Executive Summary

Economic and social transformations in many client countries over the last decade have put their economies on higher, and more sustainable, growth paths. In too many cases, however, the changes have also led to higher unemployment, and more inequality and exclusion. Such consequences are obviously not desirable and have weakened popular support for reforms.

This proposal maintains that a clear understanding of the role of labor markets in developing countries has been missing and that the Bank can make an important contribution in the policy debate about economic development and the role of structural reform through additional labor-market analyses.

Labor is most often a poor person’s only asset. A growth process that is not associated with job creation may therefore fail to reduce poverty. Moreover, a well functioning labor market can be key to a business climate where new firms are created and private agents find the proper incentives to invest and innovate. Sound labor-market conditions are needed to guarantee the success of structural reforms, to maintain the social support for those reforms, and to ensure that the benefits are widely distributed. Achieving these targets is crucial to an effective implementation of poverty-reduction strategies and, hence, progress against the Millennium Development Goals.

Labor market analysis at the Bank to date has focused on developing a foundation in the most operationally relevant issues. For example, we have examined child labor, the economic impacts of unions and the consequences of labor-market regulations. Labor market studies have been done at the national level for specific countries. We have built a basic infrastructure to accommodate training and partnership activities – a key element in our operational work with client countries.

To contribute further to overall economic development and poverty reduction, we now need to understand better how the different pieces fit together:

- How do labor market policies and institutions contribute to a better investment climate while promoting decent working conditions and supporting workers affected by changes?
- How do labor markets function in the regulated and unregulated sectors, and how could policies be tailored to the needs of workers in the two sectors?
- Because economic reform does not happen in isolation, what are the costs of reforming some areas (i.e., product or financial markets) but not labor markets? Is there an optimal sequence for reforms? How can the Bank facilitate the political process of labor reforms?
- What are the interactions between education and labor market policies that can promote human capital, enhance productivity and wages, and promote adaptability of workers?

The ultimate goal of a renewed investment in building knowledge about the labor market is to develop an integrated and operationally relevant paradigm of the functioning of labor markets in
client countries and to assess how efficient labor markets can contribute to growth and development goals, specifically poverty reduction.

More specifically, such a program should include the following elements:

- Foster an evidence-based view of how labor market policies and institutions can support development goals;
- Ground the Bank’s understanding of labor markets in the rapidly growing literature on labor markets;
- Improve the Bank’s understanding of the effects of structural adjustments and reforms on labor outcomes; and
- Situate the labor market in the context of globalization.

The success of this endeavor requires an institution-wide effort. Labor markets cut across the Bank’s traditional sectoral mapping. They are also far from uniform so regional and country-specific diversity must be recognized. Finally, there are many external partners whose resources and knowledge would be critical to achieving the objectives of the research strategy.

This note first summarizes some of the main labor market challenges facing developing and emerging economies. It then discusses how the thinking about labor market issues has evolved within the World Bank and highlights the main conclusions of a stock-taking exercise conducted at the Bank in 2004 to assess labor market issues and policy challenges in different regions of the world. The final section highlights the main topics that have been identified for further research by the Bank and with the help and support of the international research community and donor countries.

1. **Motivation: Severe labor market imbalances around the world**

The past two decades have witnessed major shakeups in the economic and social systems of many client countries. Some have gone through a fundamental transition from a centrally-planned to a market economy; others have implemented far-reaching structural adjustment packages, including financial-market and trade liberalization, privatization and product market deregulation. At the same time, all countries have been confronted with the growing challenges of a globalizing world. These changes have significantly reshaped society, itself, leading to stronger, and more sustainable, economic growth in many countries. But labor market outcomes, in many cases, have not improved, with rises in unemployment, inequality, and exclusion. We claim that these outcomes, which stand in sharp contrast to the poverty and development objectives of the Bank, were not inevitable and that they materialized with such strength in so many countries partly because the labor market was not at the center of the structural adjustment policy agenda. While the Bank has invested in its knowledge base on the labor market, this work has largely focused on the effectiveness of specific policies and has not been integrated into our broader development strategy. For such a strategy to spur growth and persistently reduce poverty and exclusion, we need a clearer view of how the labor market functions and its interactions with other factor and output markets and institutions. To this end, we put forward this proposal and outline the required steps to make it happen.

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1 This note includes a number of references to Bank’s operational and analytical work. These should only be considered as examples and not as an exhaustive list of all relevant material.
Labor market disparities have widened in many client countries, weakening support for reforms

While the aggregate economic impacts of structural adjustment packages have differed across countries depending on initial conditions and on the way such packages were designed and implemented, in many cases their implementation has been accompanied by rises in unemployment, underemployment, and inequality. For example, while unemployment was practically nil at the beginning of the 1990s in Central and Eastern Europe, it jumped to about 15% of the labor force in the early phases of the transition to a market economy and, despite general recovery in the second half of the 1990s and early 2000s, the unemployment rate often remained well above 10 per cent (or even close to 20% in Poland, Slovak Republic, in some successor states of Yugoslavia, and Bulgaria) and labor force participation rates declined steadily, leading to declining employment rates (the shares of people of working age in employment – see Figure 1). Many Latin American countries, including those with sustained growth, have also seen major rises in unemployment and inequality together with falls in participation rates: for example, the unemployment rate doubled to more than 10% in Argentina, Brazil and Chile in the 1990s and the share of working poor in total employment has risen together with wage and income inequality in most countries. At the same time, while measured unemployment has remained relatively low in Sub-Saharan Africa and in South Asia, the share of working poor has reached almost 40% and more than 50% respectively (Figure 2).2

A common pattern in most client countries has also been a high incidence of joblessness, exclusion, or poorly paid jobs amongst vulnerable groups – young and old people, women, and the unskilled: often these vulnerable groups have benefited little from improvement in aggregate macroeconomic conditions or have borne most of the brunt of deteriorating conditions.3

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2 A comprehensive WB review of how labor markets evolved during periods of structural adjustment programs confirm these observations. In a number of cases adjustment programs of the 1980s and early 1990s were associated with higher unemployment and under-employment with greater labor market segmentation. See Horton et al. (1994), “Labor Markets in an Era of Adjustment”, World Bank.

