

Workers and labor markets

chapter 7

Governments around the world share the goal of having more and better jobs for their citizens. Jobs are the main source of income for people—and the main pathway out of poverty for the poor. Young people dominate the ranks of the unemployed, with over double the average unemployment rate in all regions.¹ And in many developing countries more than half of the working population is in the informal economy, where working conditions can be poor.² Demographic changes over the coming decades will add nearly 2 billion more people to developing countries, compounding the challenge of creating more and better jobs.

Crafting an investment climate that provides firms with the opportunities and incentives to expand is fundamental to meeting this challenge. Government policies affecting the labor market play a critical role in this effort by helping to connect people to jobs. And there is room for improvement in most countries.

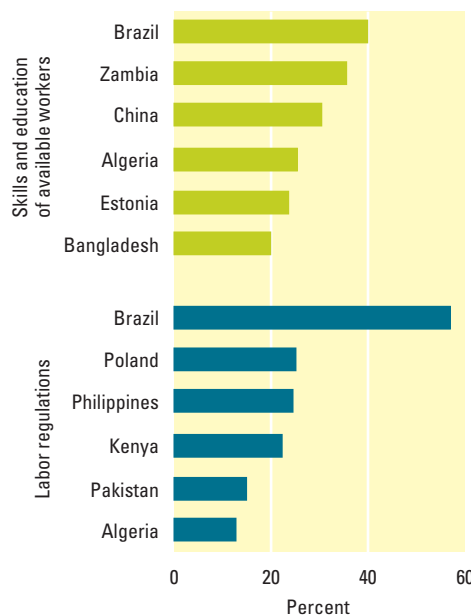
Government support for education and training affects the prospects for individuals—and the ability of firms to enter new markets and adopt new technologies. Firm-level surveys show that more than 20 percent of firms in many developing countries rate inadequate skills and education of workers as a major or severe obstacle to their operations (figure 7.1 top).

Regulation of labor markets is usually intended to help workers, but can also be a significant constraint on firms (figure 7.1 bottom). Ill-considered regulations can discourage firms from creating more jobs and contribute to a swelling of the informal economy. When this is the case, some workers may benefit, but the unemployed, the low-skilled, and those in the informal economy will not be among them.

Public policy also needs to facilitate allocation of labor to its most productive use while helping workers cope with labor mobility. Technological progress that leads to higher productivity and economic growth improves working conditions and wages, but it can also result in more rapid changes to firms and industries. In modern economies, many firms are created and destroyed each year—about 20 percent in many countries—involving 10–20 percent of the workforce.

This chapter looks at opportunities for governments to improve policies in all three areas as part of the effort to create a better investment climate:

Figure 7.1 Firms rate skill shortages and labor regulations as serious constraints in many countries



Note: Percentage of firms reporting that skills and education of available workers or labor regulations were a major or severe obstacle to the operation and growth of their business.

Source: World Bank Investment Climate Surveys.

- *Fostering a skilled and healthy workforce that can contribute to a productive and prosperous society.* Improving the investment climate goes hand in hand with enhancing human capital. A skilled workforce is essential for firms to adopt new and more productive technologies, and a better investment climate raises the returns to investing in education. Governments need to take the lead in making education more inclusive and relevant to the skill needs of firms, and create a sound investment climate for providers of education and training services.
- *Crafting labor market interventions to benefit all workers.* In many developing countries labor regulation provides a high standard of protection to a few workers but limited or no protection for most of those in the informal economy. It can also discourage firms from creating new jobs. Regulatory strategies need to be crafted to reflect this wider range of interests, and to ensure a good fit with local circumstances.
- *Helping workers cope with change in a more dynamic economy.* Inadequate mechanisms to help workers cope with change restrict entrepreneurship and the adaptability of workers. They can also increase resistance to reforms that would benefit society as a whole. While a narrow tax base reduces the feasibility of creating comprehensive social safety nets in most developing countries, there are opportunities for improving the insurance component in income support schemes and the pooling of risks across individuals. Innovative programs can also reach out to poor and informal workers who cannot be covered by broader insurance schemes.

Fostering a skilled and healthy workforce

People's skills and health affect their ability to participate in society, escape poverty, cope with economic and natural risks, and contribute to productivity increases and growth. The availability of skilled and healthy workers also shapes the decisions of firms to adopt new technologies, expand, or enter new markets. Education improves health through greater awareness and access to information.

BOX 7.1 Malaria and HIV/AIDS cloud the investment climate

Malaria and HIV/AIDS have a debilitating impact on people—and growth. They can also be debilitating for the opportunities and incentives facing firms to invest productively, to create jobs, and to expand.

Malaria-affected regions tend to have lower worker productivity and lower per capita incomes than other regions. HIV/AIDS is also having a pervasive impact, with an estimated 40 million people living with HIV/AIDS worldwide, including 2.5 million children under 15. Sub-Saharan Africa had more than 80 percent of the new infections and 75 percent of the deaths in 2003. Not surprisingly, almost 90 percent of firms there are concerned about HIV/AIDS. A survey of African firms has quantified its impact on the region's economic productivity at around 1 percent of GDP.

HIV/AIDS erodes morale, lowers productivity, weakens confidence in the future, and undermines the willingness to save and invest. It affects the most economically active age groups and reduces the quantity and quality of labor. Skilled professionals are being lost, and shorter life expectancies are raising the cost of training and reducing short-term returns.

HIV/AIDS not only destroys human capital—it also weakens the transmission of knowledge and abilities from one generation to the next.

Source: Sachs (2003); McArthur and Sachs (2001); UNAIDS (2003); Bloom and others (2003); United Nations Economic Commission for Africa (2000); and Bell, Devarajan, and Gersbach (2003).

Health strengthens the incentives and ability to invest in education. And apart from the human gains, controlling diseases such as malaria and HIV/AIDS increases the productivity of workers, encouraging firms to pursue worthwhile opportunities in once-affected locations (box 7.1).

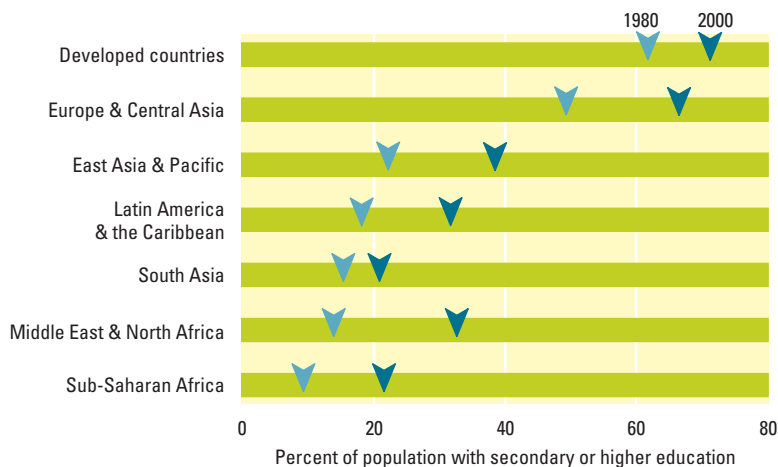
The links between education, health, and growth can create virtuous circles: good education and health enable growth, which in turn promotes further investment in them. The circles can also be vicious: poor education and health reduce incentives for productive investment and entrepreneurship, which limits the resources for enhancing education and health.

Issues associated with the delivery of health and education services were discussed extensively in *World Development Report 2004* and will not be revisited here. The focus instead is on the complementarities between the education and skills of workers and the investment decisions of firms—and on some of the ways education policies need to evolve to equip individuals with the skills required in a more productive and dynamic economy.

The skills of workers and the investment climate

Educational attainment has improved in all developing regions, particularly in East Asia and Pacific and in the Middle East and North

Figure 7.2 The share of the population with secondary or higher education is still very low in many developing countries



Note: Population aged 25 and over with secondary or higher education attainment as a share of total population age 25 and over.

Source: Barro and Lee (2001).

Africa but still remains low in many developing countries. In Sub-Saharan Africa and South Asia more than 40 percent of those age 25 and over in 2000 had not completed any formal education. And while there have been significant improvements in the proportion of adults who have completed secondary and higher education in all regions, their share in the working-age population remains very low in many countries (figure 7.2).

Strengthening the impact of education on growth requires better incentives. There is a strong link between education and living standards across developed and developing countries, but the strength of that link largely depends on the quality and delivery of education and on the incentives firms face to hire more skilled workers. The link between education and living standards has often been broken, prompting some to ask “Where has all the education gone?”³ For example, some African countries with rapid increases in human capital over the past two decades have been growth disasters.

Having more schooling tends to raise individual wages. Indeed, private returns from schooling are high in many countries around the world, even if the social returns from education, in the form of higher output, are often disappointing.⁴ The quality of education is essential: higher investment in schooling of very low quality may not lead to higher productivity.⁵ More educated workers may still

receive higher wages because schooling signals to employers positive individual characteristics, such as ambition and motivation. But these characteristics may have modest or no effects on actual productivity if there are no opportunities to take advantage of them. Social returns to education can also be low when the demand for educated workers is stagnant. If firms are not subject to competitive pressures that stimulate technical progress and the demand for more skilled workers, the effective demand for education will be weak.⁶

Another problem is that human capital may not be applied to its most productive uses. Bloated bureaucracies and overstaffed state enterprises can crowd skilled workers out of private sector activities. In some cases their contribution to society can be low or even negative.⁷

Investment climate improvements interact strongly with education. The link between investment in human capital and growth is mediated by the way education services are delivered and skills are allocated in the economy. But investment climate improvements almost always increase the demand for human capital. As firms have more opportunities and better access to new technologies, they demand more skilled workers and have stronger incentives to engage in growth-enhancing activities, raising both the private and social returns to education.

