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Labour-demanding growth: lessons from international experience?

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Job creation is a top priority for South Africa. Unemployment is unacceptably high, and the economy must be pushed into a more labour-demanding growth path. However, consensus ends there. Policy recommendations are bedevilled by theoretical, empirical and ideological difficulties.

For example, in a market-based economy, job creation depends crucially on investment growth – but the empirical literature is inconclusive on what drives investment. This does not prevent various interests from adopting strongly opposed policy positions on the matter. Even a seemingly uncontroversial goal such as ensuring that the maximum number of jobs are generated per unit of investment poses policy problems. Is labour-intensity best achieved through cheapening the cost of labour relative to capital economy-wide, or through specific trade and industrial policies aimed at promoting labour-intensive sectors?

Ensuring the sustainable growth of jobs raises even more complicated issues. Is a labour-demanding growth path best pursued solely through labour-intensive growth in the short-term; or does maximising the number of jobs per unit of investment over the medium- to long-term require the use in the short-term of more productivity-enhancing skill-intensive and capital-intensive technologies, at least in some sectors? If the sustainable growth of jobs requires productivity to be boosted, then a trade-off may arise between maximising job creation now (though greater labour-intensity) and ensuring greater job creation over a longer time horizon. The problem is to figure out the relationship between labour-intensive and labour-demanding growth, and then to adopt a strategy to address pressing short-term needs without undermining long-term growth objectives.

International experience provides pointers for constructing an optimal employment-intensive growth strategy – with the caveat that historical experiences are subject to differing interpretations, and that analytical conclusions do not necessarily apply in different contexts.

This paper reviews the international literature on labour-demanding growth and draws some general policy conclusions. Part 1 examines the contrasting records of East Asia and Latin America, while Part 2 investigates problems of job creation in today's increasingly globalised world, reviewing debates about the impact of technology, managerial strategies and international trade on labour markets in high and middle-income economies.

The author addresses South African policies more directly in a companion paper, *Growth, employment and economic policy in South Africa: A critical review*, which is also available from CDE.

Part 1: Development in East Asia and Latin America

Between 1960 and 1990 per capita GDP growth averaged 5,6% for the eight Highly Performing Asian Economies (HPAEs) – Japan, Hong Kong, South Korea, Singapore, Taiwan, Indonesia, Malaysia and Thailand – but was only 1,2% in the major Latin American economies. Although both regions experienced substantial industrialisation, the growth of manufacturing employment was four times more rapid in the HPAEs. Labour force participation rates rose significantly in Asia, but remained roughly constant in Latin America. East Asia's growth was not only faster but also more labour-demanding.

While both regions initially opted for import substitution, East Asia switched to export promotion and reaped the benefits of sustained demand during the long post-war boom. Its growth path was not, in the main, labour-intensive as employment expansion was accompanied by rising labour productivity.

This is an executive summary of a research paper commissioned by CDE. The views expressed are not necessarily those of CDE.

Employment expanded rapidly because of the even faster export-driven increase in output. Important labour market dynamics behind this included a literate labour force, faster growth in productivity than wage costs (at least until the mid 1980s), and competitive labour market conditions. Wage flexibility helped keep unemployment low in the context of labour-repressive labour markets, and limited welfare provision.

Strong growth both in output and employment ensured that wages and living standards rose in the HPAEs. The demand for unskilled but literate workers rose relative to skilled workers as well as illiterate workers (who in any case comprised only a small proportion of the labour force). The overall effect was to narrow the wage distribution and reduce inequality.

By contrast, while Latin American countries at first saw rapid growth in the post-war period as a result of import-substitution, they failed to make the necessary and timely transition from protective to outward-oriented trade regimes. Opting for (inflationary) demand management, they suffered chronic balance of payment problems until forced into painful adjustments by the debt crisis during the 1980s. In most of these countries vested industrial and labour interests associated with import-substitution were well entrenched by the 1950s. A powerful synergy arose between protective labour market policies and tariff protection.

The former raised wages and inhibited employment flexibility, while the latter enabled firms to pass increased labour costs on to consumers – at the cost of allocative inefficiency and macroeconomic instability, which slowed the growth of investment and employment, and encouraged greater capital-intensity.

Differences in the political environment and in the relative power of organised economic interests accounted for the different development strategies in East Asia and Latin America as much as their intended policy choices. East Asian governments were far freer from interest group pressures, since neither organised business nor labour, nor traditional elites (which had been devastated by post-war land redistribution) posed a serious political challenge.

