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A Public Lecture: Labour Markets and Economic Development

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Abstract
[Excerpt] I want to put forward three propositions to you based on decades of work in Asia, Latin America, and Africa. First, economic development can be (but need not be) a win-win-win situation - for businesses, for individuals and groups of individuals, and for governments and non- governmental organisations (NGOs). Second, the labour market can (but need not) serve as an effective mechanism for contributing to economic growth and for transmitting the gains from economic growth. And third, in both of these areas, whether a country experiences the more favorable set of outcomes or the less favorable ones reflects a) its choice of policies, which in turn can be influenced, for better or for worse, by b) how it specifies its economic development agenda.

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A Public Lecture

Labour Markets and Economic Development*

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Introduction

Since I last visited Barbados twenty-five years ago, your country has achieved much economic development. One sees improvements everywhere, not just for the elites but for ordinary people as well. I was pleased to see that you are now classified as a 'high human development' country by the United Nations (United Nations, 2005) and an 'upper middle income' country by the World Bank (World Bank, 2006).

It is an honor to be invited to give the keynote address at the Sir Arthur Lewis Institute of Social and Economic Studies. I first met Sir Arthur when he was a professor at Princeton and saw him later at one of the annual meetings of the American Economic Association. I was impressed by the sharpness of his intellect, his heartfelt commitment to the economic development enterprise, and his unbending insistence on intellectual rigor. I thought then, and think now, that Lewis exemplified some of the best traits of what a senior academic should be.

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I have entitled tonight's lecture 'Labour Markets and Economic Development'. It is important for me to be clear about what I mean by both these terms before I discuss them.

'Labour markets' are the places where labour services are bought and sold. Labour markets include both wage employment and self-employment. They also include both the formal sector and the informal sector.

'Economic development' entails improvements in economic well-being. Starting from a state of 'economic underdevelopment,' when choices are severely constrained, 'economic development' is the process of relaxing those constraints. Viewed in this way, economic development is about more than economic growth. What else is involved?

The most pressing part of the economic development agenda is poverty reduction. Barbados deserves credit for having largely eliminated the most abject forms of poverty based on international definitions of 'extreme poverty' (one U.S. dollar per person per day) or 'poverty' (two U.S. dollars per person per day). Nonetheless, a hard core of poverty by Caribbean standards still remains in the region (World Bank, 2005).

In trying to meet the development challenge, realistic and pragmatic approaches are needed. Let me tell you a story that brought this home to me in an unforgettable way. Shortly after he retired from politics, the late Michael Manley, the former Prime Minister of Jamaica, visited my university (Cornell). Speaking to my students, Manley said:

> 'My number one goal as Prime Minister was to eliminate the crushing burden of poverty among Jamaicans. In my first term as Prime Minister, I thought we in Jamaica could take on the aluminum companies and other multinationals on *our* terms, but I was wrong. Between terms, I realised that we had to fight for **our** people on ***your*** terms. The goal remained the elimination of poverty - it hadn't changed. What had changed were the means.'

I want to put forward three propositions to you based on decades of work in Asia, Latin America, and Africa. First, economic development can be (but need not be) a win-win-win situation - for businesses, for individuals and groups of individuals, and for governments and non-governmental organisations (NGOs). Second, the labour market can (but need not) serve as an effective mechanism for contributing to economic growth and for transmitting the gains from economic growth. And third, in both of these areas, whether a country experiences the more favorable set of outcomes or the less favorable ones reflects a) its choice of policies, which in turn can be influenced, for better or for worse, by b) how it specifies its economic development agenda.

The Win-Win-Win Scenario

My first proposition is that economic development can be a win-win-win situation. Businesses face an opportunity to grow in existing markets and tap new ones, thereby becoming more profitable. Individuals can benefit from economic development in two ways:

a) as workers, through more and better earning opportunities in wage employment and in self-employment, and
b) as citizens/residents, through improved benefits and services.

