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Labour Markets and Income Inequality

What Are the New Insights after the Washington Consensus?

Rolph van der Hoeven

UNU World Institute for
Development Economics Research
(UNU/WIDER)

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Rolph van der Hoeven
Geneva, December 2000

ABSTRACT

The economic reform policies in the 1980s and the 1990s under the so-called Washington Consensus have recently led to growing concern for inequality. This paper looks at some of the labour market outcomes of the economic reform policies in terms of inequality. The paper argues that labour market policies, regulations and institutions have at least three goals, *improving allocative efficiency* (matching supply and demand), *improving dynamic efficiency* (increasing the quality of the labour force) and *improving or maintaining a sense of equity and social justice* among labour force participants.

The paper observes that in many developing countries employment became more informal, wage shares declined and the difference between skilled and unskilled wages increased. These developments are set against some of the typical labour market elements of reform policies under the Washington Consensus such as a reduction in minimum wages, breaking up of bargaining power, reduction of employment protection, reduction in public sector employment and reduced government outlays in human capital formation. Typically, these policies were taken to increase the allocative function of labour market institutions.

In reviewing past experiences the paper concludes that the dynamic, equity and social cohesion elements of labour market policies have to be an important element of redistributive and growth policies. Including these elements of labour market policies in economic reform policies are not only necessary to reduce inequality but makes it also easier for economic reform policies to deal with the allocative aspects of the labour market. By focussing narrowly on the allocative aspect of the labour market, the reform policies under the Washington Consensus have seriously compromised the options for equitable and pro-poor growth development policies

I INTRODUCTION

The adjustment experiences in the 1980s and the adjustment and liberalization experiences in the 1990s have recently led to renewed attention to issues of inequality. Inequality was a topical issue in the 1970s, when major attention was being paid to it by scholars and international organizations such as the Economic Commission for Latin America and the International Labour Organization. The emphasis on adjustment policies under the so-called 'Washington consensus' in the 1980s relegated the discussion on inequality to the sidelines, notwithstanding a greater concern for poverty at the end of the 1980s and in the 1990s. One stream of thought argued that the best way to tackle poverty was to grow out of poverty. Income inequality is often the consequence of deep-rooted societal structures, which would take time to change. Others regarded measures to reduce inequality detrimental to growth and therefore not warranted during periods of adjustment when all the emphasis should be placed on reviving growth quickly. These and similar views did not go uncontested, of course (van der Hoeven, 1995; ILO, 1996; Ravallion, 1997), but only recently has the concern for inequality in the debates on adjustment and liberalization entered into mainstream discussions again (Rodrik, 1998; Stiglitz, 1998; Tanzi and Chu, 1998). Specific sociopolitical reasons can partly explain this renewed attention: large inequalities would incite a growing coalition of different groups in various countries against current measures of capital and trade liberalization, and large inequalities would threaten the social peace needed for foreign investments to fructify. Advocates of globalization have therefore joined structuralist economists in being concerned over large inequalities.

Several questions surround the issues of economic reform and inequality. A first set of questions revolves around whether economic reform has led to greater inequality and, given our interest, especially inequality in earnings. A second related question is whether inequality is seen as a desired outcome of economic reform policies, under the understanding that greater earnings inequality speeds up adjustment, or whether inequality has been an undesired by-product of economic reform. This question is not unimportant, as some research outcomes in the 1990s demonstrate that inequality is harmful for growth. None of these views are uncontested, especially in Europe (Lindbeck, 1999), but in the framework of our analysis it is perhaps sufficient to follow the conclusions of Bourguignon and Morrisson (1998):

> The main conclusion one can draw from recent literature is simply that there is no reason to consider that redistribution is systematically inefficient, contrary to what was long believed or postulated. In other

> words, redistribution may not be an engine of growth, but in some circumstances, it may be an adjuvant of it…What the recent literature on inequality and growth suggests is simply that this 'inefficiency' of redistribution should be played down and the redistribution objective significantly enhanced in development strategies.

This paper looks, in particular, at some of the labour market outcomes of economic reform policies in terms of inequality. (For a discussion of economic reform policies and poverty, see van der Hoeven, 1995).

The significance of the role of labour market institutions in the relationship between reform policies and inequality remains controversial. Some see labour market institutions as a hindrance to more efficient development and growth, while others argue that, without proper labour market institutions, an economy cannot progress. In order to deliberate among the arguments in this discussion, one might emphasize that labour market policies, regulations and institutions have at least three goals: *improving allocative efficiency* (matching supply and demand), *improving dynamic efficiency* (increasing the quality of the labour force) and *improving or maintaining a sense of equity and social justice* among labour force participants.

The important question in terms of the relationship of labour markets to reform policies and, especially in this paper, inequality is whether these different goals of labour market policies are compatible with each other, and, if they are not, which of these goals should dominate. Although the question is difficult for economists, value judgements have to be made, judgements which often creep into the discussion on labour markets without being made explicit.

Another issue emanating from the above characteristics of the functions of the labour market revolves around the fact that regulations, instruments and policies are aimed mainly at smoothing labour supply and demand and at adjusting labour supply. Hence, if economic reform policies and macroeconomic policies are not able to generate growth and demand for labour, labour market policies cannot improve the overall employment situation; at best they can have an effect on labour supply and on the labour demand for different skills categories at different sectoral levels, which influences equity. Claims about labour market rigidity are often made in connection with economic stagnation or failed economic reform. However, as Schultz (1998) argues:

> … the magnitude of the problems in trade, taxation and industrial organization may directly increase the leeway for misallocation of workers and human capital investments in the economy that seriously

retard economic development. These conditions, that contribute to the severity of labour market distortions may, therefore, have to be resolved first to expect labour market reforms to succeed.

In order to deal with these arguments of Schultz and gain a better understanding of the labour market and its interaction with other markets, we first review in Section II some theoretical aspects of labour markets and reform policies. Then, in Section III we discuss some labour market outcomes that have been noticeable in most developing regions which have undergone economic reform processes, namely, the informalization of employment, a fall in wage shares in most countries and changes in wages distribution. This is followed in Section IV by a review of some general trends in labour market reforms which have typically taken place during the recent wave of reform policies under the Washington consensus, namely, a decline in minimum wages, shifts in bargaining power, a reduction in employment protection, a reduction in public sector employment and changes in human capital formation. Section V concludes with a discussion on the various macroeconomic and labour market policies adopted in developing countries to reduce inequality and stimulate employment.

II LABOUR MARKETS AND ECONOMIC REFORM: SOME THEORETICAL CONSIDERATIONS[1]

The labour effects of economic reform and structural adjustment depend in the short run on the stabilization effects of macroeconomic policies and exchange rate policies (van der Hoeven, 1987; Horton, Kanbur and Mazumdar, 1994; Agénor, 1996). Stabilization involves a reduction in domestic final demand through restrictive monetary policies, budget deficit reduction and exchange rate policies. *The assumption is that the labour market functions in such a way that it can absorb the decline in demand*. According to neo-classical production theory, stabilization is expected to slow down any increase in prices in product markets, and this will lead to a decline in production levels and in labour demand. The general assumption is that the price of labour (real product wage) will fall, which will reduce production costs and maintain the levels of production at a lower product-price level. Textbooks even show that, if the price of labour falls sufficiently, there will be no fall in output, though this phenomenon will occur at substantial lower price and wage levels. If the price of labour does not fall sufficiently, textbooks indicate that unemployment will

[1] Some paragraphs in this section draw on van der Hoeven and Taylor (2000).

increase. It should be noted that, in both the case of full flexible wages and the case of sticky wages, the income distribution among workers, capital owners and the unemployed will change.

It is often argued that, if wages are flexible, the labour market is working well, and that therefore the rules and institutions which prohibit such wage flexibility during periods of stabilization and adjustment should be altered in order to increase the flexibility. But this short-run supply-side interpretation of the labour market has some serious flaws.

First, it ignores the fact that real wages are not only a cost factor, but are also an important determinant of aggregate demand, as the proportion saved out of wages, especially in developing and transition countries, is smaller than that saved out of other types of income (Taylor, 1988). Thus, wage reduction when the economy is below full capacity (as is often the case in countries where stabilization policies are implemented) will not lead to full employment; unemployment will exist at a lower real wage level, attaining a point where macroeconomic tightening will lead to heavy costs on the labour market.