The state was able to play a highly interventionist role in the HPAEs with regard to investment and industrial policies, and did so (except in Hong Kong and, to a lesser extent, Singapore). Governments mobilised resources, acted entrepreneurially, and otherwise coerced and disciplined capital. Some analysts therefore conclude that industrial policies were central to the growth of total factor productivity and technological catch-up; but others play down the role of strategic state intervention and attribute the HPAE's success to the business environment they all had in common: stable macroeconomic policies, stable and competitive exchange rates, and high savings rates.

The current global financial crisis has renewed the debate about state intervention versus market signals. IMF adjustment packages for Thailand, South Korea and Japan implicitly attribute the crisis largely to government intervention by placing a strong emphasis on liberalisation and deregulation – while others blame the financial deregulation which occurred in East Asia during the 1990s. This debate is far from over.

The challenge is to ensure rapid growth, and both short-term and longer-term sustainable job creation.

Capital accumulation, savings and macroeconomic policy

Growth in the HPAEs was driven primarily by capital accumulation. Latin America lagged behind in this regard. Whereas investment as a share of GDP was similar in the HPAEs and Latin America during the mid 1960s, investment growth diverged radically in the 1970s and 1980s. By 1991, while the main Latin American economies were investing an average of 18% of the GDP, the HPAEs averaged 35%. Rapid sustainable growth requires high investment, and also attracts investment. Macroeconomic stability in East Asia encouraged the rapid growth of private investment. Inflation was lower, and real interest rates far more stable than in Latin America. Relatively cautious fiscal and foreign borrowing policies helped the HPAEs to avoid the serious debt crises which beset most of Latin America, with the result that they were better able to weather the external shocks of the early 1980s.

East Asia was also markedly more successful in mobilising domestic savings instead of relying on foreign borrowing. In Latin America the only significant success story was Chile from the late 1980s onwards, where reforms to the banking system coupled with privatisation and pension reform helped to increase savings and investment. However, it must be said that the relationship between savings and growth is ambiguous. Savings can contribute to growth when used to finance investment demand – particularly once an economy is on a growth path where growth itself boosts both savings and investment; but savings can also act as a constraint on growth by reducing demand. The problem is to manage the trade-off on the way to sustainable rapid growth. As savings tend to follow growth, it would seem sensible for policy to focus on economic growth rather than trying to establish national savings programmes.

Growth does not require high savings, since foreign borrowing can finance domestic investment. Of course this involves the danger of destabilising capital outflows of the kind sparked off by a debt crisis or investor panic – a danger all the greater with short-term capital flows, which are inherently more volatile. Chile's policy of discouraging inflows of short-term capital (through taxation and the requirement that a substantial sum be deposited at the Reserve Bank for a fixed period) was an innovative response to the problem.

(Chile has now discontinued this policy – editorial note).

Human capital, growth and inequality

According to the new 'endogenous growth' theory, higher levels of accumulation of both social and human capital are vital contributory factors to per capita income growth. It is estimated, for example, that growth in Korea and Japan was raised by as much as 1,5% per annum by their above-average levels of schooling. But increasing education on its own does not lead to growth. An increased supply of educated labour is beneficial for growth only if it is matched by an increased demand for workers with basic education, as was the case in East Asian countries, with their export-oriented economies and increasingly skill-intensive growth paths.

With economic development, the share of wage employment in total employment rises, and wage differentials consequently play an increasing part in overall inequality. Conventional wisdom had assumed that growth and inequality were likely to be positively related. But most of the countries in East Asia experienced rapid growth over several decades with low (and predominantly decreasing) levels of inequality. Rapid increases in the demand for unskilled labour, together with a rise in the supply of better-educated labour, circumvented the expected growth-equity trade-off.

The evidence from East Asia has led to a major rethinking of the relationship between economic growth and inequality. It has been argued that lower income inequality in fact helped to boost growth in East Asia, by expanding opportunities among the poor to save and invest in human capital, and fostering entrepreneurial activity. Other benefits of shared growth and a more equal income distribution include the development of vibrant internal markets, and a reduced likelihood of political upheaval and economic populism.

There are now very strong reasons to believe that a more equal society is better for growth. How can greater equality be achieved? One strategy is to give poor people access to productive assets such as land. Land was redistributed in South Korea, Taiwan and Japan in the aftermath of the war – but it is questionable whether this could be done on the same scale in other countries today without massive capital flight. Attempts to narrow income distribution probably have to work on the margins rather than through dramatic redistributive measures.

