INTERNATIONAL LABOUR OFFICE
Governing Body

GB.292/ESP/1
292nd Session

Geneva, March 2005

Committee on Employment and Social Policy

ESP

FIRST ITEM ON THE AGENDA

An overview of the World Employment Report 2004-05

I. Background and context

1. The *World Employment Report 2004-05* (WER), published by the Office in December 2004, is the fifth in a series of ILO reports offering an international perspective on current employment issues. It brings together the three linked themes of employment, productivity and poverty reduction. Employment creation and poverty reduction have long been mainstays of ILO research, policy advice and technical cooperation. Their need to remain so is again reinforced in an environment in which economic interdependence is coinciding with imbalances, asymmetries and inequality in the world. Less common is the association of employment and poverty reduction with the third theme, productivity.

2. Investing in improvements in productivity enables working men and women to obtain income and assets to lift themselves out of poverty. With decent and productive jobs, workers can invest in the health and education of their children, and thus in the future of the economy as a whole. In this context, the WER supports the ILO's Global Employment Agenda (GEA) and the promotion of decent and productive work.

3. The fundamental reason for addressing these three issues together is based on the simple observation that a substantial share of poor people in the world is already at work: it is not the absence of economic activity that is the source of their poverty, but the less productive nature of that activity. It is clear that if people – in particular, the 550 million people working in extreme poverty – were able to earn more from their work, then poverty would decline. It is not just any work that can raise people out of poverty; what is needed is productive work. Therefore, a narrow focus on "unemployment" and "employment" as a means of describing labour market conditions is in fact an inadequate measure for most countries of the world.

II. A controversial topic? A simple understanding of productivity

4. If the beneficial outcomes of productivity improvements are so obvious, why does the topic elicit such a broad range of views from those who view productivity gains as the route to faster economic growth, to those who are considerably more wary? The answer is simply that productivity increases and jobs can be, and often are, inversely related – jobs can be lost as a result of improvements in productivity. In this regard, wariness over the impact of productivity growth is roundly justified, and the concern is even greater in today's world of growing economic interdependence.

5. In the long term, however, there is no necessary trade-off between the growth of productivity and that of employment. And the evidence broadly corroborates this. Economic history shows that, in the long run, the growth of output, employment and productivity proceed in the same, positive direction (see the example in box 1). This is not, however, to say that the trends in each variable are either linear or similar across countries. Indeed, a stagnation or decline in productivity characterizes some countries in the world well beyond the short term.

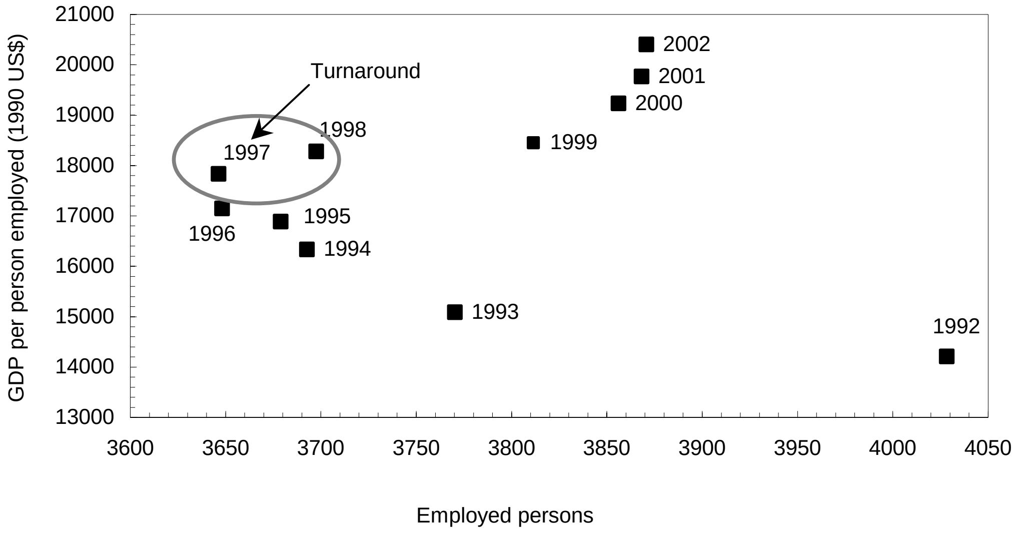
Box 1
Labour productivity and employment in Hungary

The Hungarian economy provides an interesting example of employment-productivity trade-offs resulting from intense structural transformation due to the change from a centrally planned to a market-oriented economy. As in all centrally planned economies, full employment was achieved and maintained through huge amounts of hidden unemployment. From the beginning of the transition in 1992 until 1997, nearly 2 million jobs were lost. Though output decreased, it was not in proportion to the employment declines, causing labour productivity to increase considerably. Economic growth improved after 1997, leading to a period of employment creation, which was also accompanied by continued productivity growth.

