

DISCUSSION DOCUMENT

The Challenges of Growth, Employment and Social Cohesion

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Overview: Challenges of growth, employment and social cohesion

“We were formed from the ashes of a ruined world, imbued with the determination of our founders to never again make the mistakes of the past -- mistakes that led to economic nationalism and war. Our overarching goal is fostering better relations between countries, and avoiding the economic roots of instability and conflict. Our role begins with economic stability, but it ends with the goal of all multilateral institutions -- a stable and peaceful world.”¹

“The crisis has again put before our eyes something that we all know: good jobs, quality jobs, decent work are, everywhere, central to the lives of women and men. Decent work is a source of personal dignity. Stability of family and households. Peace in the community. Trust in government and business and overall credibility of the institutions that govern our societies. Labour is much more than just a cost of production. This simple aspiration to have a fair chance at a decent job is at the top of the political agenda, on top of opinion surveys; yet, policies are not delivering.”²

¹ D. Strauss-Kahn (Managing Director, IMF): “Crisis and beyond – The next phase of IMF reform”, Presentation at the Peterson Institute for International Economics, Washington, DC, 29 June 2010.

² J. Somavia (Director-General, ILO): “Achieving and sustaining an employment-based recovery: United States and global strategies for governments, businesses, workers and families”, Address for a panel discussion at the Brookings Institution, Washington, DC, 26 Feb. 2010.

1. Introduction

The world faces major challenges in creating enough quality jobs to sustain growth and development. The financial crisis of 2007–09 led to a sharp increase in layoffs and a slowdown in hiring, and thus to rising unemployment, underemployment and informal work. Now, nearly two years on, unemployment remains at very high levels in many advanced economies, with little sign of an early fall.

In emerging and developing countries, the economic shock hit jobs in export sectors hard, but these are now recovering, in part as exporters have diversified their markets to rely less on those of the advanced economies. But the slowdown also hit the large informal economies of the developing world. Informal employment has increased, and the numbers of working women and men who cannot earn enough to keep themselves and their families out of poverty have risen.

The scars of this distress in labour markets could last for a very long time – in the case of young workers unable to get their first job, a lifetime. Political, community, business and labour leaders all over the world are asking for answers to the threat of a slow jobless recovery. And they want to know that recovery can transition into strong, sustainable and balanced growth.

This is the challenge that has brought the IMF and the ILO together to stimulate an active discussion of how international cooperation and policy innovation can address the urgent need to improve the capacity of economies to generate enough good jobs – decent work – to meet societies’ needs.

This discussion paper is intended to launch debate at our joint Conference on the Challenges of Growth, Employment and Social Cohesion in Oslo on 13 September 2010. And we hope

that the Oslo Conference, made possible by our host, Prime Minister Jens Stoltenberg of Norway, will in turn focus thinking and action on how to ensure that policies have the same priorities as people – more and better jobs.

Our objective at the Oslo Conference is to improve the integration of employment and social policies with international and national macroeconomic policy strategies. This requires a better understanding of the forces at work in the global economy, and the contributing factors, both globally and nationally to these, and how a wider array of policy tools can contribute to better outcomes for people, communities and global sustainable development.

The ILO and the IMF have different mandates and different constituencies, albeit in more or less the same member States. Not surprisingly, our approaches and analyses are also different. This joint publication has two contributions: on the human cost of recessions, assessing it and reducing it, prepared by the staff of the IMF, and on building an employment-oriented framework for strong, sustainable and balanced growth, prepared by the staff of the ILO. In the process, the authors consulted extensively and rewardingly with each other. The exercise has highlighted many important and urgent issues for discussion at the Oslo Conference and more generally amongst researchers, analysts and policy-makers. These include:

1. What was the impact of the Great Recession of 2007–09 on labour markets? What are the prospects for employment in 2011? How do the prospects differ between advanced countries and others?
2. Which policies proved most effective in reducing the human costs to labour markets of the recession – fiscal and monetary stimulus, short-time work programmes, provision of unemployment insurance benefits, job subsidies, others?
3. Can fiscal and monetary policy continue to support aggregate demand, and thus employment, in the short term, i.e. 2010–12? Is coordination of fiscal and monetary policies across countries needed to enhance their effectiveness?
4. Can the policies adopted to ease the pain of the crisis on labour markets, e.g. short-time work programmes; provision of unemployment insurance, continue in the short term or do they need to be modified or phased out?
5. Which policies, e.g. job subsidies, can accelerate recovery in jobs in the short term?
6. What policy mix is needed to transition from recovery to strong, sustainable and balanced global growth? Which policy tools could help ensure the balanced development of wages and productivity to support sustainable growth?
7. What training and small enterprise development policies work best to augment aggregate productivity growth and overall economic performance?
8. Which policies for social protection and inclusive labour markets are needed for a more balanced global development?
9. How can the roles of collective bargaining, tripartite consultation and social dialogue be reinforced?
10. How can policy coherence for a fairer globalization be improved, including between macroeconomic and employment and social market policies?