Skilled workers are needed to adopt new technologies because they are better at dealing with changes.⁸ This is true for different types of firms and different levels of technological development. Technology transfers by multinational firms, and technology adoptions by local firms, require a minimum of human capital and training (box 7.2). New technologies generally require significant organizational changes, which are also handled better by a skilled workforce.⁹ Even among self-employed farmers in low-income countries, having at least primary education enables them to use more efficient production techniques.¹⁰

Skill constraints are a common problem for firms in developing countries (figure 7.1). The constraints are especially severe for firms planning to innovate and expand. The World Bank’s Investment Climate Surveys show that

the firms that consider a lack of skilled workers to be a “major” or “very severe” constraint are those upgrading their production processes. Those firms are also more inclined to invest in training their workforce (figure 7.3). While large firms have the capacity to organize internal training for their workforce, smaller firms often do not.

A sound investment climate strengthens the incentives for individuals to obtain more education. This is best exemplified by the major surge in returns to education in the formerly centrally planned economies during their transition to market systems. Similar patterns have emerged in other countries. In Cambodia investment climate improvements, coupled with higher returns to well-trained people, boosted the demand for vocational training, mostly provided by private firms.

High levels of formal education are not needed for all firms or activities. Lack of availability of workers with tertiary education may be more of a constraint for firms in higher value-added manufacturing and services than for those in less complex industrial processes. For some activities, language proficiency may be important. For example, a large English-speaking population has helped India attract “back-office” services for foreign firms. In many cases education to provide basic literacy and numeracy skills can be complemented by on-the-job or vocational training to enhance the productivity and hence potential wages of workers.

Creating a skilled workforce

World Development Report 2004 discussed strategies for improving the delivery of basic education. Secondary and tertiary education and vocational training also matter for a good investment climate. Governments can help in a variety of ways.

Public funding to expand access to educational opportunities. Public funding can improve the equity of the education system by opening opportunities to those who could not otherwise afford it. Many traditional approaches focused on providing funding through public educational institutions. Newer approaches direct resources through individuals so that they have greater choice, with the resulting competitive pressure on

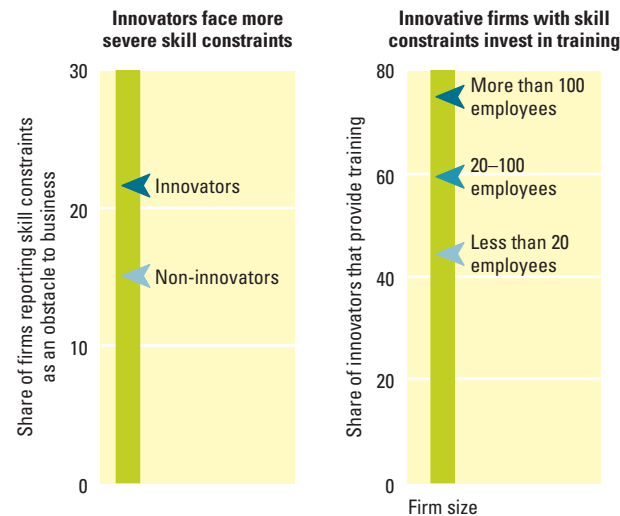
BOX 7.2 Why Intel chose Costa Rica as the site of a multimillion dollar plant

In 1996 Costa Rica beat out Brazil, Chile, Indonesia, Mexico, the Philippines, and Thailand to become the site of Intel’s \$300 million semiconductor assembly and test plant. Many factors made Costa Rica attractive to Intel, as well as other U.S. companies: its stable economic and political system; its central location within the hemisphere; its openness and liberalized economy, including the absence of capital controls; and its receptive investment environment. Another key factor was its educated labor force, and the government’s commitment to invest in further training.

Since 1948, when democracy was restored, Costa Rica has placed a strong emphasis on education. The government invested heavily in education and technology training, and adopted a bilingual English as a Second Language curriculum. Computers were introduced in elementary schools as early as 1988, and by 1996 many schools were equipped with them. In response to the large investment by Intel and other U.S. companies, several education centers—providing technical skills in the electric and electronic fields—have emerged.

Source: World Bank (2003e) and Spar (1998).

Figure 7.3 Skill constraints and innovative firms



Note: “Innovators” are firms that have upgraded an existing product line or developed a major new product line in the previous three years. “Skill constraints” refers to those firms that considered lack of adequate skills a “major” or “very severe” obstacle to the operation and growth of their business. The left panel is based on a sample of 13,300 firms in 33 developing countries. The right panel is based on a sample of 12,099 firms in 29 developing economies.

Source: World Bank Investment Climate Surveys.

providers sharpening the incentives to be efficient and responsive. Options for providing such support include income-contingent loans (as in Namibia)¹¹ and voucher schemes of various kinds. For example, the Africa Educational Trust provides educational vouchers in Somalia to enable disadvantaged girls and young ex-militiamen to attend special afternoon and evening classes.¹²

Improving quality assurance mechanisms. Minimum quality requirements and quality assurance mechanisms through certification

or accreditation schemes can foster quality improvements at schools and universities. It can also boost demand for education by students and increase demand for skills from firms. More than 20 developing countries have introduced accreditation agencies or national evaluation systems. Experience suggests that quality assurance is best provided by agencies that have authority over both public and private providers, rely on explicit standards, and publicly report results. Evaluation criteria are moving from the measurement of inputs (characteristics of the service provider) to a stronger focus on outputs (student performance). Many countries are also establishing national qualifications frameworks that allow comparison of qualifications from different

providers according to defined competency levels (China, Mauritius, Mexico, Uganda).¹³

Facilitating private provision. The market for private education has grown strongly in recent years, augmenting public resources and providing a broader range of choices for students. In Brazil, for example, private institutions accounted for more than 70 percent of higher education enrollments in 2002. Strong increases have also occurred in most regions of the world, including Africa, where the private sector is a significant source for secondary and tertiary education in countries such as Côte d'Ivoire, Gambia, and Ghana.¹⁴ Expanding opportunities for private education involves improving the investment climate for private providers. While private providers of education face many of the same constraints as other firms, additional constraints can flow from poorly defined regulatory frameworks and policies that discriminate in favor of public sector providers. The private sector may also be engaged through public-private partnerships of various kinds. In Burkino Faso, for example, the management of colleges of general education is being delegated to private education providers.¹⁵

Supporting lifelong learning. Lifelong learning improves the adaptability and employability of workers as economies undergo economic and technological change. Worldwide, annual spending on corporate training reached \$28 billion in 2002. By the end of the 1990s almost half the workers age 35–54 in the United States were adult learners.¹⁶ Although most workers are involved in some on-the-job training, it is often not enough to enable them to adjust to major changes in technology or to move across different jobs. Firms themselves may have difficulty internalizing the returns to training investments because workers may move to other firms. At the same time workers' incentives to invest in training may be low if wages are compressed or if workers cannot finance their training because of credit market inefficiencies. In all these cases there is a role for government to support training and retraining. Experience with schemes to meet these goals remains mixed, however (box 7.3).

BOX 7.3 *Tackling skill imbalances through public support for training and retraining programs*

Government support for the training and retraining of workers can take many forms, depending on the target group, the funding source, the form of training, and the mode of delivery.

In Mexico the Job Training Program for Unemployed Workers (PROBECAT) combines short-term training for unemployed and displaced workers with income support (at the minimum wage) and, more important, placement services from the local employment offices. On-the-job training was found to be more effective than classroom training, and private training centers seem to outperform government-run centers.

Training programs for youths, even when well-targeted, tend to have a poor track record. Earlier interventions at the schooling stage are likely to be more effective than trying to later remedy education's failures. The experience of some Latin American countries offers interesting insights, however. The "Jovenes" programs in Argentina, Chile, Peru, and Uruguay are targeted at disadvantaged youth—combining training and work experience with other services, including psychological development and vocational assessment. While effective in promoting employability of the targeted youths, they tend to be costly. An evaluation in Argentina estimated that at least nine years of higher earnings due to the program would be required to show a positive net present value for the groups with statistically significant results. Enhanced job opportunities for the targeted group also tended to be

associated with displacement of other workers.

A growing number of countries are funding enterprise-based training and retraining through compulsory levies on firms rather than relying on general tax revenues. Brazil's National Industrial Training Service (SENAI) funds training from a compulsory contribution from industries of 1 percent of payroll. SENAI has been associated with an increase in the provision of training, especially among medium and large firms. Singapore's Skills Development Fund relies on a levy of 1 percent on payroll for low-wage workers, and reimburses the levies by the amount of training that firms provide. The number of individuals trained has tripled since the Fund's inception in 1979.

While these schemes can facilitate a more systematic, structured approach to enterprise training, many firms, especially small ones, may not have the capacity to provide training to their workers. Training funds are also difficult to manage in countries with weak administrative capacity and where public provision tends to be supply-driven. To address these concerns, Kenya has established a voucher scheme for training services that allows the trainee to choose among providers and courses.

Source: Middleton, Ziderman, and Adams (1993); Calderon-Madrid and Belem (2001); Betcherman, Olivas, and Dar (2003); Aedo and Núñez (2001); and de Ferranti and others (2003).

Crafting interventions to benefit all workers

Governments intervene in worker–firm relations on three main fronts. They intervene in the wage-setting process, they regulate working conditions, and they control the hiring and firing of workers. These interventions are theoretically justified by the (perceived or effective) inability of laissez-faire conditions to deliver efficient and equitable outcomes. Efficiency arguments stress information problems and a need to improve the matching of labor demand with supply. There may also be equity arguments if there is unequal bargaining power between employers and workers, discrimination against vulnerable groups, or incomplete or imperfect insurance of workers against risks.

Beyond the core labor standards—the minimum framework for a sound labor market (box 7.4)—government interventions need to strike a balance between several interests. It has been common to portray the tension as primarily between the interests of firms and workers. But this ignores the broader range of interests involved. Workers in the informal economy and the unemployed can have very different interests from those currently employed in the formal economy. And consumers and potential recipients of tax-funded services also have a stake in the outcome. Where the

balance between these interests is struck will be influenced by social preferences in each country. But as in other areas of government intervention, approaches can deviate from the socially optimal level because of factors such as rent-seeking by particular interest groups and a failure to adapt approaches to local circumstances (see chapter 2). Indeed, as in other areas of regulation, labor regulation in many developing countries mimics or exceeds that in developed countries,¹⁷ benefits only part of the population because of widespread informality, and imposes a disproportionate burden on those firms that do comply (chapter 5).