Hungary's experience can roughly be divided into two phases: from 1992 to 1997 and from 1998 to 2002 (see accompanying graph in this box). During the first period, employment declined while productivity increased owing mainly to the effects of downsizing public enterprises and the need to make them efficient.

Reforms introduced in 1995 encouraged foreign direct investment and stimulated exports. By establishing itself as part of the European production network, Hungary has been successful in obtaining high growth rates since the mid-1990s, which has also translated into employment creation. At the same time, businesses have adopted more efficient practices, leading to gains in productivity growth.

Labour productivity and employment, Hungary: 1992-97 and 1998-2002 (in thousands)



Source: Román, Z. 2003. "Labour productivity and employment in the Hungarian economy", background paper for the *World Employment Report 2004-05*, unpublished (Geneva, ILO, Employment Sector, Employment Trends Unit).

6. Of course, to the worker who loses his or her job as a result of productivity gains, the notion that this is an "adjustment cost in the short term" is of little consolation. The fact that job losses will occur is an argument in favour of institutional and policy preparedness on both the supply and on the demand side of the labour market. The former, for example, would rely on efficient mechanisms for labour market intermediation through public and private employment services. Support to the demand side is also essential, which is why many countries engage in counter-cyclical spending or adjustments in monetary policy over the business cycle as a means of curbing the decline in aggregate demand and encouraging investment.

7. A simple focus on the inverse relationship between employment and productivity growth is too narrow. In fact, the loss of jobs resulting from productivity growth is just what is "supposed to happen" in the course of development. As a country gradually transforms out of relatively low value-adding agriculture and into higher value-adding manufacturing and services, overall productivity is increased. At any level of development, productivity growth is pushing the structural transformation of economies. It is also a channel through which poverty reduction can occur. The WER presents evidence that when productivity and employment growth occur in the sectors in which poverty is heavily concentrated, the effect on poverty reduction is the strongest.

III. Main policy messages of the World Employment Report 2004-05

8. The main aim of the WER 2004-05 is to explore the evidence regarding the impact of productivity performance on both employment growth and poverty reduction. It tackles four key issues central to narrowing the decent work deficit in the world and finds that there are trade-offs to be made in striking the right policy balance between employment and income growth, and between productivity growth and poverty reduction.

Productivity and employment growth: Trade-offs and complementarities

9. This section of the report provides the basic economic framework for analysing productivity and employment growth. That productivity and employment are at times in inverse relation to one another is a partial view based on enterprise-level considerations and specific time frames. The latter is most apparent over the business cycle, although it is also true that this inverse relationship can be rather durable over time. For example, ever-higher productivity and less employment describe the secular trend in agriculture and, in many countries, manufacturing as well.

10. Adjustment at the macroeconomic level to gains in productivity wherever they originate can indeed be employment-enhancing. Two qualifications might potentially challenge this outcome, however. The first is whether, in view of rising economic interdependence and greater mobility of production factors, the positive link between employment and productivity growth – at least at any particular national level – has undergone qualitative change. Much of the contemporary popular debate in the United States, for example, is on the information and communication technology (ICT)-induced surge in outsourcing attending the recent years of economic recovery. This was in turn reflected in substantial productivity gains and, until recently, poor employment growth in the country. A claim can be made that ICT has been a catalyst in reshaping an international division of labour in which any service sector work that can be "digitalized", e.g. data processing, or software development, can be located in areas that enjoy comparative cost advantages.

11. As noted in paragraph 6 above, it is safer in this context to argue in favour of renovating labour market institutions so that they are equipped to keep pace with today's more rapid structural dynamics in the economy. This underscores the need for a focus on “supply-side preparedness”, with particular emphasis on providing access to skills relevant to the future demand for labour.

12. A further qualification relates to whether differences in an economy’s stage of development alter in any way the analysis of the macroeconomic advantages of productivity growth. Here, two issues are noteworthy. The first arises from the observation that the positive gains in productivity, employment and output growth have eluded some regions in the world.