Second, the increased imports caused by greater inequality (a wage-profit relationship in favour of profits) will put renewed pressure on the balance of payments, necessitating a further spell of stabilization policies.

Despite these uncertainties about the allocative function of the labour market, policies to improve the allocative efficiency of the labour market dominate the reform process (Taylor, 1993). Yet, in the long run it is not the allocative efficiency of the labour market which will allow reform efforts to be translated into a renewal of growth, but rather the dynamic efficiency of labour market policies. Policies under the aegis of structural adjustment are supposed to increase dynamic efficiency. The components of structural adjustment are manifold (van der Hoeven, 1995; Toye, 1995; Horton, Kanbur and Mazumdar, 1994).

One main component of structural adjustment is the set of policies to change the composition of national production in favour of the production of tradable products (export products and import-competing products) through the use of exchange rate policies. The change in production in favour of tradables requires a reallocation of labour from the non-tradable to the tradable sector. Although various labour market instruments can be used to achieve this, many studies emphasize the importance of increased differentials between the tradable and non-tradable sectors to achieve reallocation in favour of tradable production. In the long run the movements of supply and demand are then assumed to reduce

the sectoral wage differentials once more. Hence, some authors argue that emphasizing wage differentials as the outcome of a successful adjustment mechanism is not correct, as increased wage differentials should be seen as an intermediate outcome, and it is more important to examine whether actual changes in sectoral output and labour reallocation to these sectors have taken place (Horton, Kanbur and Mazumdar, 1994).

But changes in sectoral output depend on many more factors rather than only well-functioning sectoral labour markets. Infrastructural changes, the development of new capacity, credit, and so on are all important elements in determining sectoral output shifts (van der Hoeven, 1987). *Hence, the reallocative function of exchange rate policies is heavily mortgaged on a large number of other policies and changes in institutions*. Over the years a large number of other policies aimed both at improving the allocative function of stabilization policies and at easing the adjustment process have therefore been included among structural adjustment policies. These include, first, a set of policies to make all markets more 'efficient'. Hence, they emphasize price liberalization (including agricultural price liberalization), privatization, trade liberalization. Second, they include policies to increase capacity and productivity in all sectors of the economy, but especially in the tradable sector, and therefore they also involve measures aimed at capital market liberalization, banking reform and public sector reform.

The relationship of these sets of policies with the labour market is more complex because they go beyond the view that the labour market can function as an allocative mechanism and attribute to it the more significant role of raising dynamic efficiency. It is in this sense that the interplay between short-run and long-run factors becomes very important. Short-run phenomena such as growing unemployment, declining wages and retreating government expenditures have serious impacts on human capital investment, through education and training, and can affect seriously the longer term dynamic function of the labour market (Buffie, 1994). This has been demonstrated, for example, in the recent crisis in Indonesia and Thailand when children were put out of school, reducing the potential human capital development. Similarly, stabilization programmes which result in larger inequalities and clashes among social groups destroy some 'social capital', thereby making it more difficult to reach consensus and to embark on longer term balanced development. The experiences of Russia during the second half of the 1990s show this clearly.

Distinguishing between the short-term and long-term consequences of structural adjustment policies is especially important with respect to the role and the functioning of the labour market. In the opinion of policy-makers, if the

short-term allocative function of the labour market prevails, which is often the case, many labour market instruments can be considered not to be 'macroeconomically compatible' (Toye, 1995). This then leads to recommendations that minimum wage laws be abolished, that the practice of making wage settlements binding for whole sectors be contested, that dismissal regulations be repealed, and so on, and frequently trade unions come to be seen as a 'hindrance factor' in the achievement of stabilization policies. Yet, as labour economists have argued, many of these labour market policies have not been adopted to increase the allocative function of the labour market, but (indirectly) to increase dynamic efficiency by building up social stability and augment human capital through the provision of a minimum living wage and the achievement of a more equitable society. These contrasting views of the role and function of the labour market often give rise to contrasting policy recommendations from within the government.

A complicating factor, frequently advanced in the discourse on the function of the labour market, is that the slow transformation from an economy dominated by small-scale agriculture to a more industrialized economy leads to a situation in which labour market institutions are relevant to only a small part of the workforce, which is not expanding very rapidly, if at all. *One frequently observes that the deregulation of labour markets so as to allow for more 'macro-compatible' policies is often proposed in conjunction with the (correct) observation that the formal sector and the share of formal sector workers in total employment are not expanding sufficiently rapidly*.

Yet, the *allocative function* of the labour market and the *slow growth of the formal industrial sector* are two distinct problem areas. The instruments needed to improve the allocative and dynamic functions of the labour market (where trade-offs may well exist) are not necessarily the same instruments required to deal with the lack of sufficiently rapid growth in the formal sector. Labour market rigidities may be part of the explanation behind a slowly growing formal sector, but certainly they are not the only explanation. Other explanatory factors in the slow growth of formal employment may be a lack of investment, a lack of final demand, a lack of access to diverse markets, or a general lack of development incentives which night foster a shift from backward sectors to modern sectors. Basing the policies for labour market reform solely on improvements in 'macro-compatibility' and expecting that this will solve simultaneously the problem of slow growth in the industrial sector and the slow growth in the formal economy in general is conceptually flawed. A fresh research agenda is clearly needed.

Although the labour market performs a wide range of functions, we can distinguish at least three distinct allocative functions of the labour market related to the discussion on structural adjustment (see Horton, Kanbur and Mazumdar, 1994), namely:

- Matching workers to employment opportunities in such a way that the overall employment level, wages and other working conditions are optimized.
- Allocating employed workers among sectors and matching worker skills to job requirements so that relative wages and employment are optimized in terms of economic sectors and skill categories.
- Assuring the intertemporal allocation of resources in education and in sector-specific training initiatives so as to protect human capital accumulation.

The intertemporal allocative function of the labour market, in respect of human resources, contributes not only to allocative efficiency, but also to the *dynamic efficiency* of the labour market. Other factors contributing to the dynamic efficiency of the labour market are sufficient social stability to foster higher productivity levels in firms, an adequate social security system to encourage wage moderation and a reasonable level of equality in income distribution, which minimizes the social discourse over government expenditures and thus helps tame budget deficits and inflationary tendencies, thereby avoiding the eventual implementation of stabilization policies.

Although most stabilization and structural adjustment instruments and policy recommendations were designed in the 1980s for countries suffering the effects of foreign exchange shortages and high capital outflows, the situation became more complicated in the 1990s, especially for those countries in which, after spells of stabilization and adjustment policies (not necessarily all successful), the market regained confidence and which began to witness capital inflows leading to larger trade deficits.

The relationship between product and labour market liberalization and the effects of capital inflows can be illustrated, following Amadeo and Pero (1997), as in Figure 1. At first, liberalization leads to productivity growth and cost-cutting, with a reduction in (formal) employment, especially in industry.[2] This