From an investment climate perspective, the question is how labor market interventions influence the opportunities and incentives for firms to invest productively, create jobs, and expand. Firm-level surveys show that labor regulations can be a major or severe constraint on firm operations in many developing countries (see figure 7.1). Regulations can reduce incentives to make new investments, adjust the organization of work to take advantage of new technologies or opportunities, or hire more workers. Some curtailment of those incentives can be justified by social goals beyond those reflected in the core labor standards including, for example, the promotion of workplace safety. But ill-conceived approaches can exacerbate

BOX 7.4 The core labor standards

The international community, acting through conventions elaborated through the International Labour Organisation (ILO), has identified four core labor standards as the minimum for all countries, whatever their stage of development: eliminating all forms of forced or compulsory labor, abolishing child labor, providing equal opportunity and nondiscrimination in employment, and ensuring the freedom of association and the right to collective bargaining. The past decades have witnessed an acceleration in the number of countries that have signed these conventions, particularly that banning the worst forms of child labor.

The economic effects of enforcing core labor standards depend on the interventions and sociopolitical circumstances. Ensuring the freedom of association and collective bargaining

can go a long way toward promoting labor market efficiency and better economic performance. And there are obvious economic and social reasons for banning slavery and all forms of forced labor. Unfortunately, child labor and different forms of explicit or implicit discrimination, while generally perceived as violations of human rights, are still widespread in many developing countries.

Child labor in particular still looms large in the developing world, where one child in six between the ages of 5 and 17 is at work. Child labor hinders human development, reducing future earnings for the children and aggregate growth for the economy. For example, children in India perform tasks that require no particular skills and develop no human capital. Cheap child labor, if combined with poor investment conditions, reduces the incentives for firms to invest in

new technology that has higher productivity potential but requires more skilled workers.

Reforms that promote stronger economic growth are fundamental to combating child labor. In Vietnam strong economic growth in the 1990s led to a significant rise in poor families' wealth, reducing the number of children in the workforce by 28 percent. Improving the delivery of education is generally more effective than banning child labor. Such bans are generally not enforced in many developing countries, and where they are, can also force children into more dangerous, hidden forms of work (prostitution), especially where parents have no choice but to use child labor to survive.

Source: ILO (2003b); Burra (1995); Edmonds (2004); Krueger (1996); Brown (2000); OECD (2000a); Martin and Maskus (2001); and Miles (2002).

poverty by contributing to unemployment and swelling the size of the informal and unprotected economy. If a society's goal is to advance the interests of all workers—rather than just those who currently benefit from regulated employment—governments need to confront these difficult and often sensitive tradeoffs.

Striking a balance between promoting job creation by firms and protecting existing jobs or workers is particularly contentious during periods of economic reforms—when the long-term benefits of increased employment and wages are often clouded by short-term concerns for the job and wage security of those affected during the transition. Successful reforms bring about higher wages and better working conditions—as well as higher employment and lower unemployment and informality in the long run.¹⁸ There are, however, short-term costs due to changes in job characteristics and greater labor mobility in a modern, productive

economy. This reinforces the importance of looking at labor market policies in the context of broader strategies, including efforts to foster a more skilled and adaptable workforce and to help workers cope with change.

Governments can take three steps to ensure labor market interventions benefit all workers:

- Encourage wage adaptability and ensure workers are properly compensated for their work
- Ensure workplace regulations reflect a good institutional fit
- Balance workers' preference for employment stability with firms' need to adjust the workforce.

Encouraging wage adaptability

Governments intervene in the wage-setting process by establishing rules for wage bargaining and for industrial relations. These interventions can reduce negotiation costs if they do not reinforce the monopoly power of the parties or impose rigidities in wage adjustments. Many governments also set wage floors in an attempt to reduce the number of working poor, but setting the floors too high can reduce the jobs available for low-skilled workers and the opportunities for low-tech firms to emerge in the formal sector.

Wage bargaining benefits from a clear policy framework. The dialogue between freely elected (and representative) associations of workers and employers can reduce uncertainty and transaction costs and improve information flows.¹⁹ Collective bargaining offers a platform for involving both employers and workers in discussions with government about structural reforms. Consider the tripartite negotiations promoting macroeconomic and structural reforms in several western European countries in the past decade. Also consider the pivotal role of unions in promoting political openness and democracy in other countries, as with Solidarity in Poland and black labor unions in South Africa. But unions can sometimes act as monopolists, improving wages and conditions for their members at the expense of nonunionized workers and broader society (box 7.5).

BOX 7.5 *The role and impact of unions*

Trade unions can play an important role in representing the interests of workers. Their impact on wages and economic conditions varies greatly across countries and regions, however, and depends largely on the economic and social context. Wage premiums for unionized work tend to be fairly small in developed countries but quite high in countries or sectors with weak competition in output markets and large rents. Available estimates suggest high wage premiums in countries such as Ghana (21–28 percent) and South Africa (10–24 percent) but much lower premiums in countries such as South Korea (2 to 4 percent).

Union members also tend to enjoy longer job tenure and receive more training than their nonunionized counterparts. And in a number of countries employers favor dealing with unions, because highly representative unions can reduce industrial unrest.

The effect of unions on productivity is less clear cut and depends on market conditions and industrial relations. In Mexico unions have attempted to protect low-skilled jobs at the expense of higher productivity. In Guatemala unionization is associated with lower productivity of coffee farmers. However, greater participation of workers in some aspects of company management in Brazil contributed to better productivity and profitability. The effect was

greater in unionized firms because unions facilitated communication between management and workers.

Given the reductions in union membership in recent years, and the growing size of the informal economy, unions in many developing countries have started to expand their engagement with the informal sector. A union in Argentina operates a health insurance and unemployment fund that also covers unregistered and unprotected agricultural workers. In the Philippines unions initiated loan schemes for poor areas. In Ghana an agricultural workers' union includes self-employed rural workers as members; it supports them through revolving loans and facilitates their access to other forms of institutional credit. In India a union helps unorganized and self-employed workers to obtain licenses.

Associations of informal workers have also been created, with some taking a high profile in defending informal workers' rights. Examples include the Ghana Private Road Transport Union, the Cissin-Natanga Women's Association in Burkina Faso, and the Self Employed Women's Association in India.

Source: Aidt and Tzannatos (2002); Harrison and Leamer (1997); Maloney and Ribeiro (2001); Urizar and Lee (2003); Menezes Filho and others (2002), OECD (1997a); and Ratnam (1999).

In industries where regulation shelters firms from competition, unions are likely to bargain for a share of the rents. An unstable political environment also tends to reduce incentives for unions to “invest” in wage restraint in exchange for expected better economic outcomes in the future.²⁰ High union wage premiums and bigger drags on productivity are indeed found in countries and sectors lacking competitive pressure. Investment climate improvements that enhance economic stability and competition in output markets are likely to lead unions to behave in ways more conducive to stronger economic growth and job creation.²¹

Enhancing wage adaptability. Governments can foster wage adaptability by promoting pluralism of representation in wage bargaining. They can also reinforce the links between wage agreements and firm performance either through improving coordination among social partners or through more decentralized negotiations.

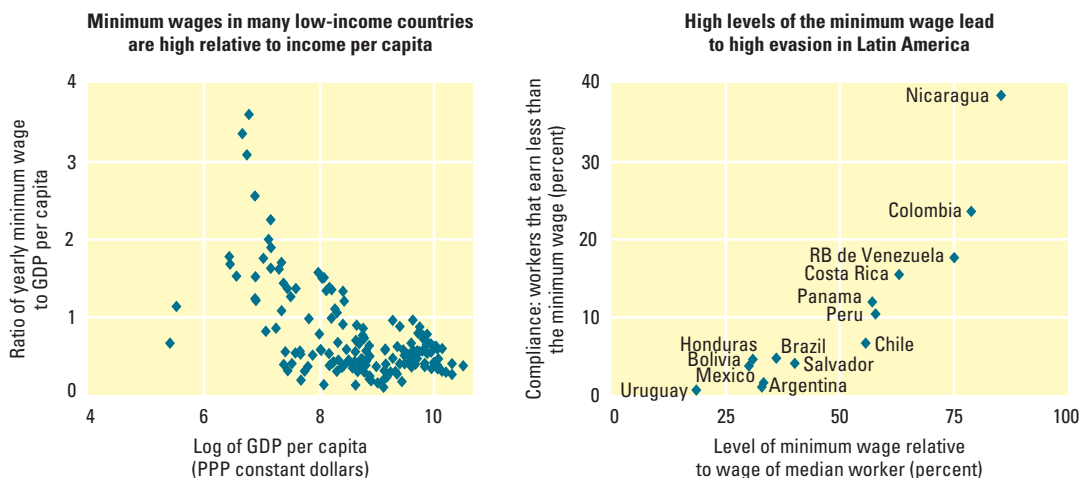
- **Improving coordination.** Some developed countries with a tradition of collective bargaining have reinforced coordination among the different levels of wage negotiation (national, sectoral, firm). In some of them, such as Denmark, Italy, and Portugal, nationwide agreements now fix only the basic wage increase, leaving to the firm-level negotiation further increases consistent with a firm’s performance. Unions have also been part of the design and implementation of large structural changes in many countries. In Mexico and Israel, as well as in the Netherlands, Ireland, and Italy, unions have participated in the design of adjustment programs, including actions in the labor market, and agreed on social pacts that facilitated macroeconomic stabilization. In Kenya, following the abolition of price controls in the mid-1990s, government guidelines on wages were removed, giving employers and workers greater latitude in wage negotiations.
- **Decentralizing negotiations.** Following the experience of other developed countries—such as Australia, New Zealand, and the United Kingdom—some emerg-

ing and transition economies have reinforced wage responsiveness by shifting wage bargaining to the firm. In the Baltic States, the Czech Republic, and Hungary, unionization is low in newly created private firms, especially small ones, and wage bargaining mostly takes place at the firm level.²² Along the same lines, the wage-bargaining system in Peru was reformed in 1992, increasing direct negotiation by relaxing the collective negotiation process, introducing voluntary arbitration as an alternative to state administrative decisions, and eliminating state approval of agreements. The reform also increased collective autonomy by protecting the unions’ right to registration, and strengthened union pluralism by allowing more than one union to exist in a firm.²³

Reassessing minimum wages. The main goal of setting minimum wages is to promote decent jobs and reduce poverty among workers. But its effectiveness in many developing countries is questionable. Minimum wages represent a high proportion of the average wages in these countries, and any further increase shifts the wage distribution upward, punishing rather than helping the workers intended to be supported—young, low-skilled, and female workers. When enforcement is weak, as is often the case, a hike in the minimum wage encourages even more underreporting of wages and strengthens incentives for firms and jobs to remain in the informal economy.