13. The second issue is whether a strong policy focus on productivity can be made in the context of the widespread unemployment or underemployment that is characteristic of developing countries. In short, is there a policy choice between favouring employment and favouring productivity growth?

14. In policy terms there can be no such “either/or” choice: both employment and productivity growth must be jointly pursued. It is also the case that, for companies that compete in global markets, a focus on productivity is essential, irrespective of its employment consequences, and a prescription to forego productivity improvements in favour of employment would not be sustainable. In fact, it could carry with it the implication of widening inequality, since at higher levels of economic growth, it is productivity growth that contributes the major share.

15. In this context, a labour-intensive development strategy is not necessarily a low-productivity strategy. Wage employment in the labour-intensive modern sector is more productive than the alternative it replaces. Focusing on the abundant factor, labour, can thus be an employment-rich, as well as a productivity-enhancing strategy.

16. Finally, there is widespread agreement that economic growth is the outcome of the shift of resources out of declining activities and into emerging, higher value-added ones. In policy terms, a sensible approach to addressing decent work deficits in the more immediate term is to focus on where *labour actually works*. In so doing, the focus shifts to the informal economy, on the one hand, and to the growing service sector, on the other – a sector which encompasses both sides of the decent work spectrum and has witnessed both productivity and employment gains.

17. Increasing productivity and employment for long-run sustainable growth requires a twin strategy of investing in dynamically growing sectors while at the same time building capacity in labour-intensive sectors. A strategy of investing only in dynamic sectors in attempts to “leapfrog” may not be enough to reduce poverty, mainly because the fastest growing sectors may often not be where the majority of the poor are employed and may require skills and training that the poor do not possess.

18. The growing ICT sector in India is a case in point. Currently, India’s ICT sector employs about 800,000 people, a figure that is expected to increase to 2 million by 2008.[1] But job growth in the rest of India’s economy has been insufficient to provide adequate employment opportunities for the over 400 million people who make up the labour force, two-thirds of whom are located in the rural sector and lack the education and skills to compete for ICT jobs. The challenge then is to broaden the ICT sector, while deepening its linkages with the labour-intensive sectors of the economy. At the same time, workers need skills and training in order to prepare them for work in the dynamic areas of the economy.

[1] *The Economist:* “The remote future?”, 19 Feb. 2004, London.

Agriculture: What role in development?

19. The observation was made earlier that the decline in agricultural employment arising from productivity increases has been the classic path to economic development. Indeed, the point at which countries experience an absolute decline in agricultural employment has long been regarded as the "turning point" in development.

20. A major part of the characteristics of the productivity/employment relationship in the agricultural sector arises from the nature of agricultural production itself; as standards of living rise, people tend to spend a proportionately lower share of their income on food. The main implication is that an expansion in output made possible by improvements in agricultural productivity is often not met by an equal expansion in demand, and employment in the sector declines as a result.

21. But 75 per cent of the world's poor live in rural areas where agriculture is the mainstay of the economy. In fact, the agricultural sector employs 40 per cent of developing countries' workforces and contributes over 20 per cent of their GDP. The United Nations family has set itself the ambitious aim of halving the numbers of those in extreme poverty by 2015. Any serious effort to do so must acknowledge that there is both a geographical and sectoral component to address. In particular, the bulk of the world's extreme poor live in rural Asia and sub-Saharan Africa, and most of their economic activity is in agriculture.

22. In a longer time frame, for economic development to occur, underpinned by the migration from low- to high-productivity sectors, the policy framework – including investment, education, skills, and infrastructure policies – needs to play a strong, supportive role. While such a role is essential, a prescription for rapid structural transformation would seem easier said than done. Without a convergence of many factors, sustained productivity growth in agriculture could merely result in employment displacement, rural-to-urban migration, and the replacement of rural poverty with the poverty of the urban informal economy.

23. Neglecting the agricultural sector during the process of industrialization can constrain the development process. While economic development needs industrialization, in many economies industrialization also requires the development of the agricultural sector. The policy challenge is to find the right balance in fostering the development process in all three sectors – agriculture, industry, and service – simultaneously.

24. It is in this context that two points are of particular interest. First, there are many developing countries in which both productivity and employment have increased in the agricultural sector – and it is in those countries where extreme poverty has declined the most.