Governments and NGOs can benefit from economic development by being able to take in more in taxes and contributions and use the proceeds to provide more and better social services and programs.

The countries that have been most successful in achieving this kind of broad-based economic development are all in East Asia – first Japan, then Singapore and Hong Kong, then South Korea and Taiwan, then Malaysia, Indonesia, the Philippines, and Thailand, and now China. Their stories are much the same (World Bank, 1993; Fishlow *et al.*, 1994; Asian Development Bank, 2005). Economic growth rates in those countries are higher than anywhere in the world and have been so in many cases for decades. Where there is private enterprise – and China is very much in transition in that respect – businesses have grown and have often become world-class. More and better jobs are being created. Social programmes that previously had been unaffordable have been created. Social services are much improved.

As we all know, the engine of growth in East Asia was production for world markets. Skeptics argue that in today's globalised world, producing for world markets is inherently self-defeating. As one critic, Doug Henwood (1996: 4), puts it:

> 'The antiglobalisers are right that economic growth doesn't necessarily make people happier, and often makes them miserable; that institutions like the World Bank have made the rich richer while making the nonrich poorer; that conventional ideas of free trade are wonderful for managers and stockholders, but hell on workers and nature; and that a turn away from the accumulation of things and toward more humane pursuits would be highly welcome.'

All these forces are alleged to have become even more powerful during the heightened globalisation of recent years. Jagdish Bhagwati (2002: 2), an eminent free-trader, put the critics' position this way: 'Globalisation's enemies see it as the worldwide extension of capitalism, with multinational corporations as its far-ranging B-52s'.

The skeptics' position is not supported by the evidence I have seen. Studies have shown that economic growth has nearly always led to **reductions** in poverty, and the faster was economic growth, the faster was the fall in poverty (Fields, 2001; Dollar and Kraay, 2002). When poverty did not fall, it was usually because economic growth did not take place. Growth **does** reduce poverty.

Still, two important qualifications should be kept in mind. First, the extent to which economic growth reduces poverty depends not only on the ***rate*** of growth but also on the **type** of growth pursued. What type of economic growth to pursue is very much a policy choice.

Second, economic growth may help the economy as a whole but will not help every individual within the economy. The losers, be they automobile workers in Detroit or sugar workers in St. Kitts, are going to fight vociferously to keep what they have. They may be able to exert enough pressure to prevent programs in the general interest from being put into place. The answer is to protect the incomes, not the jobs, through trade adjustment assistance and worker retraining programmes (Blanchard, 2005; Kletzer, 2005). Such programmes now command support across the political spectrum, albeit for very different reasons.

I conclude that growth in today's highly open economy remains a viable option for all countries in the world, developed and developing alike. Globalisation presents great opportunities – its challenges should not be underestimated.

Markets and Economic Growth

My second proposition is that the labour market can (but need not) serve as an effective mechanism for contributing to economic growth and for transmitting the gains from economic growth. Labour market models are useful for thinking about these issues. By a 'model', I mean a set of guiding principles that help us understand how things work and how things would change if certain policies are (or are not) put into effect. However, no single model holds in all contexts, so it is necessary to think in terms of a number of different models.

The basic supply-demand model of labour markets produces two important results. The first is that employment is maximised, and hence output is maximised as well, when wages are set by supply and demand. The second is that if the demand for labour curve shifts to the right, workers will benefit from economic growth through fuller employment and/or higher wages.

Consider the alternatives. First, suppose that wages are set **above** the point where supply equals demand, which arises in many countries because of strong trade unions, effective minimum wages, or government's own pay policies (Fields, 2003; Inter-American Development Bank, 2003). The supply-demand model leads us to expect that firms would want to hire fewer workers than they would have otherwise. In South Africa, the broad unemployment rate (including discouraged workers) is now 39% (Statistics South Africa, 2006), to a large degree because of the strength of the Congress of South African Trade Unions working in partnership with the government (Kingdon and Knight, 2004).