These labor market outcomes are obviously not what reformers had hoped for. Understandably, they have also weakened popular support for reforms. In this context, we are obliged to ask what

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4 For example, in his speech “Dynamic Development: Innovation and Inclusion” (delivered at CES, Munich, November 2002), Nicholas Stern pointed out that the failure of development to reach many poor people, and the related disillusionment about reforms, is one of the main problems to be addressed in the years to come.)
The role of labor markets for development has evolved over time …

Understanding of the links between economic development and the labor market has evolved dramatically over the past decades. At the risk of over-simplifying, our thinking has evolved along the following lines. Back in the 1980s, a widely shared view was that stabilizing the economy and setting relative prices right would increase the demand for the abundant factor of labor and thus help workers and the poor. Adverse transitional effects were perceived to be short-lived and, at least in middle income countries, social safety nets were considered sufficient to protect workers affected by structural changes. Towards the end of the 1980s, it became clear that macro stabilization and trade liberalization did not lead, by themselves, to improvements in labor market conditions, especially for the most vulnerable groups. Such packages were often accompanied by tough fiscal austerity programs, which generally squeezed expenditures for social safety nets. Thus, efforts to protect social expenditures and improve their effectiveness in order to mitigate potential adverse effects of structural adjustments on the poor and other vulnerable groups became one of the main thrusts of the Bank’s activities in the 1990s. In this context, the Bank’s work in the labor market area largely focused on the assessment of specific labor market policies and institutions to help the unemployed or those excluded from the formal labor market, a key element in our operational work with client countries. Yet, a clearer sense of how labor markets fit into a comprehensive development strategy was not part of this focus but is now required.5 In particular, the main challenge for the years to come is to understand how specific labor market conditions of developing countries affect economic growth and the response of the economy to structural reforms, as well as the distribution of costs and benefits of such reforms amongst different social groups.

…but further work needed to assess how labor markets contribute to economic growth and empower poor people

We believe that the labor market is critical for a sustainable and inclusive development strategy for at least three reasons. First, because it is in this market that the employment shocks related to (and often required by) structural reforms must be handled. Second, labor is most often the only asset of poor people, and a growth process that is not associated with sustained job creation may fail to reach them. And last but not least, a labor market that facilitates job creation and increases in productivity is a key ingredient in a business climate where new firms are created and private agents find the proper incentives to invest and innovate. So a well-functioning labor market is

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5 A retrospective study of the Bank’s adjustment lending policy suggests that such policy has grown more long-term and developmental in nature over the past decade. However, it also recognizes the need for further improvements in several key areas, including the treatment of social aspects (see Operation Policy and Country Services, “Adjustment Lending Retrospective – Final Report”, June 2001). Results from a review of structural adjustment projects of the Bank over 1999-2001 confirm this point. For example, labor market conditions were only seldom included in these programs: of the 183 adjustment projects reviewed for 77 countries, only 13 projects (for 13 countries) had at least one labor market condition. ECA countries had the largest share among all countries that received lending with labor market conditionality (about half of them), LAC and EAP countries had some (15% each), while SA and MNA had none. Moreover, poverty-reduction policies (including the Poverty Reduction Strategies) generally have significant impacts on the labor market – and in some cases include direct employment-creation programs. However, in many instances, the labor market does not explicitly feature as one of the key factors for these strategies and, consequently, an in-depth assessment of their potential effects on the labor market is lacking.
needed to guarantee the success of structural reforms, to maintain social support for these reforms, and to ensure that their benefits are widely distributed. All in all, moving towards a well-functioning labor market is likely to be crucial to a more effective implementation of poverty reduction strategies and hence progress against the MDGs.

This proposal is concerned with fostering the Bank’s vision of how labor markets function and what strategies work to spur growth and reduce poverty. Its ultimate goal is: to develop an integrated and operationally relevant paradigm of the functioning of labor markets in client countries and to assess how efficient labor markets can contribute to the MDGs, specifically poverty reduction.

2. The Labor Market Stock-Taking of the Bank

HDNSP discussed an original research proposal with a number of sectors, regional units, and DEC in the Bank. Two conclusions emerged from these consultations. On the one hand, the view was widely shared that a deeper understanding of how labor markets function would strengthen the Bank’s overall development strategy. The need for new research was validated. On the other hand, it was evident that considerable knowledge and practical experience already existed on labor markets within the institution. Substantial analytical and operational work has been carried out in every region and in many sectors.

In this context, a stock-taking exercise was proposed as the first stage in implementing the research strategy. The objectives of this exercise were three-fold: (1) consolidating existing knowledge on labor markets; (2) diffusing this knowledge across regions and sectors in an accessible manner; and (3) identifying areas where important knowledge gaps remain and where further research is needed.

The stock-taking was carried out on a regional basis, with the plan for each Bank region to prepare a synthesis paper during 2004 that consolidated existing knowledge and experience in their labor markets. The suggested terms of reference for these papers included labor market trends and outcomes, a review of policy responses, major issues for the future, and knowledge gaps/research priorities. The papers ultimately varied somewhat in terms of structure and content, reflecting differences in regional expectations of the stock-taking and in the existing regional body of literature and experience.