Some of these issues have also been part of the deliberations of the Group of Twenty (G-20) to which both the IMF and the ILO have contributed.

The IMF and the ILO: recalling the origins

One of the purposes of the IMF, decided at the Bretton Woods Conference in July 1944, is “to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy” (Article I(ii)).

The Declaration of Philadelphia, which relaunched the ILO in May 1944 and became part of its Constitution, affirms that “all human beings, irrespective of race, creed or sex, have the right to pursue both their material well-being and their spiritual development in conditions of freedom and dignity, of economic security and equal opportunity” and that “it is a responsibility of the International Labour Organization to examine and consider all international economic and financial policies and measures in the light of this fundamental objective”(Article II). The Declaration also “recognizes the solemn obligation of the International Labour Organization to further among the nations of the world programmes which will achieve ...full employment and the raising of standards of living” (Article III).

These two conferences, taking place one after the other in 1944, were driven by the conviction that the mass unemployment of the 1920s and 1930s which was widely seen as both a cause and a consequence of the breakdown of international cooperation that led to war, must never be repeated.

Now 66 years later, the world is grappling with the aftermath of the most serious economic and financial crisis since the 1930s that threatens to leave a legacy of prolonged large-scale unemployment, underemployment and increased job insecurity and informality.

As the creators of the post-1945 architecture for global governance envisaged, achieving full employment and poverty-eradicating development requires policy coherence across the responsibilities of different ministries and international organizations. Yet the history of much of the period since then is one of increasing policy specialization and even contradiction. Taking off these blinkers is likely to play a big part in finding a better way to shape a fairer globalization.

2. The human cost of recessions: Assessing it and reducing it

Unemployment in the Great Recession of 2007–09

Dire state of labour markets: Over 210 million people across the globe are estimated to be unemployed at the moment, an increase of more than 30 million since 2007. Three-quarters of the increase in the number of unemployed people has occurred in the “advanced” economies and the remainder among emerging market economies. Within the advanced countries, the problem is particularly severe in the United States – the epicentre of the Great Recession and the country with the highest increase in the number of unemployed: an increase of 7.5 million unemployed people since 2007.

Unemployment rates in advanced economies: The unemployment rate has increased by 3 percentage points in advanced countries since 2007 and by a $\frac{1}{4}$ percentage point in emerging markets. Within the advanced economies, some of the largest increases in the unemployment rate have occurred in Spain – where the rate increased by nearly 10 percentage points – the United States, New Zealand and Taiwan (China). In contrast, in Germany and Norway, the unemployment rate barely budged. Three sets of factors appear to account for these cross-country differences. The first is the extent of the fall in aggregate demand. The second is the co-incidence of the aggregate demand decline with acute stresses in other sectors, such as the financial and housing sectors. The third is the extent to which countries used active labour market policies, such as short-time work schemes, to shield employment and the labour market institutions in place, such as the prevalence of temporary employment contracts.

Youth unemployment: Historically, the unemployment rate for youth (15–24 age group) has been two-and-a-half times higher than for older age groups. Youth unemployment increased substantially in most OECD countries during the Great Recession, and more so than in past recessions. The largest increase was in Spain, where youth unemployment doubled from under 20 percent to almost 40 percent.

Long-term unemployment: The share of long-term unemployed has increased in most OECD countries since 2007. In the few cases where it did not – such as Germany, France, Italy and Japan – the share had been persistently very high even before the crisis. In the United States, the share of workers who have been unemployed for 27 weeks or more (as a share of the total number of unemployed) has been rising with every recession, but the increase during the Great Recession is alarming: nearly one in every two unemployed people has been out of work for 27 weeks or more.

The human cost of unemployment

If the effects of past recessions are any guide, the cost to those who become unemployed could be a persistent loss in earnings, reduced life expectancy, and lower academic achievement and earnings for their children. And unemployment is likely to affect attitudes in a manner that reduces social cohesion, a cost that all will bear.

Lower lifetime earnings: Layoffs are associated not just with immediate loss of earnings, but also with future loss of earnings, and the losses are higher if the layoffs occur during a recession. Studies for the United States show that even 15–20 years after a job loss in a recession, the earnings loss amounts, on average, to 20 per cent. The adverse effects on lifetime earnings are most pronounced for unemployment spells experienced in youth, especially upon college graduation.