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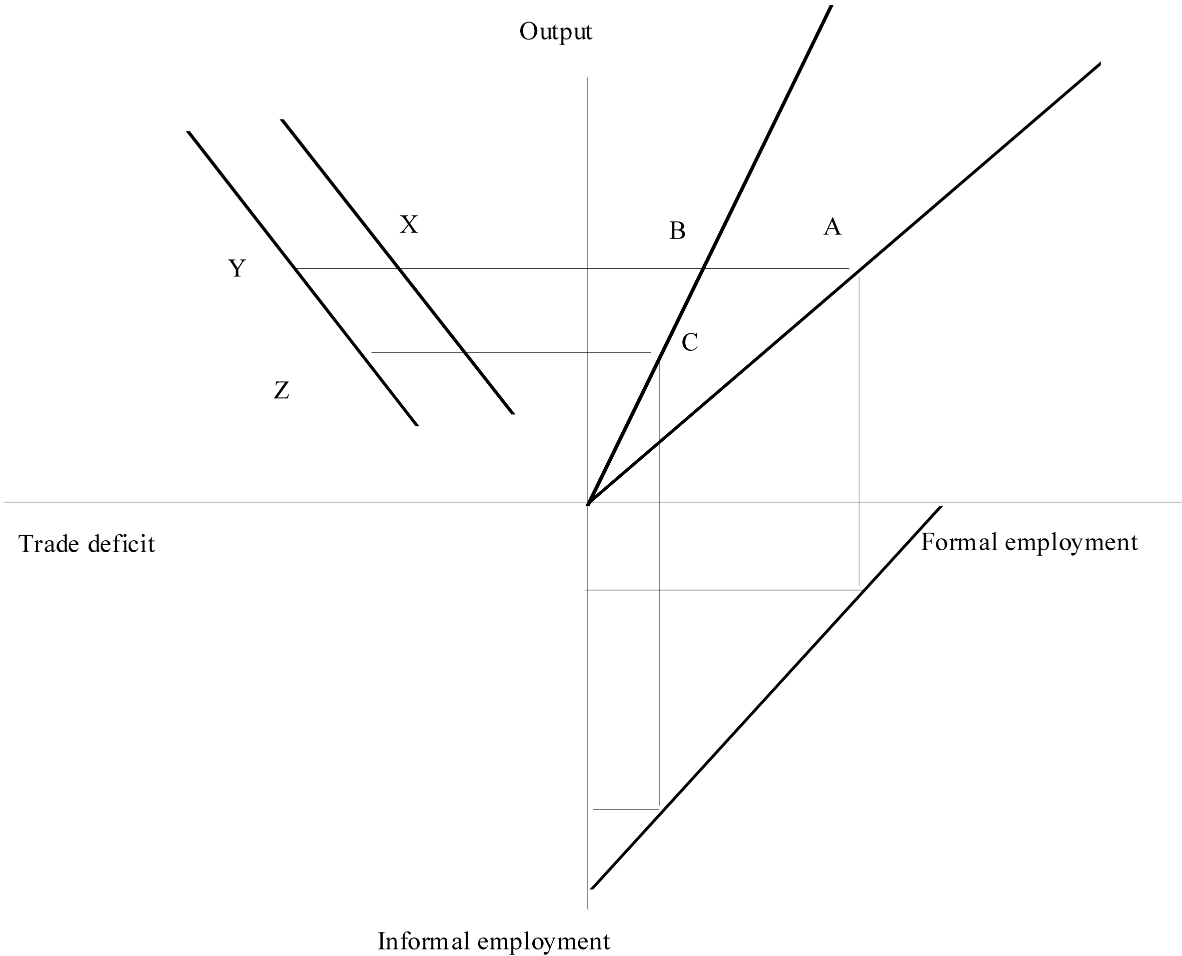
[2] This phenomenon was observed in a survey article by Amsden and van der Hoeven (1996) for most Latin American and African countries. Only in a limited number of East Asian countries did liberalization result in productivity growth and expansion in production, as also documented by Pieper (1998).

reduces employment-output elasticity and causes the output-employment curve to rotate inwards, initially resulting in less formal employment and more informal employment.

FIGURE 1
TYPICAL RESPONSES OF OUTPUT, TRADE DEFICITS AND EMPLOYMENT TO THE LIBERALIZATION OF TRADE AND THE CAPITAL ACCOUNT OF THE BALANCE OF PAYMENTS



At the same time, the deficit in the balance of trade is increasing, and, at a given level of output, this shifts the relationship between output and the trade deficit outwards. This external deterioration leads policy-makers to seek stabilization by increasing interest rates and implementing restrictive demand policies, thereby influencing the (outward-shifted) relationship between output and the trade deficit, resulting in a lower level of output. As a consequence, (formal) employment declines further not only because of the initial change in

employment-output elasticity, but also because of the lower level of total output.

A related question is: How can labour market institutions improve their support for investment so as to help expand production, increase productivity and, hence, upgrade the workforce. For this, Amadeo and Pero (1997) call for improved employer-worker relations at the enterprise and the national levels so as to foster a process of restructuring among enterprises, leading to greater productivity. They thus make the case for national reform policies which acknowledge the strong relationship among financial liberalization, trade liberalization, economic reform and labour market outcomes.

III RISING INEQUALITY WITHIN LABOUR MARKET TRENDS

In examining labour market trends, one may wonder whether the direction of these trends is the consequence of reform policies. Some argue that, because reform policies have been adopted in all developing countries and considering that most have been carried out for a decade or more, there exists a causal link between these policies and the trends. Others argue that adjustment policies have prevented a fall in production and income and that, without them, the situation would have been much worse, including, as a consequence, in employment. This frequent debate over the so-called 'counterfactual' is difficult to settle, but the question can be explored more thoroughly on the basis of careful country studies involving the use of (general equilibrium) models to generate hypothetical courses of development without adjustment. However, such methods also have drawbacks. Robinson (1991) argues that general equilibrium models are useful in increasing understanding, but that, because of the assumptions in parameter values and reaction coefficients, they are improper for policy evaluation and policy-making. The next subsection provides, within the general framework of this paper, a broad overview. For more specific country analyses on adjustment and labour market issues, the reader is referred to, for example, van der Geest and van der Hoeven (1999), Garcia (1993), Islam (1994), Khan (1993), and Toye (1995).

3.1 Changes in employment patterns

In Africa since the introduction of reform programmes, the percentage of the labour force working in formal sector jobs has fallen (Table 1). This is mainly due to a declining number of workers in state enterprises and the inability of the economic and social system to generate sufficient jobs in other sectors to

accommodate the retrenched workers. Industrial and formal service employment has barely increased (van der Hoeven and van der Geest, 1999). The aim of the reform programme has been to create conditions for stronger (formal sector) growth, and quite impressive policy changes have been undertaken. Exchange rates have been adjusted; currencies have become (almost) fully convertible, and budget deficits have decreased. In most countries per capita growth has become positive. However, despite all these policy changes, the recovery in Africa has not yet translated into massive job creation. Of course, reform takes time, and reform programmes have been stretched from an initial round of two or three years to five years and longer in order to take into account the necessary structural changes. Nevertheless, results have been very slow in coming, and this has put pressure on the stabilization process. International markets have sensed this ambivalence in African adjustment programmes. Despite Africa's wealth in terms of primary commodities, climatic conditions and low (international) labour costs (following successive currency devaluations, especially in English-speaking Africa), the foreign domestic investment that is needed to provide the financial backing for structural change has not become available. This has made the transitional costs even more difficult to manage.

TABLE 1
EVOLUTION OF EMPLOYMENT IN THE FORMAL SECTOR IN SUB-SAHARAN AFRICA DURING THE ADJUSTMENT PHASE[a]

	1990	1995
Kenya	18.0	16.9[b]
Uganda	17.2	13.3
Tanzania	9.2	8.1
Zambia	20.7	18.0[b]
Zimbabwe	28.9	25.3

Note: [a]as a % of the active population; [b]1994.
Source: van der Hoeven and van der Geest (1999).

In Asia, the employment experiences in East and South Asia have differed substantially. In East Asia there has been sustained high formal sector employment growth in most countries, resulting in increases in real manufacturing employment. In South Asia there are strong indications that employment in the informal sector has expanded. (See ILO, 1996 for more details.)

In Latin America the transitional costs of liberalization have been high. As Lee (1996: 489) points out:

The experience of Chile in the early 1980s illustrates the severe effects of overshooting in terms of stabilization policy. Output contracted by 23 per cent in 1982-93 and unemployment remained above 23 per cent for 5 years. Similarly the Mexican crisis of 1994-95 illustrated the devastating effect of wrong monetary and exchange rate policies.

Strong recovery took place in Latin America in the 1990s, with almost all countries showing positive GDP growth rates. However, unless the GDP growth rate is sustainable and robust at levels well above labour force growth, growth in formal sector jobs remains limited (ILO, 1995; see also Fanelli and Frenkel, 1995; Amadeo 1996). In effect, in most countries in Latin America one detects an increase in the number of workers in the informal sector, which makes many workers understandably fearful of further liberalization measures (Table 2). Investigations by the ILO Regional Office confirm that growth in formal sector jobs is correlated with high economic growth, irrespective of the type of labour market regulations being applied (ILO, 1995).