Alternatively, suppose that wages are set **below** the point where supply equals demand, as the government of Singapore tried to do in a misguided attempt to improve that nation's international competitiveness. Severe labour shortages resulted. They persisted until **employers** pressured the government to allow them to raise wages. Needless to say, workers and their unions were delighted by this turn of events and were happy to go along with the employers' request (Fields and Wan, 1989).

A third alternative concerns labour market functioning, one aspect of which is the hiring and firing of workers. In the supply-demand model, firms for their part are able to hire as many or as few workers as they need, and workers for their part are free to move from one labour market to another in search of the best available employment opportunity. Some countries such as India have put into effect stringent regulations regarding the dismissal of workers, with the unintended effect that many employers will not hire workers in the first place, because it is too difficult to dismiss them in the face of performance issues or downturns in business (Besley, Burgess, and Esteve-Volart, forthcoming). South Africa has a similar system in place. There, I met Mr. Isaacs, a ninety-three-year-old man who has been recognised by the Guinness Book of World Records as being the oldest practising pharmacist in the world. Despite his advanced age, he operated his pharmacy all by himself with no employees. Why? Because, as he explained, it would be too difficult for him to dismiss a worker who 'did not work out.' Instead, he hired no one - this, in a country with 39% unemployment!

The point is **not** that supply and demand are inherently good *per se*. The point, rather is that tampering with the forces of supply and demand in labour markets can have unintended side effects – in particular, by slowing both economic growth and the rate of improvement in earning opportunities for workers.

The basic model just presented can and has been modified to fit different countries' realities. Sir W. Arthur Lewis formulated a dualistic model designed to fit the Caribbean economies (Lewis, 1954). For Lewis, the capitalist part of the economy paid sufficiently high wages as it faced an unlimited supply of labour. In his model, any worker who was not employed in the capitalist sector was assumed to be able to work in the informal sector, earning the average product there. Lewis then proceeded to analyse economic growth in such a context. It is this analysis that won him the Nobel Prize. Even today, Caribbean labour markets continue to be characterised as dualistic or segmented (World Bank, 2005b). However, unemployment is relatively high in Caribbean countries compared to other developing regions: 10% or higher in all Caribbean countries except one (Downes, 2005). This fact suggests that the Lewis model needs to be amended to allow for such unemployment.

A different dualistic model was formulated by Harris and Todaro (1970) in the context of East Africa. In Kenya, the labour market was dualistic but in a different way than in the Caribbean: 'all' the high wage jobs were located in the cities and the low wage jobs in the countryside, and it was necessary to migrate to the urban areas to search for a high wage job. This migration resulted in urban unemployment. The model led to two policy conclusions: first, that urban employment creation would *worsen* Kenya's already-severe unemployment problem, and second that the solution to urban unemployment would be rural development. After experimenting with an urban employment creation programme and finding that it did not work, the Kenyan government put into effect an integrated rural development programme. Indeed, as the model predicted, urban unemployment fell (Todaro, 1976). In these and other ways, labour market models have been useful in helping countries formulate labour market policies. Modeling and policy can and should go together.

Formulating Labour Market Policies for Economic Development

My third proposition is that labour market policies need to be formulated carefully with the development agenda clearly in mind. To set the agenda, let me start by talking about what I think economic development is **not**. Nowadays, few of us see economic development as being economic growth **alone**. Nor do we see economic development as being the creation of completely free, unfettered markets – another Nobel Prize-winner, Amartya Sen, has written in the context of famines that free markets can produce perfectly understandable outcomes which are perfectly hideous (Sen, 1981). Nor do we see economic development as government stepping out of the way so that the various parties can negotiate as much as they can for themselves