The papers were presented and discussed at a stock-taking conference at the Bank in November 2004. This conference included Bank staff and external experts from academia and national and international institutions. The external resource people played an important role in bringing in non-Bank experience and knowledge and in helping to frame the key issues for further research. The intention of the conference was to lead to a shared view of “what we know and what we don’t know.”

It was clear from the stock-taking exercise that labor market analysis and experience was less extensive in low-income countries than in middle-income ones. Therefore, as a follow-up to the November Bank conference, HDNSP sponsored a workshop at the GDN annual conference in Dakar to focus specifically on a labor market stock-taking in low-income countries. The South

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6 In the end, five of the six Bank regional units prepared stock-taking papers. The East Asia paper was prepared by the Asian Development Bank.

7 The papers/presentations, thematic talks by external specialists, and a final summation are available at: http://www.worldbank.org/sp
Asia and Africa papers were presented and discussed at this conference along with other studies by the Bank and by external researchers in the two regions.\textsuperscript{8}

The stock-taking exercise underlined the diverse experiences in different regions. As a result, some of the important knowledge gaps that should be addressed through regional or country-level work programs were pointed out. It also became evident that some outstanding research issues were relevant either universally or in a number of regions, and that these issues would be handled most effectively through a collaborative work program. The next section presents a preliminary list of such issues.

Before turning to this proposed common agenda, however, it is useful to review the main messages that emerged from the stock-taking exercise:\textsuperscript{9}

1. \textit{The objective of employment creation and better jobs is an important but under-focused dimension of the development agenda.} As labor is often the only asset of the poor, providing jobs and making the market where this asset is exchanged more efficient must be a crucial aspect of poverty reduction. Yet, as there are many working poor, access to jobs is not sufficient for poverty reduction; this requires jobs with decent wages and, hence, higher productivity levels. However, the objective of more and better jobs will not be achieved by simply replacing growth with employment at the center of the development debate; rather, we need to think differently about the labor market and development, and how this contributes to employment, poverty reduction and economic growth.

2. \textit{The importance of labor market institutions for employment and growth differs substantially across regions and countries.} These institutions – comprising labor market regulations, active and passive labor market policies, and wage-setting rules – seem to have relatively little impact on the labor markets of some regions. This is particularly the case in regions where most of employment is in the informal economy (although regulations and institutions may be causing some informality). On the other hand, they are perceived as a binding constraint in other regions.

3. \textit{The labor market discussion seems to lack a conceptual framework to analyze labor market outcomes, partly because of lacking diagnostic tools and agree-upon labor market models.} There is a need to improve the diagnostic tools to assess labor market conditions in a given country, to identify vulnerable groups, and ultimately to provide better policy advice. Standard labor market indicators may not be appropriate in low-income countries where vulnerability often takes different forms than in middle- or high-income countries. Related to this is also a shared view that there is no labor market model that fits all countries. And there might be countries with no applicable labor market model at all. This model uncertainty may have consequences in the real world since it is not conducive to a rational policy discourse and may explain the lack of a clear-cut concept on the political economy of labor market reforms.

### 3. A list of research priorities

On the basis of the stock-taking papers and discussion, a preliminary list of research priorities has been identified. These have been organized into seven broad themes – within each, there is a rich analytical agenda. The priorities were identified according to the following criteria: (i) they

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\textsuperscript{8} The papers from this workshop are also available at [http://www.worldbank.org/sp](http://www.worldbank.org/sp)

\textsuperscript{9} See the summing-up of the conference by Robert Holzmann at [http://www.worldbank.org/sp](http://www.worldbank.org/sp)
identify a gap in our knowledge; (ii) they were raised in more than one regional paper; and (iii) further knowledge on these issues would yield potentially large development gains.

It should be stressed at the outset that, despite their broad coverage, these seven topics do not exhaust the list of factors determining labor market outcomes. First and foremost, these outcomes are influenced by macroeconomic policy and the broad range of policies influencing the investment climate at the national, sectoral, and local levels. They all contribute to promote higher sustainable growth, create more and better jobs, and ultimately reduce poverty. Labor market policy and institutions in turn contribute to the investment climate and job creation prospects by promoting the reallocation of labor towards more productive and rewarding jobs and by supporting workers affected by shifts in labor demand. The seven topics discussed below explore these interactions and how labor market policy can better promote economic efficiency, equity and social inclusion, and poverty reduction.

It should also be emphasized that the effects of macroeconomic conditions, the investment climate, and labor market policies and institutions on the quantity and quality of jobs are likely to differ across gender, age, ethnic, race and urban/rural dimensions. They are also likely to have differential effects on workers with disabilities. An important component of this research strategy will be to learn more about the causes and consequences of heterogeneous impacts, as well as to explore the effects of preferential policies on the labor market outcomes of disadvantaged workers.

I. Improve diagnosis of the labor market and identification of vulnerability

Improving our assessment of labor market conditions and policy challenges requires more and better information. In many low-income countries, standard labor market indicators are inappropriate. Most workers cannot afford to be unemployed and may well be engaged in full-time employment, while remaining in poverty. Better diagnosis is particularly needed to identify vulnerability in the labor market. In many countries, the traditional dichotomy of formal/informal employment may not characterize well the vulnerability of workers (more on this below). Vulnerability may also be the result of misguided policies or social norms that lead to social exclusion and discrimination. While in some countries, social exclusion is entrenched, we only have rough and incomplete measures to identify this phenomenon. A more complete set of labor market diagnostics needs to be developed in order to assess labor market performance and to identify vulnerable groups and design effective policies to improve their welfare.