TABLE 2
INFORMAL EMPLOYMENT IN LATIN AMERICA*

	1990	1991	1992	1993	1994	1995	1996	1997
Latin America	51.6	52.4	53.0	53.9	54.9	56.1	57.4	57.7
Argentina	47.5	48.6	49.6	50.8	52.5	53.3	53.6	53.8
Brazil	52.0	53.2	54.3	55.5	56.5	57.6	59.3	60.4
Chile	49.9	49.9	49.7	49.9	51.6	51.2	50.9	51.3
Colombia	55.2	55.7	55.8	55.4	54.8	54.8	54.6	54.7
Mexico	55.5	55.8	56.0	57.0	57.0	59.4	60.2	59.4
Paraguay	61.4	62.0	62.2	62.5	68.9	65.5	67.9	59.4
Uruguay (Montevideo only)	36.3	36.7	36.6	37.0	37.9	37.7	37.9	37.1
Venezuela	38.8	38.3	37.4	38.4	44.8	46.9	47.7	48.1

Note: *as a % of the non-agricultural labour force.
Source: ILO (1998a).

3.2 Changes in wage shares and wage distribution

An increase in wage and income inequality is another phenomenon which has been observed in many countries. Among those countries for which reliable data are available for the 1980s, income inequality increased in four of the eight countries in the lower inequality band, in eight of the 13 countries in the medium inequality band, and in six of the nine countries in the higher income inequality band (Table 3).

TABLE 3
GINI RATIOS AND PER CAPITA GROWTH IN SELECTED COUNTRIES, 1970s-90s

	Gini Ratios			Per Capita Growth	
	1970s	1980s	1990s	1980-90	1990-95
Taiwan	20.9	21.1	–	–	–
India	30.9	31.4	31.1	3.7	2.8
China	–	31.5	36.2	8.7	11.7
Indonesia	36.6	33.4	33.1	4.3	5.9
Pakistan	35.5	33.4	–	3.2	1.7
Korea	36.1	35.6	–	8.2	6.2
Bangladesh	34.8	37.3	–	1.9	2.5
Jamaica*	–	43.2	39.8	0.8	1.9
Côte d'Ivoire	–	39.1	41.4	-3.7	-2.2
Singapore	–	39.0	40.0	4.7	6.8
Uganda*	–	33.0	41.0	0.7	3.5
Venezuela*	41.5	42.9	44.4	-1.6	0.2
Jordan*	40.8	36.1	40.7	-5.2	3.4
Sri Lanka	38.8	43.7	–	2.8	3.6
Tanzania*	–	44.0	48.6	0.3	0.2
Tunisia	44.0	43.0	41.0	0.8	2.1
Philippines*	41.9	45.0	45.0	-1.6	0.0
Hong Kong	41.9	41.4	45.0	–	–
Bahamas	48.2	44.4	43.0	–	–
Costa Rica	46.1	45.1	–	0.2	3.0
Trinidad and Tobago	48.5	41.7	–	-3.8	0.2
Thailand	41.9	47.4	50.1	5.9	7.2
Senegal*	49.0	45.1	54.1	0.2	3.0
Chile	48.0	51.0	50.3	2.5	5.7
El Salvador*	46.1	48.4	50.0	-0.8	3.9
Guatemala	–	58.6	59.5	-2.0	2.8
Malaysia	51.5	48.0	–	2.6	6.4
Colombia	52.1	51.2	–	1.8	2.8
Honduras	–	54.0	52.7	-0.6	0.5
Mexico*	55.0	52.7	57.0	-1.3	-0.7
South Africa	51.0	49.0	62.3	-0.9	-1-1
Brazil	57.0	58.7	60.6	0.5	1.0

Sources: Gini ratios: Bruno, Ravallion and Squire (1998); *UNU/WIDER database.[3] GDP per capita: World Bank (1997a), (1998).

[3] Thanks are due to Sampsa Kiiski for providing the data from UNU/WIDER.

TABLE 4
SHARE OF WAGES IN VALUE ADDED*

	1975-80	1980-85	1985-92
Argentina	21.4	19.2	19.1
Brazil	20.6	22.1	20.6
Chile	16.4	17.9	15.4
Colombia	20.1	19.4	15.4
Mexico	36.7	27.8	19.6
Panama	29.8	31.7	35.7
Peru	15.2	17.7	16.0
Venezuela	27.2	28.5	22.2
India	48.2	49.0	45.2
Pakistan	23.5	19.6	19.9
Sri Lanka	29.5	23.8	17.2
Hong Kong	52.4	54.3	56.9
Republic of Korea	27.0	27.2	27.6
Singapore	32.5	34.1	31.4
Indonesia	19.7	18.7	21.1
Malaysia	26.5	29.4	27.5
Thailand	23.5	22.8	25.5
Philippines	22.3	23.4	23.3
Ghana	19.2	16.0	13.8
Kenya	41.1	44.2	42.6
Zambia	26.2	26.4	25.8
Zimbabwe	43.7	42.6	33.3
Egypt	53.5	59.4	41.5
Morocco	53.6	51.0	39.2
Tunisia	48.5	45.7	41.4
Turkey	34.6	24.8	19.2

Note: *total remuneration of labour as a percentage of value added in manufacturing.
Source: Karshenas (1997).

Changes in income inequality are in themselves often worrisome, although they must also be seen in a wider perspective. First, some countries start from a low base. Income inequality is low in many Asian countries, and slight increases in inequality, especially when they are accompanied by strong growth, may not result in increased concern by workers. Second, income inequality figures give only a limited indication of the inequalities in a society. A rich person in one country who is paying for an expensive medical treatment may in fact not be so much more well off than a person of more moderate means in another country where the state covers the same treatment. Nonetheless, changes in income inequality generally reflect changes in the inequities in a society, and they can

therefore be indicators of the social climate and the willingness of the population to suffer through economic transitions.

The reform process in many countries has caused a decline in the wage share and thus weakened the position of workers. Table 4 provides the wage share in manufacturing industries for a large number of developing countries. For 20 of 26 countries the wage share declined between the early 1980s and the early 1990s, and in those countries where the share increased the increase was slight. (The East and Southeast Asian countries were the most well performing in terms of unchanged wage share.) The shift towards profits has led to changes in consumption patterns and life styles and added to inequities (see Pieper, 1998; ILO, 1996).

The declining wage share is partly explained by what some call the 'ratchet effect'. After an economic shock or a financial crisis, it has been well established that the wage share in gross national income decreases (Pastor, 1985). In the 1980s some authors were arguing that the decline in the wage share following the economic shocks was in effect the consequence of the wage share being too high before the crisis during the 1980s. Thus, they partly blamed labour for the build-up to the crisis. However, further research has established that only in a minority of cases have financial crises been caused by the bidding up of wages and labour shares. In most cases the crises have been generated by external events or by the rent-seeking behaviour of the owners of capital. Since many countries have undergone more than one crisis, the decline of the wage share during a crisis and the partial recovery following it has led to secular decline in the wage share. Based on a large sample of countries, Diwan (1999) reports an average drop in the wage share per crisis of 5.5 per cent of GDP and a recovery of 2.5 per cent following the crisis, leaving a decline of 3 per cent of GDP. Given that most countries have undergone more than one crisis, the cumulative drop in the wage share over the last 30 years is estimated at 4.1 per cent of GDP. From the 1970s to the 1990s, the figure in Latin America was an especially high 6.7 per cent of GDP.

Amsden and van der Hoeven (1996) therefore conclude that 'forcing firms to restructure under the highly contractionary (and destabilizing) conditions of the 1980s stymies rather than stimulates change' and 'import liberalization, except for imports destined directly or indirectly for use in manufactured exports, was not generally an important means of reducing anti-export bias'. Based upon a large sample of developing countries, they argue (p. 522) that, 'Given what appears to have been an absence of thorough-going industrial restructuring in most non-Asian developing countries in the 1980s, the decade's decline in real wages and its fall in wage share of value added suggest that what mainly

happened in the manufacturing sector was a distribution of income from labour to capital'. They express the fear that 'lower wages rather than higher productivity may have to bear the burden of creating competitiveness in the 1990s as a result of unsuccessful restructuring in the 1980s'.