Trade liberalisation as such will not necessarily have egalitarian consequences. Developing countries with low ratios of human to natural resources are unlikely to achieve significant increases in manufactured exports, and employment may well contract as a result of liberalisation. Even if manufactured exports do increase, inequality will not necessarily decline. A greater demand from the manufacturing export sector for relatively unskilled but literate workers will narrow the wage gap between them and skilled workers, but widen the gap between literate and illiterate workers. The overall impact on inequality will depend on the relative shares of skilled, less skilled but literate, and illiterate workers.

Improving the productivity of the poor and unskilled through education and training can help to reduce inequality, but this must be matched by more income-earning opportunities.

In South Africa the gap between the employed and the unemployed is an important determinant of inequality. Where there is a large pool of surplus labour (as in South Africa), a necessary first step is to create jobs – even low-wage, low-productivity jobs.

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Lessons for economic reform

How can a country boost itself onto a self-sustaining growth path? The initial 'Washington consensus' concluded that countries trying to reform their economies in order to achieve success in an increasingly globalised world should do so primarily by reducing their fiscal deficits (through cutting spending and removing subsidies), controlling inflation, liberalising their trade regimes and financial sectors, privatising state-owned enterprises, deregulating their labour markets and otherwise letting markets work without interference. This consensus is now being modified in a number of respects – largely as a result of the lacklustre performance of developing countries that have tasted this medicine.

Relatively few economies have shown clear gains from adjustment programmes, and there is emerging evidence that short-term adjustment measures were in sharp conflict with poverty alleviation and long-run growth. Such concerns, together with recent literature on the benefits of greater equality and human capital accumulation, has led to a shift within the dominant policy consensus, which is reflected in the points made below.

A country looking for rapid, labour-demanding growth would do well to draw on the following lessons:

- Producing for the export market is good for output and productivity growth. Avoid over-valued exchange rates and other policies that discourage export production.
- Liberalise the trade regime, but co-ordinate this with other reforms. Capital account liberalisation may attract investment, but also brings the danger of destabilising flows of hot money.
- Keep macroeconomic policies growth-oriented but stable; avoid negative real interest rates; keep deficits low enough to avoid excessively inflationary forms of financing; don't allow anti-inflationary policy to undermine growth.
- Encourage the process of financial deepening through institution building and other reforms (e.g. privatisation, pension reform); and ensure effective regulation of the financial sector.
- Make the state more efficient. For some commentators, this implies a significantly reduced role; for others, a shift towards more performance-oriented criteria for state support.
- The workforce must be literate. Provide good quality education as widely as possible.
- The poor must have access to income-earning opportunities (through job creation, small business development) and productive assets (including land). Structural adjustment programmes must incorporate measures to protect the incomes of the very poor.
- Labour market institutions and regulations must facilitate labour-demanding growth. There may have to be trade-offs between institutions that encourage productivity growth, and measures that ensure greater wage flexibility.

Countries undergoing trade liberalisation must be particularly concerned about their labour market policies. Where high tariff barriers provided the space for both profitable investment and labour market protection, trade liberalisation reduces that space dramatically.

Reforming countries thus face a dilemma: either the labour market must be made more 'flexible' (by reducing non-wage labour costs and/or allowing wages to fall); or productivity must rise dramatically if firms are to remain competitive. Boosting productivity is desirable from a long-term point of view, but takes time – and may involve slow employment growth (if not substantial job losses) in the short-term. An appropriate development strategy to ensure sustainable job creation must support structural change in favour of more skill-intensive, higher value-added sectors of the economy; but to be equitable, must not exclude the relatively unskilled and the very poor. Labour market policies must not hinder the creation of jobs for less skilled workers – especially in earlier stages of take-off – as this will slow down growth and exclude the very poor from a process of shared growth.

The two-fold challenge is to ensure rapid growth, and to create labour market institutions that support both short-term and longer-term (sustainable) job creation.

Countries undergoing trade liberalisation must be particularly concerned about their labour market policies.

Part 2: Job creation in a globalised world

The second part of the paper investigates the nature of job creation in an increasingly globalised world. It examines employment figures for the major capitalist countries, and discusses the general trend towards less secure, part-time and flexible forms of employment. It then reviews the debates about the impact respectively of technological change, managerial strategies, and trade with low-wage countries in accounting for the relative decline in unskilled jobs and wages in relatively high-income economies.