Having told you what I think economic development is **not**, let me try to tell you what I think economic development **is**. As I said earlier, economic development is a response to underdevelopment, under-development is the existence of severely-constrained choices, and economic development is the process of relaxing those constraints. To explain what I mean by constraints, let me ask you to imagine two scenarios. In one, you are out walking on a beautiful day when somebody asks you for money. You are in a good mood because the day is so beautiful, so you reach into your pocket, pull out some small notes or coins, and comply with the request. Now, put yourself in a second situation. Suppose that somebody approaches you, holds a gun to your head, and demands your money. You hand over your wallet, hoping that the robber will run off with it in one direction so that you can run off in the other. In everyday English, we say that in the second situation you had no choice – you **had** to give the robber your money. Yet, in a very perverse way, we economists might say that you **did** have a choice (and indeed one of my economist friends made a tragic choice in precisely such a setting). In comparing the two situations, what matters is not what was chosen – to give money in both settings. What matters is the setting itself. If you know the story of *Sophie's Choice* (Styron, 1979), you know that the horror was not what Sophie chose – the horror was that Sophie was made to choose. Economic underdevelopment can be thought of as the gun to the head or Sophie being forced to make an obscene choice.

As we think about policies to help achieve economic development *via* the labour market, it is important to be clear about what the objective of these policies is. The objective is **not** to achieve the highest possible level of employment. If it were, such an objective could be achieved by lowering wages as close to the market-clearing level as possible. Rather, the objective of labour market policies goes beyond employment *per se* to include also the terms and conditions of employment.

In 1999, the International Labour Organisation, a specialised agency of the United Nations, set for itself a new mission: 'Decent Work for All' (ILO, 1999). Decent Work has shifted the focus of the ILO's work from process (how many ILO conventions have been ratified by how many countries) to outcomes, including: how many people are working, what kinds of jobs they are working in, how remunerative and secure this work is, and what rights workers enjoy in the workplace. The objective is not just the creation of jobs, but the creation of jobs of acceptable quality. 'Acceptable quality' is open to varying interpretations. Elsewhere (Fields, 2003), I have suggested that the Decent Work agenda be operationalised thus: jobs, at acceptable earnings levels, in which core labour standards are honored.

When are earnings levels 'acceptable?' The best way for me to answer that is to state what I judge to be unacceptable: according to ILO figures, nearly half of the world's working people do not earn enough to raise up their families, namely, two U.S. dollars per person per day (ILO, 2006). These 'working poor' are seven times as numerous as the number who are openly unemployed in the world. Even if job opportunities were to be generated for all of the unemployed, the Decent Work challenge would be far from over.

Turning now to the 'core labour standards' aspect of Decent Work, in its 1998 Declaration on Fundamental Principles and Rights at Work (ILO, 1998), the ILO affirmed that all ILO member states (now 175 in number) have the responsibility to 'promote and to realise, in good faith and in accordance with the Constitution [of the ILO], the principles concerning the fundamental rights,' which include:

(a) freedom of association and the effective recognition of the right to collective bargaining;
(b) the elimination of all forms of forced or compulsory labour;
(c) the effective abolition of child labour; and
(d) the elimination of discrimination in respect of employment and occupation.

Note too what is not on the ILO's agenda - minimum wages, maximum hours of work, and occupational safety and health regulations – even though these are part of U.S. trade law (National Research Council, 2004).

What policies would help create more and better employment opportunities? There are three main sets of policy instruments within the labour market as well as a number of others that impinge upon the labour market.[1]

Lewis, in the work for which he won the Nobel Prize, emphasised one policy prescription above all others: promoting savings, investment, and capital formation. In this respect, Lewis was very much a man of his time as Solow (1956), Kaldor (1957), and other leading contemporaries were emphasising the same things at the same time.

Today, the view on how to achieve economic development is somewhat more nuanced. Economic growth appears to be necessary for improvements in standards of living, but it is not sufficient. Also needed are mechanisms to assure that economic growth reaches the people, either as workers or as citizens. In the interests of brevity, I shall restrict myself to policies that reach people as workers, and discuss three types of policies: labour demand policies, labour supply policies, and labour market functioning policies.