Further required work

• Reviewing diagnostic tools to assess labor market conditions in countries at different stages of development and with different economic and social structures. In which cases would unemployment and employment rates be reasonable indicators of the labor market situation? In other cases, what indicators would be more meaningful to assess labor market conditions? What data are necessary in order to measure appropriate indicators? Diagnosis is particularly

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10 See the World Development Report 2005 on “A Better Investment Climate – for Everyone” for a detailed discussion of how improvements in the investment climate can improve long-term sustainable growth, job creation, and ultimately poverty reduction. The 2006 WDR on “Equity and Development” focuses on the role of policy and institutions in determining the distribution of income, access to services, and more generally social and economic opportunities, and thus complements the previous WDR.
problematic in labor markets where employment is predominantly rural and/or informal. This must be a priority for development work on diagnostic tools.\textsuperscript{11}

- \textbf{Improving identification of vulnerability in the labor market.} Is “working poor” a useful concept to identify vulnerable groups? If so, what is the appropriate benchmark for the working poor? How should the definition of vulnerability be tailored for those groups who are more likely to combine paid work with other activities (education, family responsibilities, etc.)? Should the analysis of labor market vulnerability be based on an individual concept or should it be extended to the household level?

- \textbf{Improving identification of vulnerability among children and the youth.} In many developing and emerging economies, child labor prevents children from acquiring the required skills for a productive working life. In others young people are experiencing difficulties in gaining access to decent jobs. In some countries, youth unemployment is the main source of concern, while in others, the unemployed youth are not the most vulnerable. Instead, idle youth or young people working in very low-paid and unproductive jobs might be more at risk. Identifying these sources of risk, allowing for differences across countries and for children and youth of different family background and education levels, is a priority for assessing child labor and youth employment. An important dimension of this research is also the analysis of the school to work transition: Which schooling and/or labor market interventions can help increase successful transitions? Which interventions can help to level the playing field among girls and boys, or between youth of different family backgrounds? Significant knowledge gaps remain in this area in most developing countries\textsuperscript{12}

- \textbf{Understanding the gender dimensions of vulnerability in employment.} In many countries, labor markets are segmented by sex, with women concentrated in low paying occupations. As female education increases, the question is how much segmented labor markets affects gains in productivity and earnings for women. Research needs to explore gender labor market segmentation, including gender differences in formality status. Questions include what drives men and women in and out of formality? What are the social protection alternatives for female informal workers in urban and rural areas? Which mechanisms can combat gender labor market segmentation?

- \textbf{Identifying and facing up to social exclusion.} Social exclusion is a deep and entrenched aspect of many societies that can run along race, caste, religion, ethnicity, age, gender or disability lines. Often, these dimensions interact with each other and the result is compound discrimination. In the labor market, exclusion affects access to work and all aspects of employment including earnings, promotions, dismissals, and working conditions. There is a need to identify the extent of social exclusion beyond traditional measures of wage differentials. In addition, there is a need to identify which policies yield better outcomes to deal with exclusion. Are non-discrimination or preferential quotas appropriate policies, or do they have unintended effects? What other types of policies might increase the labor market inclusion of traditionally excluded groups.

\textsuperscript{11} In 2007, a draft diagnostic tool – including a guide on how to construct improved labor market indicators using existing data sources – for assessing labor market outcomes in low-income countries with large informal employment and own-account jobs has been developed and piloted in nine countries (Brazil, Bangladesh, Senegal, Ghana, Madagascar, Morocco, Jordan, Egypt) and the results presented at a workshop.

\textsuperscript{12} HDNSP together with the HDNED and the Children & Youth Group is preparing a research proposal for a cross-sectoral study of the school to work transition in different client countries.
II. Understand the linkages between investment climate, labor demand, and poverty

The challenge of creating more and better jobs largely relies on improvements in the investment climate in which firms find the incentives and opportunity to invest productively, grow, and hire workers. Existing bottlenecks in the investment climate affect the three main channels through which growth can affect poverty reduction: i) the sustainable growth path; ii) the employment content of growth (i.e. the elasticity of employment to output growth); and iii) poverty-reduction effect of employment growth (the poverty elasticity to employment). Moreover, different reforms of the investment climate may affect these three channels in ways that may affect the short-term and long-term effect of growth on poverty reduction. In many developing countries dominated by traditional economic production, two other important issues relating to labor demand concern rural, non-agricultural activity and the efficient migration of rural workers to urban areas where employment opportunities are growing. These have direct and potentially powerful implications for poverty reduction.

Further required work

• Assessing labor demand in countries at different levels of development and with different investment climates. Aggregate data would enable the analysis of differences in the employment content of growth across countries and regions. This analysis needs to be complemented by a more in-depth assessment of the sources of economic growth, productivity and job creation at the sector and firm level using available data in many developing countries. What are the sectors and types of firms that play an important role in productivity growth and job creation? Are those the same across countries, or are there differences? Do small firms play an important role in net job creation? What are the links between technological progress (through innovation and adoption of technologies) and the level and composition of labor demand? Are these links mediated by policy and institutions?