The minimum wage cuts the lower end of the wage distribution and makes firms and jobs with low productivity levels unviable, at least in the formal sector. The level of the minimum wage affects firms, jobs, and income distribution:

- In developed countries minimum wages tend to be relatively low (although in some cases may approach 50 percent of the median wage) with only a modest impact on low-tech firms and the employment of low-productivity workers.²⁴
- In several low-income countries minimum wages are close to, if not higher than, the average income per capita (figure 7.4).²⁵ At these levels many private

Figure 7.4 The minimum wage is very high in many developing countries and, at high levels, leads to weak compliance

Note: In the left panel each dot represents one country/year observation. Data refer to the period 1980–2000. Per capita income is expressed in constant dollars adjusted for purchasing power parity (PPP). The wage used in the right panel is the median wage for workers between 26 and 40 years of age, who work for more than 30 hours per week during the reference period of the surveys.

Source: Left panel: Rama and Artecona (2002). Right panel: IDB based on countries' official data.

firms, especially those in low-tech activities, cannot afford to comply. The poor continue to work in informal activities for only a fraction of the mandated minimum wage.

- In middle-income countries, the minimum wage is generally about half the median in the formal sector. Its coverage and enforcement tend to be low, but its impact on low-productivity firms and jobs can be large. In Latin America the largest proportion of workers who earn less than the minimum wage is found in countries where it is comparatively high (figure 7.4). Examples include Paraguay, where the majority of workers earn less than two-thirds of the minimum wage; Nicaragua (40 percent of workers below the minimum); and Colombia (25 percent).²⁶

Noncompliance with the minimum wage is also concentrated among the most vulnerable workers. Youths and other workers lacking skills or work experience may have little chance of being hired at the minimum wage when it is set much higher than their productivity potential. In backward areas the national minimum wage may be close to the underlying local average wage, severely affecting labor demand from small and medium firms that rely largely on low-skilled workers.²⁷ Despite low compliance,

the minimum wage can act as a strong pay signal for the informal sector, implying that hikes in the minimum wage can have distributional implications that go beyond the formal sector—the income of the low-paid might increase in both segments of the economy, but their employment prospects might decline.²⁸

Given these effects, a growing number of countries are reassessing minimum wages to expand opportunities for low-skilled workers and encourage formalization. They have done so mainly by reducing indexation of the minimum wage and by having lower subminima for some groups (young workers) or for subnational labor markets. For example, the erosion of the minimum wage in Mexico in the 1990s is credited with boosting female employment. Subminimum apprenticeship wages are estimated to have significantly increased job opportunities for young graduates in Chile.²⁹

Ensuring workplace regulations reflect a good institutional fit

Promoting health and safety conditions in the workplace, regulating working time, and encouraging paid leave have been major achievements in all societies. As in most other areas, improvements in working conditions in developed countries evolved gradually, hand in hand with more general

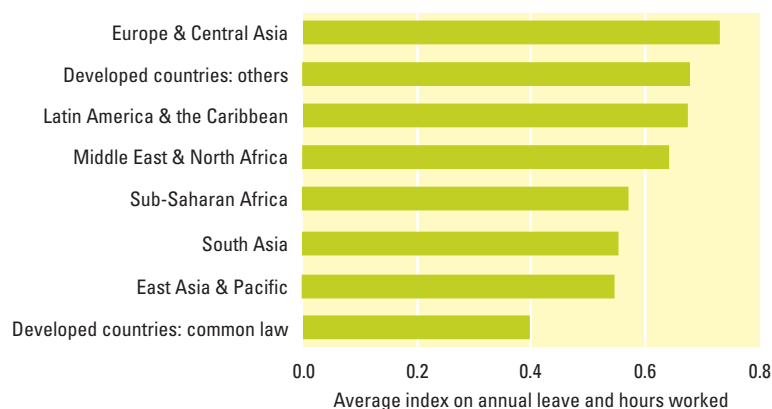
economic progress. Attempting to apply the same or higher standards to countries at earlier stages of economic development and with weaker enforcement capacity often leads to poor or even perverse results.

Improving workplace safety is an important objective for all countries, and well-designed regulation can help to achieve this goal. But safety or other regulations will have limited impact if they or other features of labor regulation have the effect of keeping firms or workers in the informal economy where workers usually lack any statutory protection. Stronger enforcement efforts can help in some cases. When regulations are out of step with local realities, however, there will be tradeoffs between providing high levels of protection for workers that enjoy regulated employment and expanding protection and opportunities to a broader group of workers.

Regulations affecting working hours and paid leave can involve similar tradeoffs. Many developing countries have adopted far-reaching regulations on these subjects—in some cases going beyond what is on the books in most developed countries (figure 7.5).³⁰ Even among countries at similar stages of development, the differences in regulations can be large, with significant effects on labor costs and on the ability of firms to accommodate fluctuations in demand:

- *Workweek.* Botswana, Chile, Costa Rica, Ireland, Malaysia, Morocco, the United Kingdom, and Vietnam all allow 48-hour workweeks. Most western European countries have 40-hour limits, with France recently moving to a 35-hour workweek. In cyclical or seasonal industries, firms often use overtime work to accommodate demand. In Burkina Faso, Cameroon, Hong Kong (China), Spain, and the United Kingdom, there are no regulatory requirements to pay a premium for overtime work. In Bangladesh, Belarus, India, Nicaragua, Pakistan, and Uzbekistan the mandated premium is up to twice the regular pay. To promote employment, many developing countries are moving to liberalize restrictions in these areas—examples include Hungary, Latvia, Namibia, and Slovakia.

Figure 7.5 Developing countries have more stringent regulations on worker hours and paid leave than many developed countries



Note: Higher numbers mean more stringent regulations.

Source: Pierre and Scarpetta (2004). The indicator is based on the World Bank Doing Business Project.

- *Paid annual leave.* Some developing countries have mandated relatively generous annual leave—30 days in Burkina Faso, 33 in Ethiopia, and 39 in Sierra Leone³¹—but in most other countries paid annual leave is less than 30 days. The United States leaves the decision on annual leave to individual or collective agreements.

These regulations can benefit workers in the formal sector and, by promoting better working conditions and motivation, can contribute to productivity. Beyond any potential productivity effect, however, the impact on firms' incentives to create jobs depends on who bears the costs. The evidence suggests that wages do not fully adjust to compensate for the additional costs of these benefits. For example, in Latin America, firms bear up to 50 percent of the costs of nonwage benefits,³² thus reducing firms' potential for expansion and job creation. These effects would not be a source of concern if they reflected the rational choice of workers to trade off not only lower earnings, but also some unemployment, for better working conditions. When this is not the case, workplace regulations reduce wages below what poor workers would be willing or able to accept. They can also encourage unregulated and unprotected employment.

Indeed, workplace regulations have long suffered from poor compliance in many

BOX 7.6 Labor regulation and global integration

Differences in labor regulations and their enforcement might give a cost advantage in internationally traded goods to countries with weak regulations, and new technologies allow labor services to be directly subcontracted to workers in countries with less onerous regulation. This has led to concerns that multinational firms may be exploiting weak labor regulation or putting pressure on governments not to enforce existing regulations.

Evidence of noncompliance with labor regulations abounds in developing countries, but there is no clear indication that this is related to greater integration in the world market. This is true whether integration is measured by export market shares, revealed comparative advantages, FDI, or trade prices. Even in export processing zones—which are often used by governments to attract investment by providing firms with a more favorable policy environment (chapter 8)—it is not clear that enforcement of labor regulation is systematically lower than what is observed outside the zones. Of 73 zones reviewed in a recent study, in only 6 was there any deliberate attempt by government to restrict workers’ rights.

Indeed, a body of evidence suggests that multinational firms tend to provide better working conditions and pay higher wages than alternative local employment. The World Bank’s Investment Climate Surveys also suggests that foreign-owned firms tend to have a larger share of workers with permanent contracts and tend to provide more training for their workers.

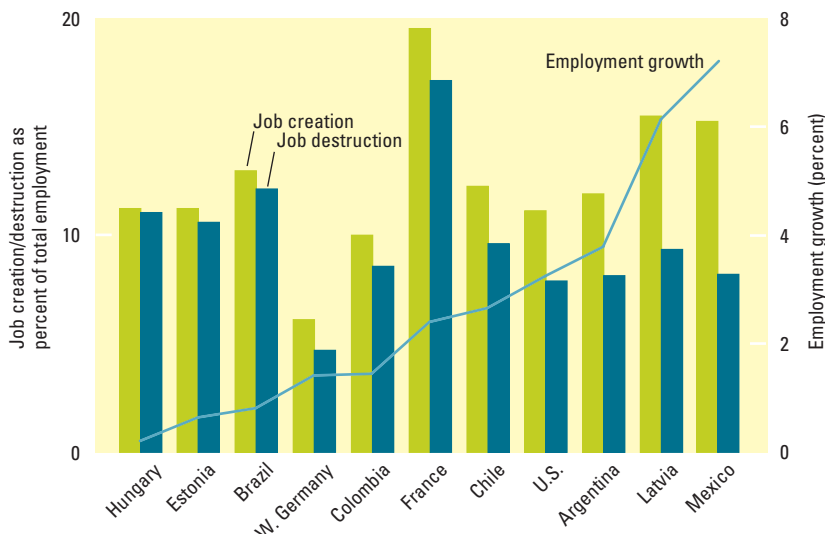
Multinational firms concerned with maintaining their corporate reputations are also increasingly adopting codes of conduct that reflect global norms on a range of issues, including labor practices (chapter 9). Compliance with codes is monitored by buyers or by independent auditors.