Flexibility, technological change and employment

Advanced capitalist countries (ACCs) experienced rapid growth in output and employment in the long post-war boom. This came to an end in the early 1970s under the combined weight of the oil-price shocks and systemic productivity-growth slowdown. Since then economic life in the ACCs has generally been characterised by slow growth in output and employment, and by the rise of more 'flexible' forms of production and new technologies. Those jobs that are being created appear to be increasingly outside of stable, full-time employment. Non-regular forms of employment account for a rising share of employment in the major capitalist countries. This is part of a trend towards greater job insecurity, typically also involving lower social wages, diminished trade union power and fewer social entitlements. All round the world greater use is being made of temporary workers, part-time workers, contract labour and outworkers, sub-contracting and other forms of outsourcing.

'Flexibility' has many dimensions. The most important are functional flexibility (the ability of firms to adjust job content and to redeploy workers within the firm), numerical flexibility (the ability to adjust employment and working hours in line with changes in demand), and externalising the employment relation through sub-contracting and the like ('distancing'). It has been argued that firms are applying different aspects of flexibility simultaneously to different parts of the workforce: functional flexibility to 'core' workers, who have firm-specific skills and permanent job-tenure; numerical flexibility to 'peripheral' workers, with skills that are readily available on the job market; and 'distancing' to external workers performing routine tasks. While this model is intuitively plausible, there is no clear evidence of a widespread new and deliberate managerial strategy. The empirical evidence suggests piece-meal, non-systematic and reactive behaviour by managers constrained by a range of factors such as market conditions, trade union strategies, shareholder preferences and local labour market conditions.

The fact that the growth of flexible forms of employment coincided with rapid technological change has led many to conclude that modern capitalism is becoming structurally less capable of creating jobs, i.e. is increasingly less employment-intensive. But according to the ILO, the overall responsiveness of employment to growth has generally not declined in the industrialised countries, although jobless growth appears to have taken place in Germany, Italy and the United Kingdom. The USA economy has been the most labour-absorbing (per unit of output produced): a doubling of the GDP between 1960 and 1994 was associated with a 51% increase in employment. If economy-wide employment slowdown were a function of technological change, then employment elasticities could be expected to fall over time, as computer-driven technologies become more widespread. However, in G-7 countries the opposite has been more common. Economy-wide elasticities were higher in the period 1980-94 than they were between 1960 and 1973, except for the United Kingdom and France (and also Germany, when adjusted for changes in working time). Technologically based explanations of falling employment are confounded by questions of timing.

However, unlike the economy-wide statistics, manufacturing elasticities were worse in all G-7 countries (except Japan) in 1980-94 than they were in 1960-73. In manufacturing there is a clear cross-country trend towards less labour-demanding forms of production. It is not immediately evident whether this is due to technological advance per se, or to trade-induced structural change and defensive innovation. Those who highlight the role of international trade argue that the increase in average labour-productivity in manufacturing in the ACCs (as evidenced in falling employment elasticities) is the result of labour-intensive sectors being driven out by competition from low-wage countries.

Unemployment and increased labour force participation

Since the 1970s unemployment has risen markedly in Europe, but fallen in the USA. The rate of unemployment is measured as the number of unemployed (i.e. those without work who wish to be employed) over the labour force (i.e. the number of employed plus unemployed). The rate of unemployment depends on both employment and the labour force participation rate (i.e. the labour force over the working age population). If the labour force participation rate grows faster than that of employment, then unemployment will rise even if the growth in jobs matches the growth of the working age population.

For the period 1980 to 1990, labour force participation rates increased in all OECD countries (except France). This was an important contributing factor to the rise in European unemployment. In the USA the growth in employment was sufficient to outweigh the impact of higher labour force participation, and unemployment fell.

The composition of the labour force has changed significantly since the mid 1970s. Female labour force participation has been rising, whereas that of males has been falling. The fall in male labour force participation can be attributed in part to rising living standards, which has allowed men to spend more time in education; while the increase in female labour force participation is in part a function of changing social attitudes and the broadening of employment opportunities for women. But the shift is also a result of the decline in heavy industry, which typically employed men, and the rise of the service sector, which provides many jobs to women. The changing nature of employment is a further factor. Women who wish to work part-time only (because of family/child-rearing commitments) are amenable to the emerging forms of flexible employment.

Where there is a large pool of surplus labour, a necessary first step is to create jobs.

Labour markets and international trade

Globalisation is having a major impact on domestic economies, and in particular on domestic labour markets. As capital moves ever more freely around the globe, labour costs are becoming increasingly important in determining comparative advantage. Falling trade barriers and transport costs mean that firms in middle- and high-income countries, whose wages are out of line with productivity, will be out-competed by competitors in lower-wage developing countries.