TABLE 5
WAGE DISPERSION AND CHANGES IN REAL WAGES IN MANUFACTURING, 1975-9 TO 1987-91 ($)

	Wage Dispersion	Real Wage*
Singapore	-12.5	58.5
Taiwan (China)	-9.8	151.5
India	-9.3	-2.5
Republic of Korea	-8.2	116.9
Indonesia	4.7	-22
Philippines	7.4	12.5
Sri Lanka	8.2	-10.2
Pakistan	14.7	17.9
Malaysia	19.8	2.8
Thailand	49.2	29.5
Mauritius	-25.1	-37.3
Zimbabwe	-8.8	-32.2
South Africa	6.8	-7.4
Kenya	17.2	-40.4
Tanzania	38	-83.1
Colombia	-5.3	-31.5
Uruguay	1.8	-3.9
Mexico	15.1	-44.5
Guatemala	25.3	-41.2
Peru	26.5	32.7
Argentina	26.5	-29.1
Panama	27.2	-17.1
Brazil	34.2	-15.5
Chile	55.4	-16.6

Note: *the value of the real wage is partly determined by exchange rate variations since it is expressed in constant US dollars. Hence, these figures may not always be consistent with the trends reported by national sources.
Source: ILO (1996).

Another related phenomenon of the period of economic reforms is the increase in wage inequality. This phenomenon goes counter to the theory of income inequality, adjustment and trade liberalization which predicts declining inequality, since adjustment and trade liberalization supposedly favour the production of goods by the production factor in which a country has

comparative advantage, this being unskilled labour in most developing countries (Berry *et al.*, 1997). However, the evidence often does not support these theoretical outcomes. ILO (1996) indicates, for example, that in most countries that underwent structural adjustment programmes in the 1980s, wage dispersion increased as real wages fell (Table 5). The measure of dispersion is the coefficient of variation, which is the standard deviation of wages in the manufacturing sector divided by the overall manufacturing wage.

'[I]nformation on wage inequality in developing countries is sparse and mixed', argues the World Bank (1995). 'Evidence from East Asia supports the view that greater openness in countries with an abundance of unskilled labour benefits this type of labour', but 'even for these countries . . . , the picture of relative wages is more complex, reflecting the interplay of the increase in relative demand for unskilled labour and the supply of skilled labour'. For Africa 'greater openness and policy changes in the 1980s are associated with recovery in growth and some reduction in poverty, but with an increase in equality in some cases'.

'The generally favourable verdict on East Asia in the 1960s and 1970s has been brought into question by analysis of experience in Latin America in the 1980s,' the World Bank (1995: 61) continues. 'In some countries increased openness has been associated with widening wage differentials'.

The facts thus seem to be clear. Driven by differences in earnings between skilled and unskilled workers, wage inequality has increased everywhere except in Southeast Asia. Different conclusions may be drawn about this growing inequality in wages, however. One conclusion is that liberalization has not advanced sufficiently and that domestic labour market constraints have inhibited the markets from profiting from liberalization (World Bank, 1997b). Yet, one might also conclude that the liberalization process has been influenced by other mechanisms that are not explained by the traditional Hecksher-Ohlin theory which lies at the heart of theories of comparative advantage. Alternative explanations for increased inequality introduce more than two categories of labour (namely, no education, basic education and higher education) and argue that, for successful export production, at least basic education is necessary among the workforce (Berry *et al.*, 1997: 14; Owens and Wood, 1997). Other explanations are that manufacturing tends to be dominated by large formal-sector companies, which pay higher wages and which have weak linkages to the small-scale sector ('globalization accentuates the disadvantage of small-scale producers'), or that liberalization makes it easier to import capital goods (especially if exchange rates are overvalued), and this increases productivity and raises the demand for skilled labour (UNDP, 1997).

Especially in Latin America, wage inequality has increased more than has total inequality. Morley (1999) explains this through reference to two offsetting features of change over time: an improvement in the education structure of the labour force and the effect of this on the labour market. Improvements in education move people up the distribution in the labour force; hence a smaller fraction remains in the bottom, and this reduces inequality. However, the greater variation in wage inequality caused by reform policies increases the distribution, which offsets the equalizing tendencies of improved education.

IV LABOUR MARKET POLICY CHANGES DURING REFORM

In a survey of the literature on income inequality and earnings in industrialized countries, Gottschalk and Smeeding (1997) come to the following stylized conclusions about these countries:

- At any given time there are wide differences across modern countries in the level of earnings, and nations with centralized bargaining (for example, Sweden and Germany) have greater equality than nations with less centralized bargaining (for example, the US and Canada).
- Almost all industrialized countries experienced some increase in wage inequality among prime-aged males during the 1980s, but the differences in the trends were large. Wage inequality increased the most in the US and the UK and the least in the Nordic countries.
- The increased demand for skilled workers, coupled with differences among countries in the growth in the supply of skilled workers, explains a large part of the differences in the trends in returns to education and experience.
- Institutional constraints on wages also seem to matter. The rise in relative unemployment rates among the least skilled in some, but not all, countries with centralized wage-setting institutions suggests that such constraints were at least partially responsible for limiting the rise in inequality.

For the US, Gottschalk and Smeeding explain the rapid rise in earnings inequality by reference to a variety of structural changes in the economy, such as changes in industrial structure, more foreign trade, more immigration, skill-based technical change and the weakening in institutions that limit the market (a fall in real minimum wages and a decline in unionization). Real minimum wages fell by 44 per cent in the US during the 1980s. Although the decline in the *minimum wage* cannot explain the increase at the top, most of the change in inequality in the US reflects declines at the bottom of the distribution. Studies

have found that the decline in real minimum wages accounted for roughly 30 per cent of the increase in the dispersion in wage rates. In theory, the *impact of unionization* on wage dispersion is ambiguous, since unions can increase the dispersion between union members and non-union workers through special contracts for the members. However, in the US, it is estimated that the decline in unionization accounts for roughly 20 per cent of the increase in male earnings. Although some double counting may occur when one adds up the effect of the lower real minimum wages and the effect of the decline in unionization, *studies confirm that these two labour market characteristics explain a large part, possibly even 50 per cent, of the increase in the dispersion in wage earnings in the US.*

Other industrialized countries also experienced rising wage inequality. Looking for common features and differences between the US and European countries, Gottschalk and Smeeding (1997) argue that differences in wage-setting institutions may well account for some of the differences in the growth in inequality.

'There is certainly a *prima facie* case that countries with high union coverage on centralized wage setting were able to limit the growth in inequality', they write (p. 653).

It is of interest to try to verify whether changes in labour market institutions in developing countries have had a similarly large impact on the growing wage disparity in these countries. In the following subsections, we therefore review some of the changes in labour market institutions in developing countries (minimum wages, unionization and bargaining, employment protection, public employment, and human capital formation).

4.1 Minimum wages

The reform policies in the 1980s and 1990s led to a decline in real minimum wages in many countries. In Southern Africa the real level of minimum wages in the mid-1990s was 60 per cent of the level in the early 1980s (Table 6). Real minimum wages also declined considerably in Latin America, where the level of real minimum wages in the early 1990s was about 70 per cent of the level in the 1980s, and at the end of the 1990s it was still at the lower level. There are variations among countries, but only Colombia and Costa Rica managed to keep minimum wage rates constant or increasing with respect to the 1980 values. While the real minimum wage increased in Chile in the 1990s, by the end of the decade it was still comparable to that in 1980 (Table 7).

TABLE 6
INDEX OF REAL MINIMUM WAGES IN THREE AFRICAN COUNTRIES, 1987-94
(1982 = 100)

	1987	1988	1989	1990	1991	1992	1993	1994
Kenya	85.0	–	78.0	85.0	74.0	64.0	59.0	55.0
Uganda	33.3	92.7	61.9	75.1	78.1	65.6	–	–
Zimbabwe	–	–	–	89.5	84.6	63.8	–	–

Source: van der Hoeven and van der Geest (1999).