• Understanding the role of labor in the link between growth and poverty, especially in low-income countries. The impact of growth on poverty alleviation depends not only on the employment content of growth, but also on the location and quality of jobs created by stronger growth. In many low-income countries, improvements in agricultural productivity are often associated with major labor shedding and mobility towards urban areas. The creation of non-agricultural jobs in rural areas coupled with a smooth migration towards urban areas seems to be of foremost importance to reduce poverty. How can labor-intensive, non-agricultural activities in rural areas be encouraged in order to create earning opportunities for rural workers and to absorb the surplus labor in agriculture that has become so large in many developing countries? How much of an impact can education and training have for encouraging this type of job creation? Are there other policy interventions that matter? What factors determine decisions of rural workers to migrate to urban areas? What do we know about rural-urban migration patterns and about the post-migration employment outcomes? What role is there for policy to improve the transition?

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13 The WDR – 2005 identified four areas as representing the basic pillars of a sound investment climate: i) political and economic stability and security; ii) regulations and taxation; iii) finance and infrastructure; and iv) workers and labor markets.

14 Sector level data are available for a large number of countries from UNIDO and national sources. Firm-level data are available for a growing number of countries from the Bank’s Investment Climate Surveys (ICS) as well as from enterprise surveys and business registers of many countries (see Bartelsman, Hatiwanger and Scarpetta, 2004, “Microeconomic Evidence of Creative Destruction in Industrial and Developing Countries”, Policy Research Working Paper No. 3464.
III. Identify the benefits/costs of structural reforms and globalization for workers

This is closely related to the previous topic. The international evidence suggests that macro, trade, and structural reforms can involve large reallocations of resources – including labor – across firms, sectors, and locations, often with adverse effects on labor markets. In ECA, these reforms were accompanied by persistent open unemployment, declining participation, and sometimes, by stagnating real wages. In LAC, the impact of reforms on jobs has been much smaller but often at a cost of substantial wage losses. In many low income countries, increased trade openness is exposing them to greater opportunities but also more exposure to fluctuations of international markets.

Further required work

- Identifying the channels by which different types of reforms affect labor market outcomes. There are various hypotheses to explain cross-country differences in labor adjustments to reforms. One is that, in some countries, labor market regulations prevent labor reallocation, reducing the effects of reforms on employment but concentrating the effects on wages. Another hypothesis is that in some countries, the effect of trade reforms on employment has been ameliorated by real exchange rate depreciation, while in others it has been aggravated by real appreciation. A better understanding of the transmission channels will make it possible to (1) design structural adjustment programs conducive to greater welfare gains and (2) design income support and reemployment programs better targeted to the needs of affected firms and workers.

- Identifying the medium-term job growth prospects of structural reforms. Despite short-run costs, it is expected that successful integration into world markets will eventually bring large dividends to workers and firms. But is this actually the case and what does it depend upon? For example, recent evidence suggests trade liberalization has had large, positive effects on manufacturing employment in countries that are large FDI recipients, but small effect in countries that receive little FDI.

- Identifying the optimal sequencing of reforms for job creation. Is it better to reform labor markets and then open economies to trade, or vice versa? What about reforms oriented to improve the investment climate -- should they precede or follow labor reforms? Studying multiple experiences of structural reforms across the world can shed light on the sequencing that is best for job creation and poverty reduction, for a given set of initial conditions.

- Identifying the best mechanisms of income support and re-employment for affected firms and workers. Labor market adjustment to structural and trade reforms can be a complex and non-standard process. For example, while many income support mechanisms are targeted to displaced workers, some of the evidence for LAC points to the most important effects of trade reforms on wages. This suggests that is necessary to recognize the heterogeneity in country conditions in likely solutions. In some countries, income support mechanisms might need to focus on complementing the incomes of poor employed workers, in others on sustaining the incomes of the unemployed (more on this below). More and better knowledge of such country-specific factors is required to design effective labor market policies.15

**IV. Understand the different aspects of formality and informality**

All labor markets include diverse types of employment in terms of “formal” jobs, “informal” jobs, and variations in between. In many developing and transition countries, informal employment has been growing more rapidly than more formal employment (Table 1). This has raised many questions for labor market analysis and also for policy-making. It also has close links with the earlier theme on diagnosis and vulnerability. It is obvious that the reality is more complex than the traditional view of an informal “sector” where the poor, unable to find formal jobs, eke out a subsistence living through very low productivity labor. While this characterization applies in some cases, empirical studies in LAC have shown that some workers seem to be voluntarily moving to the informal sector to improve their lot. Moreover, workers in sectors traditionally considered as “formal” are increasingly employed in temporal, precarious jobs, blurring the line between formal and informal employment. We know little about informality, what drives it, and what its links are to formal labor markets.

### Table 1. Informal Employment, late 1990s, % of non-agricultural employment

<table>
<thead>
<tr>
<th>Country</th>
<th>Total</th>
<th>Female</th>
<th>Male</th>
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<tbody>
<tr>
<td><strong>Sub-Saharan Africa</strong></td>
<td>72</td>
<td>84</td>
<td>63</td>
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<tr>
<td>Benin</td>
<td>93</td>
<td>97</td>
<td>87</td>
</tr>
<tr>
<td>Kenya</td>
<td>72</td>
<td>83</td>
<td>59</td>
</tr>
<tr>
<td>South Africa</td>
<td>51</td>
<td>58</td>
<td>44</td>
</tr>
<tr>
<td><strong>Asia</strong></td>
<td>65</td>
<td>65</td>
<td>65</td>
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<tr>
<td>India</td>
<td>83</td>
<td>86</td>
<td>83</td>
</tr>
<tr>
<td>Indonesia</td>
<td>78</td>
<td>77</td>
<td>78</td>
</tr>
<tr>
<td>Thailand</td>
<td>51</td>
<td>54</td>
<td>49</td>
</tr>
<tr>
<td><strong>Latin America</strong></td>
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<td>58</td>
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</tr>
<tr>
<td>Brazil</td>
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<td>67</td>
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<tr>
<td>Colombia</td>
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<tr>
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<tr>
<td><strong>North Africa</strong></td>
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<td>Egypt</td>
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<td>57</td>
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<tr>
<td>Tunisia</td>
<td>50</td>
<td>39</td>
<td>53</td>
</tr>
</tbody>
</table>