25. The second point is that it is widely acknowledged that since the "green revolution" of the 1970s and 1980s, rural development in many developing countries fell victim to an era of policy neglect in the 1990s. It may be no mere coincidence that the decade of rural policy neglect of the 1990s also witnessed a pronounced slowdown in the rate of poverty reduction in the developing world.

26. For many, though not all, developing countries, it makes sense to promote the growth of productivity and employment in the agricultural sector. To do so requires:

- a focus on food price development. It is important that food prices in the poorest parts of the world do not rise to levels that could undermine poverty reduction. At the same time, prices have to be high enough to ensure that food-exporting countries can foster an attractive investment environment;

- a focus on income distribution, particularly a better distribution of land ownership in agriculture, both to facilitate output growth and accelerate poverty reduction;
- investment in water supply, infrastructure, health, education, agricultural research and development, and other institutional reforms;
- fostering non-farm activities as an additional source of rural employment creation.

27. Finally, whether a focus on agricultural productivity and employment growth makes sense for a country depends on: (i) its stage of development (i.e., whether it is a developing, transition or industrialized economy); and (ii) the potential of its agricultural sector, because not all developing economies have the abundant natural and human resources to obtain a comparative advantage in agricultural production. Nor is national action alone adequate.

28. The vitality of the agricultural sector depends upon international commodity prices, product niches, and market access. As such, success at any national level depends critically on the behaviour of the world community and the achievement of the Doha round of trade negotiations within the World Trade Organization, without which steps towards fairer globalization – of greater inclusion and less poverty – cannot be made.

Workforce mobility, workplace stability: How does each relate to productivity?

29. If economic development is enabled by structural transformation out of lower to higher valued-added activities, it stands to reason that a certain amount of capital and labour mobility is necessary for this inter-sectoral transition to occur. Capital mobility is present when adequate savings, whether domestic or foreign, are available for investment in new growth sectors in a context of macroeconomic stability and sufficient demand. Labour mobility relies in turn on the availability of workers with appropriate skills or the ability to acquire them with relative ease.

30. But the evidence shows that, however important the mobility of capital and labour might be for higher productivity, a certain amount of stability is just as important. A useful distinction to make at the outset is that "stability" is not synonymous with "immobility", since employment tenure is not the same as job tenure; an employee can remain in long-term employment with an enterprise but undertake new jobs and assignments over the course of his or her tenure with the firm.

31. Why, then, is such employment stability important for high levels of productivity? Much of how workers learn to do their jobs better comes from formal training and the training they receive on the job from more experienced workers, as well as from simply learning by doing. Employers have no incentive to invest in their employees' training if they believe that their employees will leave the enterprise before the gains of that investment can be realized. Employees, on the other hand, have no incentive for acquiring new, more productive ways of doing things if, in the absence of some form of employment security, they fear they will "work themselves out of a job". A major means of improving productivity is through training and here unions play an important role (see box 2).

Box 2
How do unions promote employment stability?

Unionization and social dialogue can promote employment stability both at the micro or firm level as well as the macroeconomic level. At the firm level, unions promote stability in three ways.

– Higher wages associated with unionism deter workers from switching jobs on the supply side and, on the demand side, wage pressure could force employers to seek productivity improvements to offset it.

– Institutional mechanisms available through unions give workers a “voice,” allowing them to channel the grievances of the “median” worker for resolution, rather than opt for “exiting” the job.

– Many collective bargaining agreements include provisions that limit lay-offs, again inducing cost-adjustment solutions through other channels.

At the macroeconomic level, unions also promote stability through social dialogue with government and employers’ representatives. In these instances, agreements are made on national wage policies. For example, the setting of the minimum wage or the development of wage policies which ensure wage increases match productivity growth, can help to establish macroeconomic conditions that facilitate job growth. In times of economic change or uncertainty, social dialogue can be instrumental in making job retention and job creation a priority for governments and social partners.

Source: WER 2004-05.

32. There are considerable differences in the length of average tenure across countries, sectors, and occupations. Apart from the economics of an industry or demographics of a country, institutional differences have an important role to play in explaining differences in average tenure. For example, a labour market institution such as employment protection legislation (EPL) can make an enterprise’s ability to engage in economic dismissals either more or less difficult. There is, in fact, a strong and convincing correlation between average tenure and the “stringency” of EPL in regulating economic dismissals.