TABLE 7
INDEX OF URBAN REAL MINIMUM WAGES IN LATIN AMERICA, 1990-8
(1980 = 100)

	1990	1991	1992	1993	1994	1995	1996	1997	Growth rate 1990-7
Argentina[a]	40.2	52.9	45.3	70.0	81.1	78.4	78.3	78.0	9.9
Bolivia[a]	16.1	26.3	26.4	28.8	31.7	31.1	31.3	32.2	10.4
Brazil[a]	55.4	64.8	56.5	63.9	60.8	67.1	68.9	73.2	4.1
Chile[a]	73.3	79.9	83.4	87.5	90.8	94.8	98.8	102.3	4.9
Colombia[a]	105.7	103.5	101.8	104.6	102.8	102.4	101.5	103.8	-0.3
Costa Rica[b]	127.2	123.3	125.4	130.6	134.6	129.9	130.3	135.0	0.9
Ecuador[a]	33.9	30.9	33.0	37.8	41.1	49.5	52.3	50.5	5.9
El Salvador[b]	33.9	34.6	29.2	35.9	37.3	36.8	33.5	32.0	-0.8
Guatemala[b]	108.7	99.5	87.5	78.4	74.7	89.3	88.4	80.9	-4.1
Haiti	71.4	67.0	56.8	50.2	39.0	–	–	–	–
Honduras[b]	81.9	83.5	100.1	100.9	82.8	80.2	79.5	78.3	-0.6
Mexico[a]	42.0	39.6	38.3	37.8	37.7	33.3	30.5	30.1	-4.6
Panama[b]	98.4	97.1	95.5	107.2	105.8	105.6	111.4	110.0	1.6
Paraguay[a]	132.1	125.7	114.7	110.2	113.2	112.8	103.6	107.0	-3.0
Peru[a]	–	14.9	15.6	12.1	14.4	14.7	15.2	26.7	3.2
Domin. Rep.[a]	65.2	78.6	74.7	72.7	73.1	80.3	78.0	–	–
Uruguay[a]	68.8	62.9	60.0	51.5	46.0	42.9	41.7	40.8	-7.2
Venezuela[a]	55.2	61.5	70.2	50.8	52.7	53.7	45.9	39.9	-4.5
Average[c]	68.4	69.3	67.5	68.4	67.8	70.8	69.9	70.0	0.3

Notes: [a]National minimum wage. [b]Lowest industrial minimum wage. [c]Arithmetic average.
Source: ILO (1998a).

ILO (1997a) finds that, in 1995 in Latin America, the minimum wage in high-minimum-wage countries stood at 43 per cent of the industrial wage and 75 per cent of the wage in informal enterprises, while in low-minimum-wage countries it stood at 38 per cent of the industrial wage and 63 per cent of the wage in informal enterprises. In theory, the minimum wage should cover all people working in the formal sector, but there are quite a few exceptions. In countries

with high minimum wages, 22 per cent of the wage-earners in the formal sector were receiving wages below the minimum wage. For countries with a low minimum wage, the figure was 12 per cent.

It has been argued that the existence of a minimum wage results in greater informality in the economy, but ILO (1997a) finds that the real minimum wage has fallen so much that this is not the case in most countries.

'[I]ncreases in the minimum wages up to a certain level (two-thirds of the wages of unskilled workers) will not produce substantial increases in informality', according to the ILO (1997a). 'However, increases above that point are associated with an increase of 0.6 percentage points [in the share of] workers in the informal sector'. Among the poorest 20 per cent of households, ILO finds no correlation between unemployment and the ratio of the minimum wage in urban informal sector wages.

This corroborates Lustig and McLeod (1997), who, working with an older database on about 30 countries, note 'that minimum wage increases or declines may be associated with declines or increases in poverty rates in developing countries'. This finding is consistent for high and low poverty lines in countries which are growing or contracting and can be tied to some other country characteristics as well. Lustig and McLeod conclude that a reduction in real minimum wages hurts the poor in the short run. They add that their analysis is static and that they can therefore not determine whether increases in real minimum wages tend to raise unemployment and reduce efficiency (as is argued for some European countries; see OECD, 1997). With a negative effect on growth, real minimum wage declines could hurt the poor in the long run. Rama (1995) argues that the cost of minimum wages in terms of economic growth is not significant. In a survey of labour market policies for the IMF, Agénor (1996) also argues that the existence of minimum wages has no disturbing effect on the creation of employment in developing countries.

For Latin America, Marquez and Pages (1998) find that the existence of minimum wages in Argentina, Bolivia, Chile and Peru do not affect the wage distribution in ways that lead to higher unemployment. In Brazil, Colombia, Costa Rica and Venezuela, there is some evidence that minimum wages influence the wage distribution, but that the impact is mainly restricted to young workers and women. Marquez and Pages could identify no causal link with unemployment, although they argue that higher unemployment rates among youth and women workers might be due to the fact that a higher proportion of these groups receives minimum wages.

In a more recent study on a dataset of 30 developing countries through which time-series data on nominal and real minimum wages could be constructed, Saget (2000), controlling for the level of GDP, region and average wage, finds that changes in the ratio of the minimum wage to the average wage did not have any significant effect on the employment/population ratio. Saget finds also that declines in real minimum wages increases the number of people in poverty according to national definitions. These results remain significant after one controls for the level of development and for region. Since it can be argued that in developing countries minimum-wage earners belong to the absolute poor, Saget has applied a more restrictive definition than the national definition of poverty (which usually relates poverty levels to a fraction of the median income) by using the $2 a day criterion. The results of the regression do not change, still indicating that a higher minimum wage is correlated with a lower percentage of the population in poverty.

4.2 Changes in bargaining power

Adjustment and liberalization are leading to more intense competition and are generating pressures to reduce wages and labour standards around the world as the bargaining position of labour is being weakened. As ILO (1996) has pointed out, the underlying reasons for this are, first, that the demand for labour becomes more elastic when the labour market becomes more exposed to foreign competition and, second, that the capacity of governments to regulate labour markets is weakening in the face of heightened international economic competition. However, it is not yet clear how strong these forces are, especially given the fact that in many countries the part of the labour market which is exposed to foreign competition is very small (in industrialized countries, where 70 per cent of workers are engaged in service industries, and in developing countries, where workers in tradable industries are still a minority in the labour force).

Yet, one notices a general decline in trade union membership (ILO, 1997b). The decline is not uniform, but appears to be occurring irrespective of the type of industrial relation system prevailing. Substantial declines have been witnessed in some African and Latin American countries (Table 8), where most of the labour force is not covered by collective agreements.

In the literature, there are divergent opinions on the effects of globalization on the role of social partners and, particularly, on unionization. Some observers see a high unionization rate as indicative of labour market distortions; it may occur that significant labour market distortions require governments to maintain a high degree of external protection, leading to slower growth and

slower employment creation (World Bank, 1995). However, ILO (1996, 1997b) and Rodrik (1997) argue that undertaking adjustment and liberalization through the destruction of trade unions is very shortsighted and counterproductive in the long run because trade unions contribute to social cohesion, which is necessary if globalization is to be successful.

TABLE 8
TRADE UNION DENSITY AND COLLECTIVE BARGAINING COVERAGE RATES IN SELECTED COUNTRIES

	Trade Union Density (non-agricultural)	Change, Trade Union Density (%)	Collective Bargaining Coverage Rate
Ghana	26.0	–	25.0
Kenya	17.0	-60.0	35.0
Mauritius	26.0	-25.0	40.0
Nigeria	17.0	–	40.0
Swaziland	19.0	–	25.0
Uganda	4.0	–	25.0
Zambia	13.0	-33.0	30.0
Zimbabwe	14.0	+20.0	25.0
China	55.0	-8.0	15.0
India	5.0	-18.0	2.0
Malaysia	12.0	-13.0	2.0
Philippines	23.0	+24.0	4.0
Taiwan (China)	28.0	-8.0	4.0
Thailand	3.0	-7.0	27.0
Argentina	25.0	-50.0	73.0
Bolivia	16.0	–	11.0
Chile	16.0	+37.0	13.0
Honduras	5.0	–	13.0
Panama	14.0	–	16.0
Uruguay	12.0	-14.0	27.0

Source: ILO (1997b).

'[T]he efficiency benefits are reaped only to the extent that employment expands in industries in which artificially high wages previously kept employment below efficient levels', Rodrik (1997: 25) argues furthermore, and 'the first order effects of trade appears to have been a redistribution of the enterprise surplus towards employers rather than the employment of that surplus' (as was demonstrated by Amsden and van der Hoeven, 1996, to have been the case in many developing countries in the 1980s). Adjustment and liberalization should also aim at increasing social cohesion. New forms of collective bargaining that include a greater focus on responsibility for wage adjustments and employment creation at the central, sectoral and plant levels, as ILO (1995) carefully argues, can contribute greatly towards improved social cohesion.

'Liberalized trading regimes . . . have so far been associated with the reduction of workers' rights and the concentration of wealth', Weeks (1999) observes for Latin America. If this is to change, a healthy labour movement is required to ensure effective collective bargaining.

