is no demand for these skills. For example, Amante (2003) documents the problems of the Filipino educational system and argues as follows: “The low level of benefits derived from the Philippines education, especially at the secondary and tertiary levels, is traceable to the unemployability and low productivity of Philippine labor. In turn, these could be attributed to inadequate

investments and low levels of technology utilized by business establishments and the very thin economic base of the country” (Amante 2003, p.275).

At a different level, it may be argued that the solution to the human capital problem does not lie in more schools, teachers or textbooks. Prichett (2004) has recently argued that the real constraint lies in the low demand for schooling, that is, the lack of incentives to learn in environments where the absence of economic opportunities depress the returns to education.

Snower (1996) argues that the relatively low demand for and supply of skills in a country derives from rational decisions made by both firms and individuals in the context of the particular legal and institutional framework within which they operate. Countries with a less skilled workforce have greater incentives to produce non-traded services rather than tradables such as manufactured goods because the former are relatively protected from foreign competition. This pattern of specialization creates and perpetuates the demand for less skilled labor.

The second option, i.e., higher productivity, is the one that countries should try to pursue. South Korea or Taipei, China, succeeded following this road.<sup>30</sup> Ways to improve productivity include increases in the capital labor, training and reorganization of the shop floor, and the introduction of competition policies. Of course, in a dynamic setting this option leads to the question of how gains in productivity are shared between capitalists and workers. In any case, not every country will be able to emulate these two. Countries like the Philippines, for example, are finding it extremely difficult to attain adequate output and employment growth.

The above considerations lead to the next important question: what is the role of the State, if any, in developing policies affecting the creation of new employment? In this context, it has been argued that the East Asian strategy of the 1980s and beyond, i.e., export-led growth is the optimal strategy. Despite the work of Amsdem (1989) or Wade (1988) emphasizing the important role of government in East Asia, there are voices that claim that part of the success of these countries was due to the non-participation of the State in business (World Development Report 1995). This evaluation of the East Asian model is incorrect. Moreover, the Report tries to make a connection between export orientation, non-participation of the State, and a labor policy that did not favor privileged groups of workers. These are completely separate issues, in particular the last one.

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<sup>30</sup> The governments of these countries undertook a series of measures under the umbrella of industrial policies to facilitate this.

In general terms, the Asian countries dealt with the labor surplus question following two different industrialization strategies as means of economic growth: (i) import substitution (IS), followed by the South Asian countries; (ii) export orientation (EO), followed by the Southeast Asian countries (after an initial phase of also IS). As is well known, the IS ended up not providing an acceptable solution to many of the problems that developing countries had (and still have). In particular, the domestic market for manufactured products tends to be small in developing countries and the proportion of employment in large-scale manufacturing firms (the firms IS targets) is too low to provide a basis for a large expansion of effective demand. In the face of this problem, developing countries have two options. Either there is a large increase in per capita income in agriculture and services, which provide the bulk of employment in developing countries, so that the purchasing power of workers in these sectors increases and they can buy manufactured goods; or the country has to open and export. A second problem of the IS strategy leads to problems of inefficiencies of all sorts (managerial; use of wrong techniques) due to lack of competition, and prevents transfers of better and more up-to-date techniques. Finally, the IS strategy induces the creation of vested interests. The costs of rent-seeking are known to be high. The South-Asian countries spent a long-time following this strategy. It was only in the early 1990s that India began opening its markets. The results, as it has been documented, have been positive and the country continues implementing important reforms.

The East Asian countries, on the other hand, switched early on the EO strategy and they were able to deal efficiently with the problems of IS, including the achievement of full employment. In recent times, it has been argued that the export-led strategy of the East Asian countries has led to other problems, e.g., excessive over dependence on the developed countries to absorb exports, and a fallacy of composition, that is, that while it is possible that one or several countries have significant export expansions, it is not possible for all of them to expand exports significantly. In fact, it has been suggested that the East Asian crisis could have had its roots in the real side of the economy, i.e., lack of capacity to react to problems of the export-led growth model when it came under strain in the mid 1990s. Felipe (2003) reviews this literature and concludes that although some of these criticisms are correct, the EO still offers tremendous benefits to the countries in the region.

Mazumdar (1999) advocates the search for a “golden mean” between IS and EO. By this he means that Asian countries should be able to find an optimal growth-employment strategy that avoids the problems of IS as well excessive reliance on EO.

Not all countries in Asia, however, have been as successful as the East Asian. Most other countries are constrained, in the sense that there exists a gap between the available and desired levels of resources; moreover, they have very few options to implement successfully output and employment policies, in particular because these countries are often hit by shocks. Most developing countries operate under the shadow of two constraints (Taylor 1994b): savings and foreign exchange. The first one indicates that investment must be financed out of available saving. The second one results from the fact that developing countries require imported capital imports. Hence, they need to export in order to pay for full-employment imports (i.e., the value of imports that would occur when resources are fully utilized), which support investment. This imposes an important trade-off between short-term employment and investment for long-term growth. Under these circumstances, the range of maneuver of most developing countries is rather limited. What is the impact, for example, of an adverse external shock, e.g., the reduction in capital inflows? Successful adjustment requires a wide-ranging menu. Starting from a position of equilibrium (where the saving-investment-foreign exchange schedules intersect), a reduction in capital inflows has a direct impact on the foreign exchange constraint. With lower inflows (lower savings from abroad), savings will decrease. In general, this situation will be accompanied by a tightening of the credit market and, consequently, a reduction in investment demand. As the reduction in foreign exchange becomes the binding constraint (imports cannot be paid for), the new equilibrium of the economy will be at the point where the new investment and foreign exchange schedules intersect (and not where the investment and savings schedules intersect, a Keynesian result). At this point, the economy will be operating at lower capacity utilization and potential output growth rates. Certainly the ability of the economy to generate employment would decrease. Under these circumstances, the rate of inflation has to increase (in a monetary type of adjustment) to generate forced savings to offset the lower savings from abroad and to confirm the new equilibrium.