Poor working environment conditions are, however, the reality for many workers at the end of the supply chain. Only recently have some multinational firms revised their purchasing practices and improved compliance with labor standards by local subcontractors.

Source: OECD (2000a); Krumm and Kharas (2003); Basu (1999); Maskus (1997); Brown, Deardorff, and Stern (2003); World Bank and IFC (2003); OECD (2001); and Raworth (2004).

developing countries. And while recent progress toward global integration is sometimes thought to result in a lowering of standards, experience suggests that this is not necessarily the case (box 7.6).

Figure 7.6 High job turnover in developed and developing countries in the 1990s



Note: Data for Brazil, Colombia, and Chile refer to manufacturing. Data are from firms that have 20 or more employees and cover different periods during the 1990s. Source: Bartelsman and others (2004).

Balancing employment stability with firms’ need to adjust the workforce

Probably the most contentious government intervention in the labor market is the regulation of the hiring and firing of workers—generally referred to as employment protection legislation. Regulatory intervention may be justified to protect workers from arbitrary action and to provide some stability in employment, which can be particularly important in the absence of effective social safety nets. To the extent job protection leads to long-lasting work relationships, it may also encourage firms to provide training.

But as elsewhere, governments need to balance these potential benefits against the likely costs. By affecting the cost of workforce reorganization, employment protection legislation can strongly influence the cost of doing business, especially the opportunities and incentives for firms to adopt new technologies and to expand. Modern economies require a continuous process of firms’ retooling and firm turnover to channel resources to their most productive uses. In countries for which data are available, gross rates of job creation and destruction each range between 5 and 20 percent, adding up to a total job turnover of up to 40 percent (figure 7.6). A significant part of this job turnover (often 30–50 percent) is due to the entry and exit of firms, an important factor for output and productivity growth (figure 7.7).³³ Onerous employment protection legislation can discourage job creation because firms will be reluctant to hire workers if they face significant costs in adjusting the workforce to changes in demand. As with other areas of labor regulation, onerous requirements in this area can also contribute to the adoption of informal employment arrangements, where workers will receive no statutory protection.

Regulating hiring and firing. The protection offered to regular workers and the conditions for temporary employment vary considerably across countries (figure 7.8). Countries in Latin America and in Eastern Europe and Central Asia tend to offer the strongest employment protection for regular workers.³⁴ Common law developed countries tend to have the least statutory

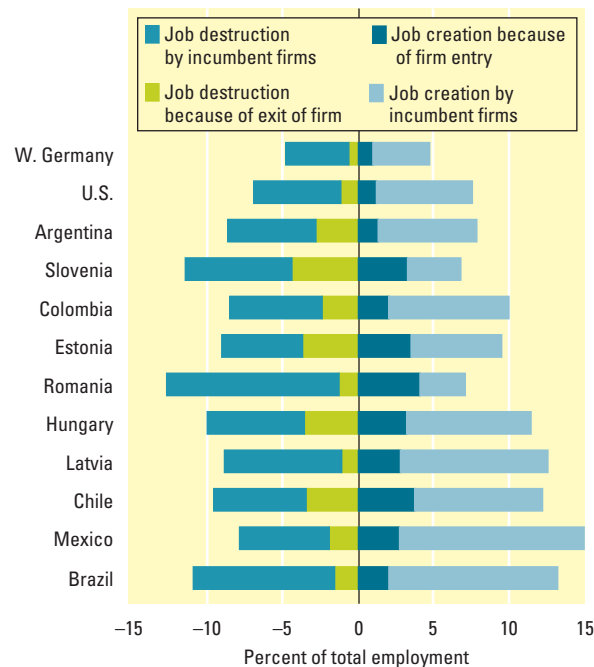
protection.³⁵ Differences within regions are also large. For example, most countries allow the termination of contracts under a list of “fair” causes, but the list can be very narrow, as in Bolivia, where redundancy is not considered a fair cause for dismissal. Advance notice and severance payments also range from a few days and a small proportion of the wage to several months and high compensation. In Sri Lanka dismissed workers receive 2–3 months salary for each year of service, and severance payments in some cases exceed 25–30 months’ wages.

Procedures for dismissal can also be cumbersome and opaque. In Sri Lanka the government decides the amount of compensation for laid-off workers and has the authority to reject employer demands. The time needed for processing the request for a layoff can be highly unpredictable, taking six months on average, but much more if the procedure involves hearings where employers explain their financial performance and business plans to the government to justify the layoff. In Russia, before the reform of the labor code, trade unions had veto power over dismissals for staff reductions or for employees not suited to the job.³⁶

Before the 1999 reform in Brazil, representatives of employers and workers sat on the jury of labor courts, a practice that often led to protracted procedures and difficulties in reaching compromise. About 2 million salaried workers (more than 6 percent of the total) usually filed a lawsuit every year and the average labor dispute took almost three years. The reform restricted the jury to professional lawyers and cut the time to resolve a dispute by half.³⁷

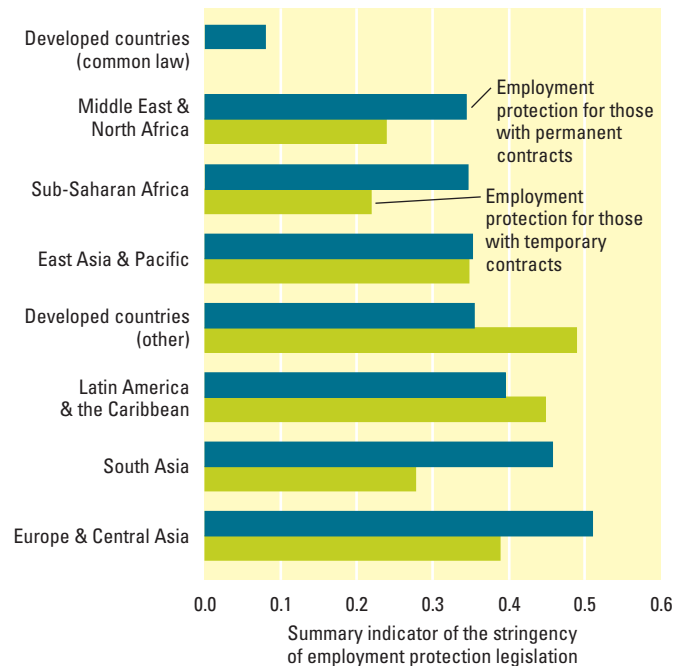
The impact on firms. Firms in many developing countries regard employment protection legislation as a significant obstacle to their expansion. When asked to evaluate eight areas of regulation for the burden imposed on the operation and growth potential of their businesses, firm managers ranked labor regulations as the major or secondmost important obstacle in many countries of Latin America, Central and Eastern Europe, and South Asia. There is also a close correlation between managers’ perceptions of labor

Figure 7.7 Job turnover is high because of both the entry and exit of firms, and the reallocation among existing firms



Note: Data are for the manufacturing sector, firms of 20 or more employees.
Source: Bartelsman and others (2004).

Figure 7.8 Many developing countries have more stringent regulations on hiring and firing than developed countries



Note: Higher numbers mean more stringent regulations. Data refer to employment protections afforded each type of contract.
Source: Pierre and Scarpetta (2004) based on World Bank Doing Business Project.

BOX 7.7 Do firms' perceptions square with actual labor regulations?

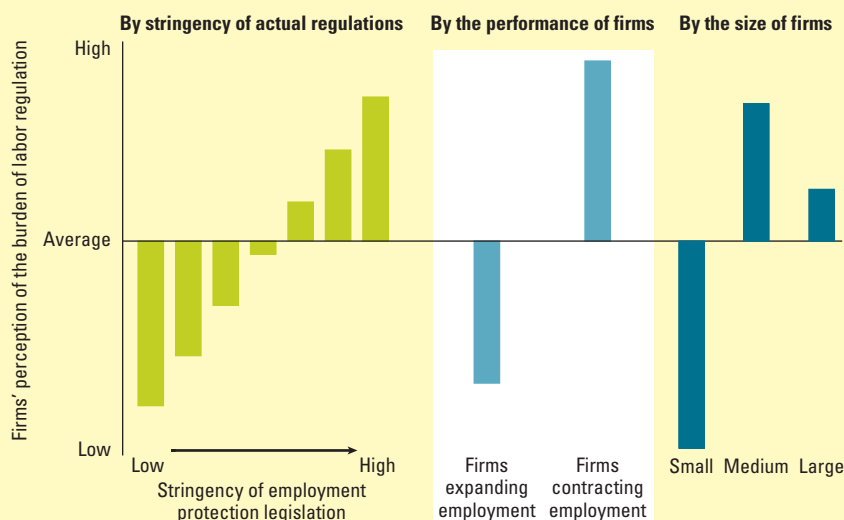
The significance of regulations in different markets can be assessed in two main ways. The first is based on international comparisons of formal laws and regulations. When noncompliance with regulations is high—as for labor regulations in many developing countries—international comparisons of laws and regulations may give rise to inaccurate assessments. Moreover, labor laws are often complex and interact with laws in other areas. The second approach is to ask those affected by specific regulations, such as the employers. Their perceptions are subjective, however, and can be affected by a range of factors.