Cortazar, Lustig and Sabot (1998) describe labour relations in Latin America as confrontational, with a non-encompassing elite which could find agreement with labour unions in protected industries; however, with the opening up of the economy, this has become impossible. The authors therefore suggest that collective bargaining should be decentralized and that the severance process and severance payments should be reformed to foster more flexibility. These recommendations run counter to recent experiences in small European countries where centralized, national-level agreements on wages, social security, disability benefits and unemployment compensation have permitted the unions to adopt positions favouring more job flexibility, while maintaining employment and income security. Emphasizing decentralized wage bargaining and abolishing job-exit options through the maintenance of a system of social security for workers will increase feelings of insecurity and block processes of change. Schultz (1998) also argues that centralized wage bargaining, if combined with a system of non-adversarial labour relations, can influence decision-making so as to help reduce real wages during periods of economic shock.

Recent research (ILO, 2000) indicates that there is a strong inverse relationship between consumer price inflation and the *coordination* of collective bargaining. In countries with a low degree of coordination in collective bargaining consumer price inflation was over 250 per cent in 1990-98, while in countries with a moderate degree of coordination average inflation was around 25 per cent, and in countries with a high degree of coordination average inflation was below 5 per cent.

Furthermore, the correlation between income inequality and *coordination* in collective bargaining has been found to be negative (significant at the 1 per cent level). Countries with a high degree of coordination in collective bargaining had an average Gini ratio slightly below 0.3, while countries with a low degree of coordination had an average Gini ratio over 0.45.

4.3 Employment protection

Little research has been carried out on the effects of employment protection on unemployment and poverty rates. Research in OECD countries on the relevant

effects on employment is mainly inconclusive (Bertola, 1990), although some have found that protection reduces short-term unemployment, but may increase long-run unemployment among certain groups (Mitchell 1997). However, most research in the OECD is tied to investigations relying on weak evidence (which is further weakened by the rapid decline in unemployment in 1999-2000 that resulted from the favourable macroeconomic situation rather than from the effect of protection on poverty and inequality). A study by Esping-Andersen (1999) finds that liberalizing measures have increased the vulnerability of poorer groups.

A cross-country study using panel data finds a negative relationship between employment protection and employment rates in the countries of Latin America (Marquez and Pages, 1998). However, when GDP per capita is added as a control variable, the relationship is no longer found to be significant, as lower GDP is positively correlated with lower employment/population rates.

Although most policy discourse points to the need to change the regulations regarding job dismissal and to employ more flexible contracts, a major study (Marshall, 1994; see also Table 9) finds that differences among labour protection regimes are not reflected in the comparative performance in manufacturing in Latin American countries.

TABLE 9
LEGAL LABOUR PROTECTION REGIMES IN LATIN AMERICA

	Dismissal	Temporary Contracts
Argentina	I	P
Brazil	P	R
Mexico	R	R
Colombia	I/R	P
Chile	P	I
Peru	R	P
Uruguay	P	I

Notes: P = permissive, I = intermediate, R = restrictive.
Source: Marshall (1994).

'Against other domestic and international determinants of manufacturing performance (including wages) individual labour law played a minor role, if it played one at all', the study finds. 'The present study confirms that the notion underlying current policy proposals in some Latin American countries, namely that flexibilization of dismissals and employment contracts is sufficient to improve economic performance is a gross misconception'.

4.4 Public sector employment and employment conditions

Under reform, public sector employment has fallen. The figures for East and Southern Africa show a decrease in the percentage of public sector workers in the total labour force. The declines have been drastic in Uganda and Zambia and less substantial in Kenya and Tanzania, while in Zimbabwe the share of public sector employment in the total labour force has remained more or less constant at the lowest level among the group of countries in 1990.

TABLE 10
TOTAL PUBLIC SECTOR EMPLOYMENT
(AS % OF THE TOTAL LABOUR FORCE)

	Kenya	Tanzania	Uganda	Zambia	Zimbabwe
1990	8.3	5.4	6.4	17.2	4.2
1995	7.7	4.1	3.9	10.8	4.5

Source: van der Hoeven and van der Geest (1999).

Public sector employment also fell in Latin America. In 14 countries the share of public employment in urban employment fell from 15.3 per cent in 1990 to 13.2 per cent in 1995. In seven of these countries public sector employment dropped in absolute terms (Lora and Marquez, 1998).

Has the decline in public sector employment had a positive or a negative effect on poverty and income inequality? The popular perception is that civil servants in most developing countries are not very productive, that they receive wages above their marginal rate of return, and that therefore they are bidding up the wage structure. However, recent events have drastically changed this picture. A large portion of public servants are primary school teachers and are not well paid, and the lower echelons of public servants have often been subject to dismissals. Frequently, in the case of Africa and Latin America, they must resort to the informal sector to find new jobs.

'As improved methods are brought to bear on this issue, pubic sector administration wages are sometimes found to be slightly lower than private sector wages', reports Schultz (1998). More recently, there seems to be a reconsideration of the policy of squeezing the public sector. First, the IMF and the World Bank are nowadays suggesting that the social sectors (education and health care) should be excluded from budgetary cuts; furthermore, research in many adjusting countries has found that the competence and the number of civil servants have decreased. Second, most observers now agree that the pay in the public sector in many African countries has declined to an extent that it

does not provide a living wage. The IMF (1999) has therefore argued for wage increases and other measures to raise productivity in the African civil service.

4.5 Changes in human capital formation

Liberalization and adjustment programmes have put social expenditure under strong pressure in developing countries. However, in some countries the downward pressure on expenditures in education, health care and social welfare had already been evident during the economic crisis before the programmes were implemented. Adjustment programmes are therefore not necessarily the principal cause of the drop in social expenditure, although they have failed to reverse the decline in most cases. An evaluation by the World Bank (1996) of adjustment programmes points out that, especially in Latin America and Africa, these programmes have been accompanied by a fall in the share of social expenditure in total government expenditure (Table 11). Given that total government expenditure has often declined in absolute terms, this means that per capita expenditure figures have decreased.

TABLE 11
COMPOSITION OF SOCIAL SECTOR EXPENDITURES

	Asia			Latin America*			Sub-Saharan Africa*		
Adjustment:	Before	During	After	Before	During	After	Before	During	After
% GDP									
Total social spending	2.7	3.3	3.4	7.1	7.3	7.8	5.9	5.6	5.3
Education	1.8	2.2	2.2	3.0	2.7	2.6	3.4	3.3	3.1
Health care	0.5	0.6	0.6	1.7	2.1	2.4	1.3	1.2	1.1
% total expenditures									
Total social spending	17.9	19.6	19.6	23.7	23.4	19.3	26.1	22.4	19.9
Education	11.8	12.9	12.6	19.6	16.9	14.3	16.3	14.2	13.5
Health care	3.6	3.4	3.7	9.2	10.9	11.0	6.0	5.4	5.2

Note: *only countries on which there are data for the post-adjustment period.
Source: World Bank (1996).

Declining government expenditure is not necessarily detrimental to the poor. Alesina (1998) notes that the middle classes and more vocal political groups frequently profit the most from government expenditure and that a decline in government expenditure might therefore hurt them more than it would the poor. However, looking at indicators measuring primary and secondary school enrolments and infant mortality, both of which have particular relevance for the poor, one can perceive that there has been a deterioration in education standards, as well as a slowdown in the decline in infant mortality rates during adjustment and less than full recovery after adjustment (Table 12). This is most

apparent in Africa, where in a number of countries primary school enrolment rates have actually fallen (a phenomenon unprecedented in history), affecting large parts of the population, especially in poorer areas (van der Hoeven and van der Geest, 1999), but also in Latin America, where middle class families in particular have suffered large setbacks in the ability to provide their children with quality education.

TABLE 12
TRENDS IN SELECTED SOCIAL INDICATORS (% CHANGE)

	Asia			Latin America*			Africa*		
Adjustment:	Before	During	After	Before	During	After	Before	During	After
Gross enrolment ratio	1.3	0.5	0.3	1.4	-0.4	1.0	4.7	-0.5	-0.4
Infant mortality rate	-2.5	-3.1	-3.6	-5.6	-2.5	-2.4	-1.8	-1.7	-1.4

Note: *only countries on which there are data for the post-adjustment period.
Source: World Bank (1996).