While the evidence is in some respects inconclusive, there appears to be a compelling case that increased openness and trade with low-wage countries has affected labour markets in high and middle-income economies, reducing the demand for relatively less-skilled workers.

The impact of this international trade is mediated by labour market institutions. Unskilled unemployment is likely to rise where labour market institutions and regulations protect the wages of relatively unskilled workers, as in Europe. Where there is greater wage flexibility, as in North America, then unskilled wages, rather than employment, will fall.

Middle income countries (including South Africa) are also experiencing greater import penetration from low-wage countries. There is evidence that employment growth in Latin America has been adversely affected by the combination of increased trade with low-wage countries and relatively rigid labour markets.

International experience suggests that if the response to competition from low-wage countries is to allow greater wage and employment flexibility, then the wage distribution will widen (as in the USA); whereas if the response is to protect the wages of unskilled labour, then unskilled unemployment will rise (as in Europe)

This might seem to imply that countries have a clear choice: either to go the USA route and make their labour markets more flexible (maintaining jobs for the relatively unskilled at the cost of rising inequality); or else to follow the European way of employment protection, high unionisation, and social insurance (protecting unskilled wages, and fostering greater equality – but at the cost of increasing unskilled unemployment).

Policy choices will depend on whether high unemployment or high wage inequality is seen as the greater cause for concern. Social considerations and values as well as economic considerations will influence the choice made; but opting for high levels of labour market protection together with welfare support for the unemployed is becoming less feasible in the face of growing macroeconomic constraints.

If firms can respond to higher wages and non-wage labour costs by increasing productivity (so as to leave unit labour costs unchanged) then employment need not necessarily fall – though growth will become less employment-intensive. Increasing the costs of employing labour could indeed be part of a high productivity growth strategy, as higher wages could force firms to move into higher-productivity sectors, or use their labour more efficiently.

Choosing the high productivity route involves one or both of the following assumptions:

- fewer higher-productivity jobs and high unemployment are socially preferable to a greater number of lower-productivity jobs and lower unemployment; and
- maximising employment growth in the longer term requires a high productivity growth strategy at the cost of high unemployment in the short term.

The first assumption runs into ethical difficulties – are people better off employed in a low-wage job, or unemployed and on welfare (assuming the country can afford this)? The second assumption rests on trickle-down benefits – which take time to materialise, if at all.

But even assuming that the high-productivity road is preferable to greater wage flexibility in terms of industrial relations as well as growth, the problem remains: What is to be done about unemployment? Productivity-enhancing measures do nothing to improve labour absorption, at least not in the short term.

The optimal strategy for any country will depend on its prevailing social values and on the level of development. A country such as South Africa, with high unemployment and limited fiscal resources, cannot simply opt for a uniform high-productivity growth strategy. This would exclude altogether too many relatively poor people from sharing in the fruits of growth. Wage inequality might fall among the employed, but overall inequality would rise with rising unemployment, at least in the short- to medium-term.

South Africa cannot simply opt for a uniform high-productivity growth strategy.

The challenge facing South Africa is to promote productivity growth in ways that do not undermine the growth of lower wage, lower productivity jobs for its many unskilled and unemployed people.

International experience shows that labour-demanding growth is best pursued through stable, growth-oriented macroeconomic policies, a trade regime that encourages exports, and a competitive labour market. Macroeconomic and labour market policies must be consistent with each other, especially during periods of adjustment.

Appendix: The case of Chile

The Chilean economy has experienced dramatic swings in output and employment since 1970, with a major economic collapse in the early 1980s.

However, from the mid 1980s onwards, Chile's macroeconomic and labour policies have been consistent with rapid growth in output and employment. Wage policies, training policies and macroeconomic policies were appropriate and consistent with the broad lessons identified above. Attention was given to skills development (through demand-driven market-oriented training schemes) in order to support manufacturing, while labour market regulations also supported the expansion of unskilled jobs. A rapid growth in exports (especially agriculture and fishing) was the major source of employment growth. Many of the new jobs were unskilled, but there were also new skilled and semi-skilled jobs through backward and forward linkages and second-round effects through increased aggregate demand in the economy as a whole. As unemployment fell and economic growth picked up, poverty and inequality fell.

South Africa could learn a lot from Chile's successful restructuring. As with the East Asian path, export-orientation and competitive labour market policies were a winning combination.

The full paper, with tables, appendix and references, is 54 pages long. Copies are obtainable from CDE at R30 each.

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Labour market policies must not impede job creation for less-skilled workers.

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