The Bank's World Business Environment Survey asked managers in 73 developed and developing countries how problematic they found regulations in different areas, including labor, for the operation and growth of their firms. Overall, the data suggest that close to 70 percent of respondents reported some concern (minor, moderate, or major) about labor market regulations. Around 15 percent reported that these regulations were a major obstacle to the operation and growth of their firms.

These data can be combined with more objective indicators of the strictness of employment protection legislation. This com-

parison suggests that the more stringent the regulations, the greater the likelihood that firms will report that labor regulations are a major obstacle. In other words, strict labor regulations, even if not fully enforced, affect firms' performance by limiting their opportunities. Medium-sized firms are most affected, while both small firms and large tend to be less concerned. Downsizing firms are more likely than the average to report that labor regulations are a major obstacle. Firms whose business is expanding are on average less concerned.

Perceptions of the burden of labor regulation vary across countries and firms



Note: The figures are based on a sample of about 9,000 firms in 81 countries around the world. All estimations control for age and size of firms, region, and public ownership. Small firms are those with less than 20 employees; medium firms have 20–100 employees; large firms have over 100 employees. Source: Pierre and Scarpetta (2004), Bertola, Boeri, and Cazes (2000), and Batra, Kaufmann, and Stone (2002).

regulations and the stringency of such regulations from a more objective standpoint (box 7.7).

Onerous regulations can affect firms' spending on innovation, the entry of new firms, their average size, and the incidence of informality.

- *Cost of doing business and exploiting technological opportunities.* Onerous hiring and firing regulations raise the cost of workforce reorganizations required by new vintages of technology, reducing incentives for firms to innovate and adopt new technologies. Evidence from developed countries suggests that stricter rules are associated with lower research

and development (R&D) expenditure and tend to tilt specialization away from high-tech industries. For example, one cross-country study suggests that by reforming their labor rules to the OECD average, developed countries with very strict employment regulations could reduce their productivity gap with the technological leader by about 20 percent.³⁸ Similar reforms in developing countries could yield even larger productivity gains, given the greater potential for catchup by adopting technologies available in international markets.

- *Creative destruction.* Onerous regulations also have repercussions on the turnover

of firms in the market. Because new firms are often better at harnessing new technologies than incumbent firms, stringent regulations reduce the potential for productivity gains. Data for 19 developed and developing economies suggest that countries with more flexible hiring and firing rules experience significantly higher entry rates of small firms (but not microenterprises, often exempt from such regulations or managing to avoid them). Stringent rules also tend to discourage foreign direct investment (FDI), especially in countries where rules are opaque and enforcement is uncertain.³⁹

- *Self-employment and informality.* Onerous labor regulations are associated with larger proportions of self-employed, informal firms, and small firms.⁴⁰ Firms facing high labor adjustment costs either remain very small—and more or less informal and thus exempt from employment regulations—or move to a higher scale or to more capital-intensive technologies, in both cases reducing the incidence of hiring and firing costs on total expected adjustment costs. In Russia many large firms have circumvented strict regulations by pushing workers to leave the firm voluntarily, through wage arrears, prolonged administrative leaves, reduced hours, and other forms of deteriorating working conditions. With no future in the firm and no source of income, many workers eventually quit.⁴¹

Onerous employment protection legislation hurts vulnerable groups. To the extent stringent regulations reduce the potential for firm expansion and job creation in the formal sector, they also reduce workers' access to decent jobs. More job stability for some workers often implies fewer job opportunities in the formal sector. So it is not surprising that stricter employment laws are not associated with a more equal labor market. If anything, income disparities tend to be greater in countries with stricter regulations (figure 7.9).⁴²

Strict regulations in developed countries, where compliance is high, tend to promote job stability for prime-age males but reduce job opportunities and lengthen unemployment spells for youths, women lacking work

Figure 7.9 Strict labor regulation is not associated with more equality in the labor market

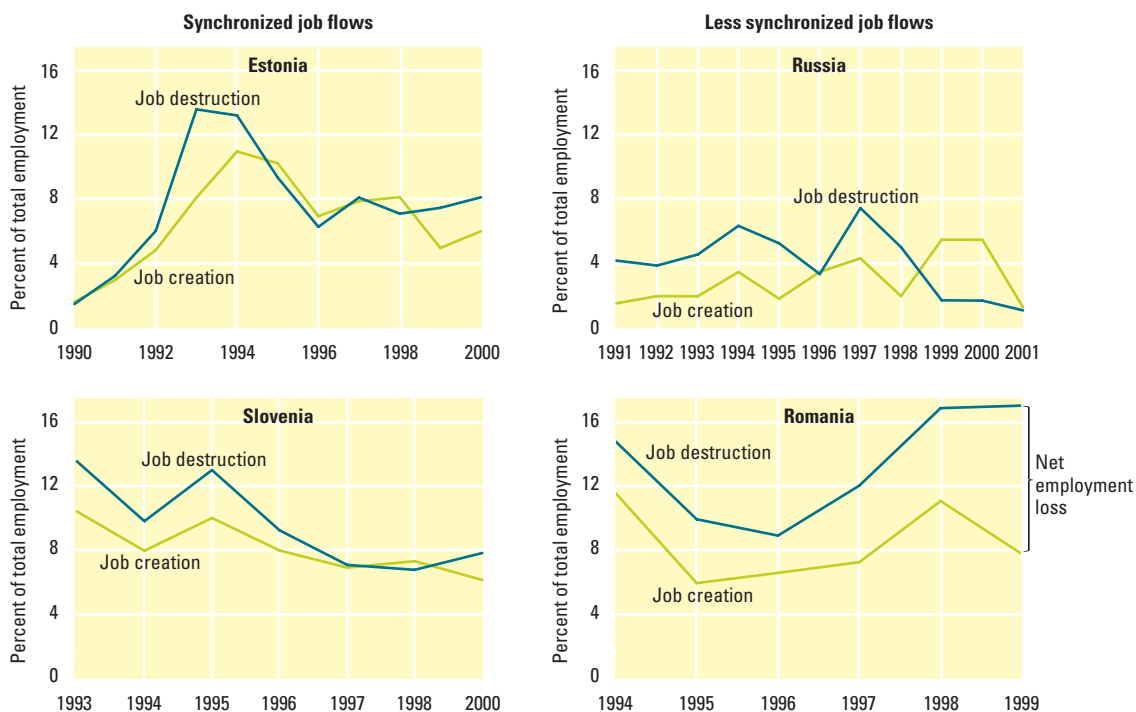


Note: Employment laws index is for year 2000; Gini data are for 1995–2000. Higher values of the employment laws index are associated with more stringent labor regulation, and a higher Gini coefficient indicates greater income inequality.
Source: Authors' calculations from World Development Indicators, and World Bank Doing Business Project.

experience, and those with low skills.⁴³ The incidence of long-term unemployment (more than 12 months without a job) is low in the United States (6 percent of total unemployment) and other countries with moderate employment protection legislation, but it is more than 50 percent in many European countries with more onerous regulations.

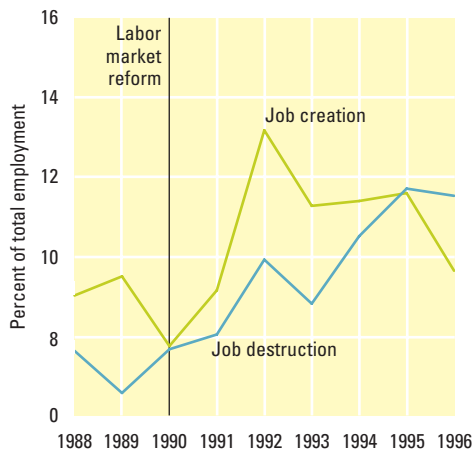
When compliance is weak, as it is in many developing countries, stringent regulations do not reduce the size of labor reallocation, but they do change its nature and reduce its effectiveness. In Argentina—a country with fairly rigid labor regulation—job flows had a negative contribution to aggregate productivity growth in the 1990s, as many workers transited from formal jobs to jobs in the informal economy.⁴⁴ Similarly, in some of the transition countries lagging behind in market-oriented reforms, stringent labor regulations have not prevented job destruction—but rather discouraged job creation in the formal economy. This has led to job destruction leading job creation (or unsynchronized job flows) and the buildup of a large pool of unemployed or informal workers (figure 7.10). Women, young people, and the unskilled—facing greater difficulties in obtaining a job in the formal sector—are more frequently unemployed or engaged in informal activities.

Figure 7.10 Unsynchronized job creation and destruction can give rise to unemployment or underemployment



Source: Bartelsman and others (2004) and Brown and Earl (2004).

Figure 7.11 Since the labor reform of 1990, there has been higher job turnover in Colombia



Source: Bartelsman and others (2004).

Reducing labor adjustment costs and formalizing work relations. Reforming governments have adopted two main strategies to reduce labor adjustment costs. The first focuses on reducing the burden of adjustment for workers hired under regular employment contracts by bringing standards more in line with international

norms. Colombia and Peru liberalized their employment protection in the 1990s, moving their legislation closer to the standards of the (still quite regulated) European developed countries. The reforms led to a higher response of employment to output growth, with speedier employment adjustment (figure 7.11) but also positive employment effects. In Colombia the reform also contributed to increased compliance with labor legislation by lowering the costs of formal production. A recent study on India suggests that amendments to the strict employment regulation in one state (Andhra Pradesh) in the 1980s allowed 1.8 million urban poor to find jobs in manufacturing and service companies in the next decade.⁴⁵ Italy and Spain also experienced sizable positive effects on employment after some easing of their restrictive firing regulations in the past decade.⁴⁶ Similarly, after more than a decade of debate, both Egypt and Morocco revised their labor codes easing contract termination for economic reasons. In Kenya since the mid-1990s employers no longer have to seek permission from the government to dismiss workers.