The limited or total absence in progress in education has serious implications in terms not only of efforts by countries to raise productivity in the output for domestic and export markets, but also of income inequality. Londono (1996) argues, for example, that the increasing imbalance in human capital distribution in Latin America has aggravated income inequality and then provides figures showing that the dispersion in human capital has raised the Gini concentration coefficient by five points. Furthermore, there is strong reason to suspect that a correlation exists between the growing number of households in poverty and the growing number of households headed by illiterate individuals.

'[The analysis] lends support to the hypothesis that educational attainment is a necessary but not a sufficient condition for skill-intensive production', UNCTAD (1997: 158) reports in a study on educational attainment and the skill intensity in the production of exports in a number of countries:

> All countries with a high share of skill-intensive exports also have a relatively high educational attainment while evidence from countries such as Argentina, Chile, Peru and Uruguay suggests that relatively high educational attainment does not automatically translate into skill-intensive exports. . . . Almost all countries where high educational attainment has translated into skill-intensive exports are those that have sustained a rapid pace of capital accumulation, technological upgrading and productivity growth over many decades.

The relationship among adjustment, education, skills and increases in productivity are complex, but the data are sufficiently robust to argue that a

slowdown or a reversal in enrolments and completions in primary, basic secondary and vocational education contributes to greater inequalities in society and that this hampers countries seeking to take full advantage of production for export.

V CAN LABOUR MARKET POLICIES REDUCE INEQUALITY?

The preceding paragraphs have shown that in many developing countries reform policies have put greater strain on workers. The theoretically expected fall in income inequality between low-skill workers and high-skill workers frequently did not take place, and in many cases human capital investment to raise skill levels declined. Furthermore, there is a serious risk that domestic dissatisfaction with reform may well result in growing political pressure to alter liberalization policies (Rodrik, 1997). One therefore needs to look critically at the content of the current set of policies and reflect on the reasons why reform policies have often not brought about the expected results. Whether one can indicate appropriate changes in the current set of economic reform and labour market policies so as to foster reductions in inequality thus becomes a relevant question.

Since the issue of stabilization has been playing a major role in the formulation of reform policies, it is important to review first the current approaches to stabilization and the related labour market policies. On this issue, we see convergences in that both a mainstream economist such as Rodrik (1997) and a structuralist economist such as Fitzgerald (1997) argue strongly that stabilization and prudent fiscal policies are needed so as to spur economic growth, industrial development and new job creation. Stabilization policies are necessary for the establishment of a stable macroeconomic framework.

There remains then the key questions about the kind of stabilization policies required to favour more growth, equality and poverty alleviation and about the interaction between these policies and labour market policies. At least two considerations are significant in this respect. First, *the choice of instruments of stabilization can have consequences for future economic growth and employment creation*. Amadeo (1996) asserts convincingly that, by keeping the exchange rate overvalued in order to cut inflation, exchange-rate-based stabilization can lead to a loss in industrial competitiveness and thus undo some of the potential gains of globalization for which stabilization policies are supposed to provide the groundwork. Fanelli and Frenkel (1995) contend further that a drastic reduction in inflation jars industry and institutions, thereby

harming industrial capacity and reinforcing tendencies for renewed inflation. Hence, *the choice of instruments of stabilization in a context of reform is more narrow*, and the stabilization instrument needs to be more finely tuned if it is to generate acceptable and sustainable results.

A second observation is that cross-country evidence indicates forcefully that *income equality and social consensus can contribute to successful stabilization policies*, as they help avoid political uncertainty and potential conflicts about who profits from the stabilization measures. Van der Hoeven and van der Geest (1999) provide such evidence for Africa, and Rodrik (1998) shows by means of cross-country regression analysis that variables like social conflict and income distribution possess strong explanatory power about the ability of countries to cope with external shocks.

Most economic reform programmes call for changes in the labour market in order for reform programmes to become more effective. Two issues are significant in this regard. The first relates to the way regulations are perceived in developing countries. Amadeo and Camargo (1997) point out that it is important in the context of developing countries to *distinguish between written rules and the actual practice of regulation*. Their research indicates that, although, judged by the law, the Brazilian labour market can be qualified as very regulated, the actual practice is such that it is less regulated than the French or German labour market. A similar finding has also been reported by Banuri and Amadeo (1991).

The second issue is more fundamental and relates to overall development goals. There is currently a broad consensus that the *overarching goals of any nation should be a reduction in poverty, the provision of employment and the social inclusion of all segments in society*. Labour market reforms which are restricted to the goal of rendering economic reform programmes more efficient miss the chance offered by the truth that *well-organized and well-functioning labour markets can also contribute to these overarching development goals* (of poverty alleviation, employment creation and inclusion) *in other ways*. This has been one of the major flaws of the Washington consensus on reform (Stiglitz, 2000). By emphasizing merely the allocative function of the labour market, the Washington consensus has overlooked the other functions of the labour market, namely, the dynamic function, the equity function and the social-cohesion function.

The *de facto* flexibility in the labour market has increased with growing informal sector employment, declining minimum wages and widening wage disparity except in some high-growth countries. Despite this observed trend,

poverty rates have remained substantial, and economic growth has not been vigorous. One can therefore conclude that the emphasis on the allocative function of the labour market during the reform process, which has resulted in greater inequality in the labour market, should not be the preferred policy instrument for fostering growth and reducing poverty.

Strong growth has to be generated by more investment, improved human development and physical infrastructure, greater returns on productive factors such as land and human and physical capital, and high levels of internal and external demand. To achieve this, well-functioning capital and financial markets, equitable property rights and a fair distribution of the means of production are some of the major components which need to be put in place. It is in this sense that the dynamic efficiency, the equity and the social cohesion functions of the labour markets play an important role, perhaps even a more important role than that played by the allocative function.

The *dynamic function* of the labour market is enhanced by *greater investment in human capital*, improvements in aptitudes and the development of more innovative skills at lower school level and of complex problem-solving techniques at higher school level, as well as more workplace training and lifelong learning. Squeezing education budgets and subjecting workers to precarious contracts do not help improve the dynamic function of the labour market. Longer term contracts and established and well-negotiated roles for employment protection can provide a better climate for improvements in productivity.

Equity can be enhanced through the establishment of well-functioning minimum wage mechanisms. In most developing countries, real minimum wages have declined and lost any relevance. Yet, minimum wages can provide stability, foster the commitment of workers, represent an incentive to raise productivity and help reduce poverty. Thus, rather than regarding minimum wages as a bottleneck in the operation of the labour market, one should regard them as tools (for instance, for taking account of various groups, such as youth, so as not to price them out of the labour market).

Many have considered centralized wage-setting as a hamper on the allocative function of the labour market. Yet, the evidence is overwhelming that *centralized wage-setting has favoured lower inequality and lower inflation rates* (if it is the outcome of a genuine collective bargaining process). Hence, rather than abolish or block the creation of centralized wage-setting, as suggested by many proponents of Washington consensus reform, post-

Washington-consensus policies should seek to strengthen of the relevant institutions.

Many reform programmes have discarded efforts to promote social dialogue, as these have been found cumbersome and time consuming and are sometimes considered as caving in to interest groups (van der Hoeven and van der Geest, 1999). Although there is now some discussion about this (Stiglitz, 2000), the institutions necessary to promote constructive social dialogue and smooth out potential conflicts and redistributive issues (which are inherent in each reform programme) still do not exist in most countries. The establishment of these institutions needs to become an aim in the reform process.

The emphasis in this paper on aspects of the labour market other than the allocative aspects offers indications about the labour market policies that should be pursued in the reform policy package of the post-Washington consensus. By emphasizing the dynamic, equity and social cohesion aspects of the labour market, policy can contribute to higher growth and foster poverty alleviation. Such an emphasis would tally well with the conclusions of a survey on inequality and growth by Aghion, Caroli and Garcia-Penelosa (1999: 1,657):

> our discussion in this survey points to an important efficiency role for sustained redistribution . . . . the absence of a durable virtuous circle *à la* Kuznetz calls for permanent redistribution policies in order both to control the level of inequality and foster social mobility and growth. . . . This constitutes a whole research area still to be explored.

Labour market policies, especially the dynamic, equity and social cohesion elements, are an important component of important redistributive and growth policies. Once the process of redistribution and growth has been initiated, it becomes easier to deal with the allocative aspects of the labour market that were so much heralded by the Washington consensus. By focusing narrowly on the allocative aspect of the labour market, the Washington consensus seriously compromised the options for equitable and pro-poor development policies in the 1990s.

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