Further required work

- Investigating the dynamics of the formal/informal economy. To what extent, and for which workers, is informality a launching pad, and for which others is it the only option available? In particular, do certain workers (e.g., parents of young children, youth, etc.) pursue informal jobs in order to combine work with other activities, or alternatively, do they do so because these are the only jobs available? Is informal employment the safety net of the poor and if so, how effective a safety net is it? What are the long-term, aggregate consequences of informality for productivity growth, human capital enhancement, and poverty?

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• **Re-thinking social protection for informal workers.** While informal jobs may constitute a form of safety net, this is likely to be an imperfect or inefficient risk management strategy. What are the most efficient and cost-effective ways to improve the risk management strategies of vulnerable workers? What policies and interventions can be applied in the context of low-income countries with low capacity and limited fiscal resources?

• **Identifying the effects of labor regulations and social protection programs on informality.** To what extent is informal employment motivated by inappropriate regulations and costly social protection mechanisms? Do informal firms choose to remain small and unregistered to avoid regulations and payroll taxes? Does this behavior bring important aggregate costs in foregone productivity? And what, if any, regulations and social protection programs are most important in this decision process?

**V. Identify appropriate labor market regulations and institutions**

Research suggests that economic growth requires the capacity to reallocate resources, including human resources, from declining to expanding sectors, and from low-productivity to high-productivity activities. However, in many countries labor regulations appear to be ill-suited to facilitate this process. In many developing countries, hiring and firing regulations are much stricter than in high-income countries, hindering the reallocation of labor across uses; on the other hand, few have adequate programs to support the unemployed (Figures 3 and 4). Yet it should be recognized that labor market regulations, albeit imperfect, constitute a form of social protection and cannot simply be dismissed. To move beyond a trade-off between labor market flexibility and worker security is necessary (1) to identify the benefit/costs of existing regulations/social protection mechanisms and (2) to identify potential alternatives, which yield higher benefits at a lower social and economic cost.

**Further Required Work**

• **Identifying the impacts of labor regulations on total employment levels and growth, formal sector employment growth, informal-formal decisions, productivity growth, consumption smoothing, and risk management strategies.** While all regional stock-taking papers, with the exception of Africa’s, refer to the apparent costs of existing labor regulations, it is necessary to identify and, more importantly, to quantify the benefits as well as the costs of existing regulations and also the benefits/costs of potential labor reforms. In addition, since not all firms and sectors are equally affected by regulations, this analysis needs to be complemented by further work on the heterogeneity of impacts on firm decisions and economic outcomes.

• **Identifying the effect of labor market regulations on particular groups of the labor force.** Heterogeneity of impacts also applies to workers. Recent evidence suggests that some labor market regulations (employment protection, minimum wages) are detrimental to the

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18 See, for example, Montenegro and Pagés (2003), “Who Benefits from Labor Market Regulations?: Chile 1960-1998” WB Policy Research WP, 3143. An excellent example of work showing that strict labor market regulations produce important efficiency losses is a recent study of Ahsan and Pages, who distinguish between regulations about labor disputes and job security and show that labor regulations in India had important adverse effects on both output and employment (Ahsan and Pages, “Are All Labor Regulations Equal? Assessing the Effects of Job Security, Labor Dispute and Contract Labor Laws in India.”World Bank, Human Development Network, SP Discussion paper No. 0713, 2007.
employment of youth, women, and unskilled workers. Some labor market regulations set to protect particular workers, for instance youth, women or disabled workers, may end up restricting their job opportunities. To what extent are inappropriate regulations behind the persistently high youth unemployment rates observed in LAC, MENA or ECA? To what extent do they slow down the entry of women and ethnic or racial minorities in the labor force? Are there regulatory regimes that offer some protective benefits to these groups while not hindering their access to employment?

Figure 3. Many developing countries have more stringent regulations on hiring and firing than industrial countries

![Summary indicator of the stringency of Employment Protection Legislation (EPL)](image)

Source: Authors’ calculations from World Bank Rapid Response Database.

Figure 4. Developing countries, particularly low-income ones, offer a much weaker and less diverse protection against unemployment risk than developed countries

![Share of countries in the group](image)


- **Labor standards.** The role of international labor standards in trade and development has become an important issue for assessing conditions in the labor market and promote
improvements. In recent years, the Bank has undertaken some research on policy to combat child labor and, in particular, its worst forms, and to assess whether and how multinational enterprises enforce or even promote core labor standards. The incidence of child labor had declined over the past decade, but in low-income countries many children in between 10 and 14 years of age are working (Figure 5). But there is a need to extend this effort and build a stronger and more operationally-relevant view of how the promotion of core labor standards can contribute to poverty reduction in client countries. Under what conditions can promotion contribute most to these goals? What are the precise links in the chain between respect for the core labor standards and poverty reduction? How can the standards be adapted to maximize their impact in labor markets where employment arrangements are typically informal and where compliance is weak? How can employers, unions, and NGOs contribute to the awareness, monitoring, and supervision that are critical to core labor standards? These are questions where cooperation with the ILO would be important.