A second strategy focuses on liberalizing fixed-term or temporary contracts, an approach pursued by several countries in Western Europe, Latin America, and Central and Eastern Europe. Surveys in many developing countries show that firms facing strict regulation of regular contracts make greater use of temporary employment to foster the adaptability of their workforce. In 1991 Peru revised its labor law by lengthening the maximum duration of temporary contracts. The number of workers on term contracts shot up, and young and informal workers benefited the most. Poland, Russia, and Slovakia have also recently increased the duration of term contracts and expanded their applicability.⁴⁷

But liberalizing temporary contracts, while leaving in place strict regulations on regular contracts, reinforces the inequality in the labor market. Firms will have stronger incentives to hire more workers at the entry level and employ them for a limited period, without giving them a regular position thereafter. This increases job turnover but not necessarily overall employment or productivity, because the additional hires will be accompanied by additional layoffs at the end of the temporary contracts, and there will be little or no development of internal human capital.⁴⁸

The effects of reforming labor regulations are likely to differ depending on initial conditions and on the sequencing of the reforms in product and labor markets (chapter 3). For example, stringent employment protection legislation can influence the outcomes of trade liberalization by shifting more jobs to the informal economy.⁴⁹ Colombia's trade liberalization was associated with increased informal employment in industries with the largest tariff cuts, but once labor market reforms were introduced, this pattern was reversed. Similarly, Indian states with less stringent labor regulations experienced stronger growth in the formal sector after trade liberalization than those with stricter labor regulations.⁵⁰

Helping workers cope with change

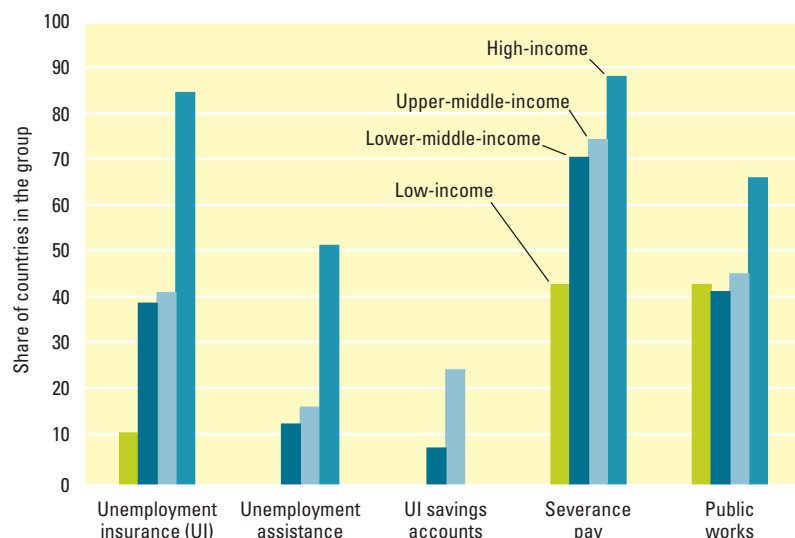
Investment climate improvements that help create a modern, productive economy facilitate the reallocation of labor across firms and

sectors in response to changes in technology, demand, and other conditions. While this reallocation of labor benefits society as a whole, workers may need to change jobs several times in the course of their working lives. This has long been a feature of work in the informal economy, but can be painful for workers who have grown accustomed to more stable employment in protected industries. Helping workers cope with these changes not only benefits the individuals concerned, but can also enhance economic efficiency insofar as it enables better matches between worker abilities and the requirements of new jobs. It can also reduce resistance to investment climate improvements. In many developing countries, inadequate or nonexistent social insurance mechanisms mean that unemployed workers cannot afford to remain without income and are forced to accept the first job that comes their way, even if it is not a good or productive one (figure 7.12).

Improving government policies in these areas requires three interrelated actions:

- Helping workers affected by large-scale restructurings
- Reinforcing social insurance mechanisms
- Reaching out to the large share of workers in the rural and informal economies.

Figure 7.12 Developing countries, particularly low-income ones, offer much weaker and less diverse protection against unemployment risks than developed countries



Note: Based on the presence of the following programs: unemployment insurance, unemployment assistance, unemployment insurance savings accounts, mandated severance pay, and public works programs. Source: Vodopivec (2004).

Helping workers cope with large-scale restructurings

There is often strong pressure to compensate groups directly threatened by structural reforms, such as workers in previously protected industries. Typically not poor, these groups are very vocal and could represent concentrated opposition to reforms that benefit society as a whole. Providing one-time compensation to them may be a socially efficient way to allow reforms to move ahead.

Workers affected by large-scale dismissals can also face particular difficulties. They may be specialized in activities that may not be highly demanded in the broader economy, and may be concentrated in specific locations, making it more difficult to regain employment locally. This was the case for most transition economies, where many one-company towns and certain rural areas experienced a collapse in labor demand and major surges in unemployment and underemployment.

The traditional approach to dealing with large dismissals is to promote voluntary departures with generous severance pay.⁵¹ This can reduce worker opposition and the social impact of restructuring or downsizing. The challenge is to set severance pay at a level that will be acceptable to workers yet be financially feasible. Setting severance pay at too high a level can lead to high short-term costs and the adverse selection of the best employees leaving first. It can also slow or even stop the process of firm restructuring. In Ghana downsizing was halted because the government could not afford the severance payments. In the 1990s Pakistan made severance payments to workers affected by the privatization of industrial units that included five months' salary for each year of service—much higher than international norms. The agreement set a precedent for the later privatization of public utilities, delaying reforms.⁵²

Governments can also provide specific retraining programs to help workers regain employment, but when these programs operate in a context of weak labor demand it is difficult to identify the best training curricula and to motivate workers to participate. In many cases a small proportion of eligible workers takes these courses, which often come too late, after workers have already left, as was the case with the retraining

Bangladesh provided for jute workers.⁵³ To make schemes more effective, early intervention and effective targeting are essential, as are efforts to tailor approaches to local circumstances. Particularly when labor demand is weak, removing impediments to job creation through investment climate improvements plays a critical role.

Reinforcing social insurance to promote labor mobility

A variety of strategies can be adopted to help workers cope with the income risks associated with external or domestic shocks as well as the demands of a more flexible labor market. Sound macroeconomic policies and public support for education are the best risk prevention instruments. Social protection programs can also mitigate the impact of risks while encouraging efficient labor reallocation and entrepreneurship. Even when public resources to finance these schemes are limited, as in the case of most developing countries, much can be done to improve their effectiveness by reinforcing insurance principles and better targeting.

The policy mix best suited to each country depends on the factors driving economic insecurity and the cost-effectiveness of alternative options.⁵⁴ However, international experience highlights the importance of four broader measures:

- *Reducing economic volatility.* Many developing countries remain vulnerable to external shocks. When a negative aggregate shock hits the economy, capital—often the most mobile factor of production—tends to leave the country, while labor tends to bear the brunt of the adjustment in either real wage cuts or unemployment and underemployment. Export diversification can reduce exposure to large fluctuations in external demand, and deeper capital markets and stronger financial systems can help mitigate the impact. The welfare benefits from reducing macroeconomic volatility in developing countries can be substantial.⁵⁵
- *Moving away from procyclical fiscal policy.* The exposure of workers to shocks is compounded by the fact that governments often lack the discipline to pro-

mote countercyclical financing for social programs. Many governments tend to adopt an expansionary fiscal stance in good times and a contractionary stance in bad. Mounting budget deficits in recessions thus create pressures to reduce public spending on social protection (among other things) just when the need for it is increasing. Greater fiscal discipline and better diversification of the fiscal revenue base are essential to ensuring resources are available to cushion the necessary labor adjustment process.

- *Removing market distortions.* Beyond macroeconomic policies, the most effective strategy for risk prevention and mitigation is to develop a sound investment climate where firms have opportunities and incentives to invest productively and create jobs. Investment climate improvements allow for stronger job creation in the formal sector and expand tax resources available for social programs. Improving the operation of financial markets also expands opportunities for firms to insure themselves against temporary shocks without resorting to wage or employment cuts.⁵⁶
- *Supporting workers' adaptability.* In addition to improving the coverage and quality of education, governments can improve the ability and willingness of workers to move to more productive and rewarding jobs by supporting training, counseling, and placement services. While the effectiveness of these programs is mixed, especially in countries with limited administrative capacity, when well-targeted they can complement skill enhancements and income support measures.

These broader measures can be accompanied by social insurance schemes. Beyond enhancing the welfare of the unemployed, these schemes improve the investment climate by facilitating the allocation of labor to more productive uses and encouraging entrepreneurship. They do so in three main ways. First, they can stimulate riskier but more productive jobs, industries, and portfolio choices.⁵⁷ For example, lack of access to insurance among poor rural households pushes them to take up low-risk activities

with lower returns, reducing their income potential by an estimated 25 percent in rural Tanzania and 50 percent in a sample of rural villages in India.⁵⁸ Similarly, uninsured risk can lead to the use of outdated but less risky production technologies, such as holding livestock as a form of precautionary savings. Second, uninsured shocks that reduce individual consumption below the threshold needed to maintain productivity can give rise to "dynamic poverty traps." This happens when families are forced to sell productive assets needed to support their microenterprises or other ventures.⁵⁹ Third, unemployment-related benefits can provide resources to increase the effectiveness of the job search or to enter self-employment.⁶⁰

Expanding and improving social insurance schemes can involve reinforcing self-insurance among workers in the formal economy through severance pay arrangements and increasing the pooling of risks across workers.

Reinforcing self-insurance among formal workers. Mandatory severance pay provisions are the main form of insurance against unemployment for workers in the formal sector in most developing countries. Generally easy to administer, the provisions exchange resources in the event of unemployment for an "insurance premium." Whether the severance pay premium is paid by the workers or not has implications for the overall labor costs for firms and hence their incentive for hiring workers in the first place. Even when workers bear the costs, the schemes offer only a limited pooling of unemployment risk because they are firm-specific and because benefits generally evolve with job tenure rather than the risk of unemployment.⁶¹

Severance pay provisions also suffer from noncompliance in many countries, increasing worker resistance to leaving a job. Required disbursements of severance payments tend to increase when financial resources are lacking because the firm is experiencing difficulties—and the resources may simply not be available if the firm goes bankrupt. Noncompliance looms particularly large among small firms and among low-skilled workers who have few alternative instruments to smooth consumption.⁶²

BOX 7.8 *Reforming severance pay in Colombia and Chile*

In 1990 Colombia introduced fully funded severance-pay savings accounts, requiring employers to deposit a percentage of wages into guaranteed individual accounts available to workers in the event of job separation (limited access to funds while employed was also foreseen). The reform reduced labor market distortions and promoted job creation. Employers shifted most of the cost of severance payments onto wages, but the total compensation of workers (wages plus deposits to their savings accounts) rose. In addition, because the reform removed the discretionary nature of severance payments, both job separations and hiring increased.