[1] In discussing them, I shall emphasise policy conclusions for developing countries in various parts of the world; for more on policies in the context of Caribbean countries, see Downes, 2005).

Labour demand policies are aimed at increasing the number of workers which firms want to employ. The demand for labour is derived from the supply of, and demand for, product. To the extent that more of a country's products can be sold to those who have the ability to pay, be they in that country or abroad, more of the country's workers can be employed in producing those products. Labour demand can be facilitated by employment-friendly labour market policies and a sound business environment, including secure property rights, enforcement of contracts, sound corporate governance, suitable competition policy, financial regulation, specifically-tailored institutional design, attraction of foreign direct investment, retention of domestic capital, and appropriate sequencing and timing of policy reforms. The World Bank's current Chief Economist, François Bourguignon, and his predecessor, Nick Stern, have repeatedly emphasised the linkage between private sector development and poverty reduction, stating that the investment climate is key (Stern, 2002; Bourguignon, 2005). In the case of the Caribbean countries, a flagship World Bank report *A Time to Choose* (World Bank, 2005b) has highlighted the importance of three aspects of investment climate: infrastructure, policy and legal environment, and taxation and customs. Similar themes have been developed in a report by the Inter-American Development Bank (2003) entitled '*Good Jobs Wanted*'.

A second area for labour market policy intervention is **labour supply policy.** Labour supply includes not only the number of people available for work but also the quality of the human capital that these workers bring to the labour market. Elements of labour supply policy include education, training, and other types of skills development. The more a country's workers present the skills needed for today's globalised economy, the better the country's chances of attaining its development goals. For the more advanced countries in the Caribbean region, knowledge work holds great potential. This is aided by the fact that your labour force is English-speaking.

And thirdly, there are policies concerning **labour market functioning**. The most important of these is wage determination – in particular, whether wages are set by supply and demand or by some other set of forces. But other factors are important too: the availability of information on job vacancies and job seekers, the ability of companies to engage workers as needed and to retrench them when not needed, and the ease or difficulty of workers moving to where the jobs are. Countries in the Caribbean rate well when compared with Latin American countries in terms of labour market flexibility, and research has shown that various legislative measures such as minimum wages and social insurance payments have not had a significant impact on employment in the region (Downes, 2005).

In addition, policies aimed at bringing about more and better jobs also involve decisions that are sometimes regarded as lying outside the purview of labour market policy *per se*. Labour demand reflects a nation's trade orientation, industrial strategy, and commercial policies. Labour supply policies involve not only human capital development but also the fuller utilisation of existing human capital through anti-discrimination policies and kindred policies such as child care and health care. Policies affecting labour market functioning can take a country into such related areas as housing market policies, pension policies, and social safety nets. What unites all these additional policy areas is that they all have ramifications for the labour market even though they are not necessarily oriented towards the labour market *per se*. Opportunities for more and better work opportunities are affected, for better or for worse, by policies in these other areas.

A Concluding Word

To conclude, I have put forth three propositions to you in this lecture. One is that economic development can be a win-win-win situation. The second is that the labour market can serve as an effective mechanism for contributing to economic growth and for transmitting the gains from economic growth. The third is that the more favorable set of outcomes is most likely when sound policies are formulated in terms of a well-defined economic development agenda. Much remains to be done in terms of policy formulation and analysis. Improved labour market models are central to this task. I have said many times and will say again now: sound labour market policies require sound labour market models.

The challenge for us today is to move forward as rigorously and comprehensively as we can, based on our understanding of the realities of the economies and the societies around us. The economic well-being of Barbadians, West Indians, and developing country citizens around the world hinges on our ability to carry out this task. I wish you all well in pursuing this vitally important endeavour.

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