While reforming some aspects of the labor market towards greater flexibility (especially by reducing excessive labor regulation) could ameliorate the situation, sweeping labor market reforms are not the solution to this kind of problems that developing countries often face. A country with highly unregulated labor market but

unstable from a macroeconomic point of view may not succeed in creating new jobs. In fact, it is extremely difficult for developing countries to devise an adequate policy response to this type of situation. What is needed is a policy package involving a certain degree of market intervention. In any case, these policies do not guarantee higher employment (Bacha1990). For example, fiscal restraint to generate savings will allow faster capacity growth and reduced inflation, but with lower capacity utilization and employment. The same occurs with increased public investment. This will affect the investment schedule, accelerating capacity growth and there is investment crowding-in on private capital formation, but probably also at the cost of higher inflation and lower current output. Finally, higher exports will relief the foreign exchange constraint. But improving exports in the short run is not easy, especially for raw material exporters. This policy option could be easier for semi-industrialized economies.

## **10. CONCLUSIONS: REFORMS FOR FULL EMPLOYMENT**

This paper has discussed different aspects of the debate about the need to reform labor markets across Asia to accelerate growth and create employment. It has been argued that the latter, in particular, will be the most important challenge for most Asian developing countries in the coming years. The problem of creating employment must be understood in a double context: (i) first, today we live in a world where “the name of the game” is *globalization*, *technical change* and *competitiveness*. The latter, in particular, means that governments’ attention has shifted from the effect of egalitarian economic policies on demand to their effects on costs and productivity. There is widespread consensus that wage restraint and the limitation of social expenditures are necessary conditions for adequate economic performance; and (ii) second, changes in the past decade, such as the end of the Cold War or the development of an integrated world market, have thrown hundreds of millions of workers who belonged to non-market economies onto the global labor market. The problem is that this large increase in the labor force has not been accompanied by a concomitant increase in capital for investment. This has led to a “race to the bottom”, that is, a situation where workers have to compete to attract capital by accepting lower wages.

The paper has argued that in a world characterized by rapid technological and productivity improvements, unemployment may increase if these improvements do not lead to a fast growth of output. This is a possibility that Ricardo and the Luddite movement recognized in the 19<sup>th</sup> century, and this is what seems to be taking place in

many countries today. At the theoretical level, these arguments can be valid if an economy is *wage-led*, that is, if following an exogenous increase in the labor share, consumer demand increases and so does overall demand. This implies the mainstream argument that wage increases lead to lower employment need not be true. The problem with wage-led economies is that they are not well prepared to absorb productivity increases. In these economies, productivity increases lead to unemployment. Thus, the dilemma of many developing countries (which probably are wage-led economies) is that growth in real wages and income per capita are impossible without productivity gains, themselves the result of technical change. The question, therefore, is not how to impede productivity gains, but how to shift them to higher real wages and aggregate demand.

The paper has also argued that Asian developing countries should place the objective of *full employment* at the top of their agendas. This should be the ultimate objective of labor market reforms. Full employment must be understood in the sense of zero unemployment, and not in the mainstream sense of the 'natural rate'. Moreover, in the case of the developing countries, characterized by labor surplus and dualism, full employment is about creating the conditions under which the high-wage segments of the economy generate more jobs. For this, the key is to expand demand for labor in the wage sectors outside agriculture so that these sectors can draw labor from agriculture.

The paper has asked whether labor market policies are the 'evil' behind the problem of job creation. Analysis of an extensive data set on labor market policies has led to the conclusion that while some policies or practices may be detrimental to the creation of employment, this is something that should be determined on a country basis. Therefore, the idea of a sweeping program of labor market reforms is not recommended. Rather, what is needed is the identification and dismantling of the particular policies that restrict the creation of employment.

Finally, it has been acknowledged that achieving full employment in developing countries is not an easy task. In countries with a large surplus labor, it is unlikely that the non-subsistence sector of the economy will be able to absorb the surplus to the point that wages in the subsistence sector will increase significantly. For this reason, it is necessary to pursue a complementary policy of increasing the supply price of labor directly in the subsistence sector by increasing productivity in agriculture. On the issue of increasing productivity and shifting it to higher real wages and aggregate demand, the option followed by the successful East Asia countries, the strategy followed by these countries (export promotion) is not easy to replicate. Ways to improve productivity which

are in the firms' hands include increases in the capital-labor ratio, training of the workforce and reorganization of the shop floor. At the policy level, enforcing competitive practices is the key to becoming more efficient. Finally, at the aggregate level, governments will probably have to implement a set of macro policies in the areas of investment and trade.

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