By transforming uncertain and conditional payments to unconditional payments monitored by the government, the reform also enhanced the insurance function of severance pay. Before the reform, few firms actually

provided severance pay (for example, firms about to go bankrupt could simply not pay severance or could negotiate a package substantially below what was owed in severance payments). The prefunding requirement increased the likelihood that the legal entitlement to severance pay would actually be carried out. The new severance-pay savings accounts also reduce transfers from other government programs as well as from relatives.

In 2002 Chile introduced a new unemployment insurance system that combined social insurance with self-insurance. Employers and employees both contribute to individual savings accounts, but an additional contribution from employers and a small public subsidy are allocated to a solidarity fund. The new program is effectively a funded system, with individual accounts managed by an administrator selected through a competitive tender.

To stimulate reemployment, benefit recipients first draw resources from their own accounts, and upon their depletion, from the solidarity account. Withdrawals from individual accounts are triggered by separation from the employer, regardless of the reason. Insufficient resources in individual accounts trigger withdrawals from the solidarity fund if the claimant meets the criteria for unemployment insurance (such as not working and being available and searching for job). Withdrawals are limited to two every five years. Benefits are linked to past earnings, with a declining schedule. Workers can also move any unused savings from their individual accounts to their old-age pension accounts on retirement.

Source: Vodopivec (2004); Kugler (2002); and Acevedo and Eskenazi (2003).

To tackle these shortcomings, some countries have introduced pre-funding or brought payments more in line with international norms. Colombia moved toward a funded system under individual savings accounts in 1990, and Chile introduced a social insurance component to its system in 2002 (box 7.8).

Increasing the pooling of risks across workers. Experience in developed countries suggests that unemployment insurance benefits are the next natural step to pooling unemployment risks and facilitating efficient labor allocation.⁶³ Following this model, most transition countries have introduced unemployment insurance schemes since the early 1990s. The schemes have been the main source of income for workers affected by labor reallocation during the transition.⁶⁴ The clear welfare gains for workers affected by job losses need to be weighed against the costs of these schemes, including their impact on economic efficiency. Both the costs and the impact depend largely on the ability to monitor eligibility requirements to minimize moral hazard and make sure that workers have incentives to actively search for a new job.⁶⁵ Effective enforcement is difficult in developing countries, which generally have weak public employment services or none, coupled with a large informal econ-

omy that offers many opportunities for undeclared paid work. In Argentina, for example, the administration of unemployment benefits was found to involve significant leakage of benefits to those who have found jobs in the informal economy.⁶⁶

Even when countries have the required administrative capacity, unemployment benefits should provide only a fraction of the previous wage—and they should be short-lived—to provide incentives for recipients to seek a new job. Poland introduced a generous and open-ended unemployment insurance scheme in the early 1990s, offering it to all job seekers irrespective of whether they had lost a job. Not surprisingly, the number of claimants soared, making the system financially unviable and contributing to the buildup of a large pool of long-term unemployed. The scheme, later reformed to reduce disincentive effects, now provides a low flat benefit for a limited duration. The Czech Republic, by contrast, opted for less generous, short-lived benefits (only six months) and, partly because of this, had lower unemployment in the early phases of the transition.

Reaching out to workers in the rural and informal economies

Most of the programs discussed so far fail to reach workers in the rural and informal

economies, which in many developing countries account for the majority of the population. They typically rely on support from employers or private transfers to cope with income losses. Rural employers often pay workers a fixed wage when they are employed, regardless of seasonal and other fluctuations in demand, or provide loans to workers who face unexpected expenses.⁶⁷ Given the informality of the employment arrangement, employers have a lot of discretion. Poor households also rely on their own savings and private transfers to cope with shocks. In Indonesia, the Philippines, and Russia, private transfers account for between 2 percent and 41 percent of income for net receivers and between 1 percent and 8 percent of income for net givers.⁶⁸ A study in Kyrgyzstan found that private transfers are provided to 12 percent of households and account for more than one-third of the incomes of the households who receive them.⁶⁹

These forms of private risk-coping provide only limited help to poor and informal workers, and can force people to resort to unproductive strategies including selling productive assets, withdrawing children from school, and cutting back medical expenditures.⁷⁰ The most promising strategy for improving their situation is through investment climate improvements that expand job opportunities in the formal economy and contribute to greater tax revenues to fund the provision of education and other services. But governments can also complement private risk-sharing with targeted public support. Three main strategies have been adopted in developing countries that can also contribute to better investment conditions: workfare programs, social funds, and conditional cash transfers.

Workfare programs as social protection schemes. In South Asia workfare programs started as “food-for-work” schemes, in which workers were paid for their labor with food aid from donor countries. Workfare programs have gradually moved to “cash for work,” operated by a variety of agencies, including local and state governments and nongovernmental organizations (NGOs). They are increasingly viewed as

insurance—not emergency—programs for informal and rural workers. The schemes generally transfer income to poor households by providing unskilled manual workers with short-term employment on projects such as road construction and maintenance, irrigation infrastructure, reforestation, and soil conservation.

Workfare programs have often smoothed consumption and kept poor people in contact with the labor market.⁷¹ Well-designed programs build much-needed infrastructure and so reduce the tradeoff between public spending on income transfers and on development. The Maharashtra Employment Guarantee Scheme in India, operating for more than three decades, has created considerable irrigation, infrastructure, and rural roads in the state of Maharashtra.⁷² Workfare programs have also helped many small private contractors emerge and grow.

A key feature of successful workfare programs is the ability to target participants through self-selection processes. In Argentina the Trabajar program kept the wage rate below the minimum wage, encouraging the poor to self-select into the program. In the Philippines, in contrast, the program wage was much higher than the agricultural market wage, attracting a substantial number of non-poor into the program. Kenya, Malawi, Mali, and Senegal also paid wages above the market wage rates, undermining the self-targeting design and diverting jobs away from the very poor.⁷³ Self-selection of participants can be accompanied by targeting to the poorest areas to ensure that programs also promote local development. In South Africa a demand-driven approach to the allocation of funds for workfare programs in the mid-1990s was found to favor more developed and better connected communities at the expense of some of the neediest communities.⁷⁴

Social funds to improve opportunities—and the investment climate—in poor areas. Social funds, introduced in Bolivia in the late 1980s, have become one of the main tools of community-led poverty reduction. They finance small projects in poor communities. Early programs focused on providing temporary work opportunities while also financing better access to basic services.

Recent programs give greater emphasis to service delivery and connecting communities—which generally identify and partly finance projects—with local governments. Social funds in developing countries now absorb close to \$10 billion per year in foreign and domestic financing.

A recent review of social funds in Armenia, Bolivia, Honduras, Nicaragua, Peru, and Zambia offers a fairly positive assessment of their effectiveness in providing income support and promoting local development.⁷⁵ Evidence suggests that spending was highly progressive, with poor districts and poor households receiving more per capita support than wealthier districts or households.⁷⁶ Schools and health centers that received funds have enjoyed equal or greater access to staff and inputs and greater participation by local communities than other institutions. The effects on poor households can also be sizable. Investments in school infrastructure were estimated to have increased primary enrollment rates, especially in Armenia, Nicaragua, and Zambia.

Conditional cash transfers to preserve human capital and health. Conditional cash transfers are another way to combine income support with local development. They belong to a family of transfer programs that combine close targeting with capital accumulation by making income support conditional on either basic needs triggers, such as utility offset payments (in some transition economies), or behavioral changes, such as the continued school enrollment of children or attendance at health clinics. They typically address chronic poverty rather than idiosyncratic risks of job loss.

The focus of conditional cash transfers on human capital formation makes them suitable to address poverty and local development at the same time. In Mexico Oportunidades (formerly Progresas) reached 2.3 million families in 1999. In Brazil (Bolsa Escola and PETI) and Jamaica (PATH), conditional cash transfers are used largely to promote the health and education of children. In some countries the transfers are a quick

response to economic crisis (Colombia) or a natural disaster (the earthquake in Turkey). In others they address long-term human development goals, such as school enrollments in Nicaragua.

As with any transfer program, conditional cash transfers can be problematic when the increased demand for services is not met by increased supply (schools or clinics) or when the targeting is not sufficiently robust. However, evaluations show that they can raise school enrollment and attendance rates and improve child health and nutrition.⁷⁷ The Mexican program Oportunidades increased primary school attendance by more than 2 percent and secondary enrollment by more than 8 percent, while increasing health visits by some 20 percent. Likewise, Brazil's Bolsa Escola reduced school dropout rates from 5.6 percent to 0.4 percent.⁷⁸ The programs also tend to be better targeted than general subsidies because of proxy means testing and geographic targeting. They are also transparent about who receives the transfers, and the level of benefits and the number of beneficiaries can easily be adjusted to take account of changing circumstances.

Creating a better investment climate is fundamental to improving the lives of people, including in their capacities as workers. An investment climate that benefits all members of society looks beyond the protection of existing jobs and confronts the challenge of creating opportunities for those in the informal economy, the unemployed, and young people joining the workforce for the first time. Labor market policies that meet this test play a critical role in the investment climate by helping to connect people to opportunities.

This and previous chapters in Part II focused on delivering the basics of a sound investment climate. Part III considers whether there is something extra that governments might do—beyond the basics—to improve the investment climates of their societies.