33. For all policy environments, the question is how best to obtain the greatest benefits from the mobility of capital and labour, and the productivity-enhancing inter-sectoral transformation that they support, while at the same time providing adequate employment stability at the micro level in the interests of promoting high levels of productivity.

34. There are no easy answers to obtaining this policy and institutional balance. In the light of globalization and rapid technological change, it is indeed possible that product market regulations will need to be made compatible with more rapid adjustments to change. It may also be that labour market institutions and regulations are in need of adjustment. The evidence now weighs in favour of new regulations or re-regulation, rather than a focus on deregulation that has dogged the debate on labour market flexibility for a quarter of a century.

35. Some countries appear to have a workable balance between flexibility and employment security. What appears to matter is whether workers feel that, if they lose their current job, they will be able to make the transition smoothly into one of equal or better quality. This in turn implies an effective (and productive) means of dealing with the changes wrought by globalization in an institutional environment that promotes an appropriate level of micro-level flexibility, backed up by a strong guarantee at the macro level of labour market security.

36. Different countries will approach the challenge of adjustment in different ways. A concept of “protected mobility”, or the promotion of both flexibility and security, would appear to make sense. An appropriate level of employment stability is important to this. Finally, employment stability is also important at the macroeconomic level; working men and women who feel secure in their jobs or in their ability to find acceptable alternative employment provide a stimulus to aggregate demand, whereas employment insecurity can weaken aggregate demand.

The small-scale/large-scale productivity difference

37. In most countries, there is the predominance of small relative to large enterprises as a share of total enterprises, and as a significant share of total employment as well. In definitional terms, the small and medium-sized enterprise (SME) sector typically refers to enterprises in the formal economy. But, relative to industrialized countries, developing countries are characterized by a higher share of a range of small-scale activities of many types, such as self-employment, and small enterprises and microenterprises, operating in both the formal and informal economies. These latter small-scale activities usually operate at lower levels of productivity than do large firms.

38. A key challenge for improving standards of living in developing countries is therefore to improve productivity in small firms and in small-scale activities generally. The challenge is all the more important in view of the productivity differential between small and large firms and, thus, the implication that inequality in the form of a "productivity divide" can have structural roots.

39. In view of their productivity disadvantage, one question is how, with a lower level of productivity, small firms manage to survive in competitive markets. Small firm survival appears to hinge on the fact that small firms compete in different markets from those in which large firms compete, even when small firms are producing the same product as large firms. The shelter of non-competitive markets (markets that may not be fully exposed to trade liberalization or markets that are in fact multiple for the same product) is useful, as it at least provides some security for the jobs that small firms create.

40. Experiences in some countries have shown that the productivity disadvantage of small firms is not necessarily an intractable problem. Despite relatively high wages, for example, small firms in northern Italy have been able to overcome their size disadvantage by being part of a dense network that blends competition with cooperation. The productivity advantages can once again be expressed in simple terms.

41. Through cooperation, such as the collective purchase of raw materials or the joint sponsorship of industry training, input costs can be lowered. Similarly, through the collective sharing of orders too large for any one small firm to fulfil, market share can be expanded.

42. As such, some models of small-firm cooperation can promote both improved productivity and employment growth, as input costs are lowered and output is expanded. Such models are not an enclave, but fully integrated into the global economy. They can also be successful in the perpetuation of local "social capital", or trust. Indeed, a considerable advantage of building cooperative links among small firms is that, in so doing, greater social cohesion can be generated as well as a shared commitment to local development.

43. The upgrading of existing clusters of small firms, the development of efficient cooperatives, access to commercial credit, and the collective provision of missing business services are ways in which developing countries such as Brazil, India and Indonesia are attempting to address the challenge of integrating their small firms in wider markets. By implication, this too is a strategy for improving productivity in the informal economy, and for building bridges between the formal and informal economies.

IV. Follow-up

44. Over the coming months follow-up will entail briefing ILO field staff and constituents on the key findings elaborated in the WER, and through consultations and workshops to develop strategies instituting these recommendations into national employment strategies.

45. The main messages of the WER can, of course, neither be prescriptive nor lend themselves to identical policy changes in a diverse world. The search for answers to all of the questions elaborated in the WER can nevertheless make a fundamental contribution to the promotion of decent work.

46. The Committee is invited to provide further guidance in carrying forward the policy recommendations of the *World Employment Report*.

Geneva, 31 January 2005.

Submitted for discussion.