- Understanding the political economy of labor reforms. A number of political economy issues have to be taken into consideration while reviewing labor market policy settings and potential reforms. In general, two considerations are particularly relevant. First, labor reforms often take time to produce positive effects in the market (especially if done in piecemeal fashion) and the time required may well be longer than the political horizon of elected governments. Second, such reforms are perceived to weaken (and often do weaken) the position of certain groups of workers (often referred to as the “insiders”) who oppose them fiercely. Thus it is often politically difficult for governments to embark on far-reaching labor market reforms, even when the economic case exists. These considerations must be understood in the broader context where reforms in other markets, by increasing the demand for greater flexibility in labor adjustment, may create strong pressure for changes, even in the absence of a direct policy intervention. Not surprisingly, labor reforms in most client countries have been fairly infrequent and when they have occurred, they have most typically reformed “at the margin” -- for example, by easing regulations on temporary contracts while leaving in place stringent regulations for permanent workers. However, the existing evidence suggests that this type of reform has adverse effects on the labor market, and that it is not a substitute for comprehensive reform. Which elements drive a successful labor reform? Are there ways to design compensatory packages that allow potential losers to accept change?

- Identifying alternative protection mechanisms with lower economic costs. Finding suitable alternatives to existing social protection mechanisms is not an easy task. It is often mentioned, for instance, that mandatory severance pay should be replaced with some form of unemployment insurance (UI). Yet, OECD-style UI systems can be very expensive and have limited effectiveness in developing and transition countries where administrative capacity is limited and where opportunities to work informally are widespread. To reduce moral

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19 These include effective abolition of child labor; elimination of forced labor; equal opportunity and non-discrimination in the labor market; and freedom of association and collective bargaining.

20 Political economy considerations can also partly explain why labor market conditionality is largely absent in structural adjustment programs: such conditions are likely to face strong opposition from interested groups delaying the approval of the overall adjustment package.

hazard, LAC countries are designing unemployment protection systems that rely on self-insurance. While such systems may be effective in countries with limited administrative capacity, preserving risk-sharing may be appropriate in middle-income countries with higher capacity. An additional complication stems from the aggregate adjustment consequences of income support programs. To what extent do income protection mechanisms reduce wage flexibility and increase unemployment (thus further increasing the need for unemployment insurance mechanisms)? To what extent do income protection mechanisms funded with labor taxes contribute to unemployment? What are the estimated financial costs of such programs? What is most appropriate for low-income countries? Finally, active labor market programs (ALMPs) are also an important consideration in designing policies to protect workers. These programs can potentially play a useful role in reducing frictions in the labor market, in addressing structural imbalances, and in providing short-term employment. However, the international evidence raises questions about the real impacts of these programs and their cost-effectiveness. What is the role of ALMPs and how can they be designed to have the most positive effect on labor markets?22

Figure 5. The incidence of child labor is still high in many countries, (% of 10-14 years old working)

• How to promote social dialogue. The experience of many countries that have undergone major reforms suggests that social dialogue is very important to improve the acceptance on the reform promote change in attitude of private agents and maintain momentum for the reform to bear its fruit. There are two dimensions to social dialogue that seem especially relevant to developing a comprehensive view of the labor market. The first concerns the identification of the most effective ways to use social dialogue (employers, labor, other constituencies) to develop and implement policies that best support overall poverty reduction. The second concerns what models of collective bargaining should be encouraged to enhance economic and employment growth, while protecting the basic rights of workers. These two issues require additional research that is soundly rooted in country experience. By their very nature, they will also be key issues in our partnership activities, especially with the labor movement.

22 Evidence on the application of income support and active labor market programs to developing and transition countries is summarized in Vodopivec, Income Support for the Unemployed: Issues and Options (World Bank, 2004) and Betcherman, Dar, and Olivas, Impacts of Active Labor Market Programs: New Evidence from Evaluations with Particular Attention to Developing and Transition Countries (Social Protection Discussion Paper No. 0402, 2004).
VI. Identify best practices in skills development and skills upgrading

The stock-taking papers identified important skill shortages in most developing countries. In many countries of South Asia and Sub-Saharan Africa, illiteracy rates are still very high (Figure 6), and enrollment in secondary education is still fairly low in many low and middle-income countries. Not surprisingly, many employers in these countries consider skill shortage as one of their main constraints in the operation of their business and potential for growth (Figure 7). Increasing the quality of the labor force is essential to increase the productivity and the earnings of workers. Yet, in many countries, state-provided training services have been inadequate and disconnected from the requirements of employers. Interventions in skill formation should take into account that (i) most training takes the form of on-the-job training; (ii) medium- and high-skill workers are more likely to be trained by firms than low-skill workers; (iii) many workers in developing countries are self-employed; and (iv) economic analysis has often shown that the returns to human capital investments in workers are highest when workers are supported in furthering their general (school-provided) education. With all of these considerations, it remains unclear what the best models are for skills development and skills upgrading of the labor force. For example, what are the best training models to build a skilled labor force? What are the appropriate public and private roles?23 How should the training system interact with the education system, facilitating the entry of young people into the labor market?24

Further Required Work

- **Identifying efficient government interventions in training programs and policies.** There are a myriad of interventions that have been adopted to stimulate workforce training and skills upgrading: publicly provided training, adult education, fiscal incentives for firms that train workers, earmarked payroll taxes to fund training, labor force certification programs, lifelong learning competencies, technical assistance to SMEs and technical assistance to self-employed workers. What are the impacts of such programs and which programs are more effective to foster skill upgrading of unskilled workers? Which are more effective to foster growth in SMEs? What is the most appropriate role for government in terms of setting the policy framework, financing training, delivering training, providing training “infrastructure” (i.e., information, standards, monitoring and evaluation, etc)?

- **Identifying the role of labor force skills in determining economic outcomes in a context of globalization.** Many developing countries have an unclear strategy regarding the role that training and workforce skills investment should play? On the one hand, a more skilled labor force is often seen as a way to attract investment and to move up the value chain in terms of exports. On the other hand, the attractiveness of keeping labor costs down might suggest that skills development and upgrading should be a less important consideration at certain stages of development. What is evidence from the international experience? To what extent does a lack of suitable skills constrain investment decisions of firms? To what extent do they constrain innovation or FDI?

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23 Amongst others, the WB study by Middleton, Ziderman, and Adams., “Skills for Productivity: Vocational Education and Training in Developing Countries” (1993) discusses different options.

24 This has become critical issue in a number of client countries, but not much expertise is available in house. A recent OECD study discusses pros and cons of specific youth programs developed in some OECD countries (“Giving youth a good start: The experience of OECD countries”) and this material could be a start in the identification of suitable programs for client countries.
Figure 6. Youth illiteracy rates still loom large in many low income countries

![Bar chart showing youth illiteracy rates in various regions](image)

Source: World Development Indicators, 2001

Figure 7. Share of firms reporting skill shortage as a major constrain in their operation, selected countries

![Bar chart showing skill shortage in various countries](image)


VII. International migration

The demographic development between the main regions of the world is characterized by large disequilibria as a result of differences in the timing and scope of fertility and mortality trends. As some of these differences will get more pronounced in the decades to come, this will accentuate the divergence in labor force growth between regions (Figure 8). Europe and Japan will have low or even negative growth, and other regions, such as MNA or India, will have continued high growth. For the rich countries in the developed world, a constant or declining labor force implies lower GDP per capita growth, unless a declining labor supply is fully compensated by higher productivity growth. But the latter risks to be negatively impacted by an older and less
entrepreneurial population. Labor force stagnation also implies a higher burden through social security programs such as pension and health, which is largely independent of how these programs are funded. On the other hand, the developing countries with continued strong labor force growth will be extremely hard pressed to create the millions of additional jobs needed to accommodate the new entrants. This disequilibrium calls for demographic arbitrage and ideas on how to structure capital as well as labor flows as a win-win-win situation (for sending country, receiving country, and migrants). This includes managed temporary or permanent migration, the better use of remittances in labor-sending countries, and appropriate social policy programs which make return migration individually attractive and fiscally sustainable for the sending country.

The World Bank has recently launched a research program on the development impact of migration.25 The objective of the research is to identify policies, regulations and institutional reforms that will lead to improved outcomes for developing countries. The research focuses on developing countries — sending countries — but also looks at the impact of migration on developed countries, as well as on migrants themselves, because the effect on both sets of countries (sending and receiving) will also depend on the degree of success of the migrants themselves. In short, a main objective is to identify “win-win-win” policies for the three groups: developing countries, developed countries and the migrants. The research program includes six main topics, including one on “Social Protection for Migrants”. The following paragraphs elaborate on labor market related issues within this broad topic.

Further required work

- **Understanding demographic disequilibria and skill gaps.** What are the consequences of insufficient adjustment to the demographic disequilibria for low- and high-labor force growth countries/regions? For the slow labor force growth countries the consequences are likely to include lower economic growth and an increased burden for dealing with population aging in pension and health programs. For the fast labor force growth group, the consequences are likely to include sustained high unemployment, in particular among the young. Moreover, what are the skills requirements for labor market “balancing” while maximizing mutual economic gains? What skill types and levels are required in low-labor force growth (i.e., receiving) regions? Can these be provided by the high-labor force growth (i.e., sending) regions, while keeping distortions in both regions low? Questions to be investigated include analyzing the needed skills, their availability, and the effects of skill formation in both sending and receiving countries.

- **Assessing migration policies in receiving countries.** Comprehensive migration policies are required in receiving countries to promote integration and win-win-win outcomes for both sending and receiving countries: What is the access of migrants to social programs/services such as education, health, income support, etc? What are the needed policy changes for a productive absorption of migrants, in particular in output and factor markets? What are the gender differences in labor migration trends and levels and how gender informs migration policies? What are the budgetary effects of migration for the receiving countries? What are good practices of social integration policies such as outreach, language skills and code of conduct?

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• **Assessing migration policies in sending countries.** Effective policies to stimulate job creation in sending countries have major implications for emigration patterns. The other components of the labor market research discussed in this note will all contribute to the assessment of how demographic pressures will translate into migration flows from sending countries. Furthermore, there is little knowledge how migration effects the local labor market and its segments of skilled and unskilled. In addition, the Bank is already working on the effects of migration on human capital formation and on remittances. Implications for brain drain, brain gain or brain circulation in sending countries awaits further investigations.

• **Understanding the role of portability of social benefits.** Greater coordination is required in the area of portability of social benefits and entitlements. Governments of sending countries have an interest in their citizens being protected by social services such as health care, education, unemployment insurance, and pension systems while living and working abroad. At the same time, receiving countries are not always prepared to offer full social protection to migrant workers and their families. Also, migrants may not have spent enough time in a particular country to be entitled to claim certain welfare provisions. How can the portability of benefits in the areas of pensions and health care for migrants among host countries and back to sending country be improved? Are bi-lateral agreements enough or are there better solutions through changes in benefit design?

**Figure 8. Growing demographic imbalances across regions of the world, changes in population by age group and region for 2005-2050 (in millions)**

Source: UN 2005 Population projections; EU25+ includes Iceland, Norway, Switzerland and Channel Islands; The projections are those of the zero migration scenario.