Cost to health: Layoffs are associated with a higher risk of heart attacks and other stress-related illnesses in the short term. In the long term, the mortality rate of laid-off workers is higher than that of comparable workers who kept their jobs. For the United States, one study estimates that the increased mortality rate as a result of unemployment persists for up to

twenty years after the job loss and leads to an average loss of life expectancy from 1 to 1.5 years.

Cost to children: Job loss can reduce the schooling achievement of the children of the unemployed: one study finds that parental job loss increases the probability that a child repeats a grade in school by nearly 15 per cent. In the long term, a father's income loss also reduces the earnings prospects of his sons: in Canada, for example, children whose fathers had lost their jobs were estimated to have annual earnings nearly 10 per cent lower than similar children whose fathers did not lose their jobs.

Policy response during the crisis

A three part policy response: To their credit, most countries mounted a strong policy response to try to minimize these costs:

- To support aggregate demand through monetary and fiscal policy actions.
- To ease the pain in labour markets through short-term work programmes and provision of unemployment insurance benefits.
- To accelerate jobs recovery through the provision of subsidies of various kinds.

Supporting aggregate demand: Monetary policy moved quickly to stimulate aggregate demand through lowering policy interest rates, quantitative easing of monetary policy, and other interventions. In addition, many governments provided support to their financial sectors and a fiscal stimulus. These policy actions were notable also for their consistency and coherence across countries, an outcome achieved in part through the deliberations of the G-20 nations during the crisis.

Easing the pain: Governments have implemented policies that have allowed firms to retain workers, but to reduce their working hours and wages. Such short-time work programmes can spread the burden of the downturn more evenly across workers and employers, reduce future hiring costs, and protect workers' human capital until the labour market recovers. During the Great Recession, such programmes were extensively used in Germany, Italy and Japan.

While it is too early to undertake a full assessment, these programmes are credited with having played a crucial role in dampening the increase in unemployment in many countries. In some countries, New Zealand in particular, employers and workers came to agreements on short-time work without much government intervention. Another step governments took to ease the pain in labour markets was to allow the automatic stabilizer of unemployment insurance benefits to work. Many countries had already extended the periods of unemployment insurance benefits; others extended them as the recession dragged on – in the United States, for instance, the provision was extended from 26 to 99 weeks.

In contrast, one labour market policy that appears to have aggravated the pain during the recession is the dual labour market system, which was introduced to make labour markets more flexible. However the increased use of such contracts meant they became a primary channel of adjustment in the labour market during the Great Recession. This was particularly the case for Spain, where the temporary employment share and its fall have been by far the largest.

Accelerating jobs recovery: In 2009, in response to the crisis, mechanisms to stimulate labour demand were widely used in many advanced countries. In particular, subsidies (direct job subsidies, wage subsidies or reductions in payroll taxes) were targeted at specific groups in the labour force that are most vulnerable to joblessness: the long-term unemployed and/or youth (e.g. in Austria, Finland, Portugal, Sweden and Switzerland). Some countries also targeted job creation in certain hard-hit regions (e.g. Mexico, Republic of Korea,) or specific sectors (e.g. services in Japan).

Policy response during the recovery

An evolving three-part strategy: Over the remainder of 2010 and throughout 2011, the three-part strategy adopted during the crisis should remain in place, although the relative importance of the parts should shift over time as – and if – recovery takes hold. And the relative importance of the three parts should differ across countries, depending on their specific circumstances.

Maintaining support for aggregate demand: A recovery in aggregate demand is the single best cure for unemployment:

Fiscal policy: As a general strategy, most advanced economies should not tighten their fiscal policies before 2011, because tightening sooner could undermine recovery. The consolidation plans that these countries have for 2011 imply an average change in the structural balance of 1¼ percentage points of GDP. A more severe consolidation would stifle domestic demand that is still weak. Clearly, however, the fiscal situation varies across countries, requiring adaptation of this general strategy to the available fiscal space.

Monetary policy: This remains an important policy lever to support aggregate demand. Inflation pressures are subdued – headline inflation is expected to remain around 1¼–1½ per cent in 2010 and 2011. In fact, in a number of advanced economies, the risks of deflation remain pertinent given the relatively weak outlook for growth and the persistence of considerable economic slack. Monetary conditions can thus remain accommodative for the foreseeable future in most advanced economies. Moreover, if downside risks to growth materialize, monetary policy should be the first line of defence in many advanced economies. In such a scenario, with policy interest rates already near zero in many economies, central banks may once again need to rely more strongly on using their balance sheets to ease monetary conditions further.

Easing the pain: Subsidies for short-time work put a strain on public finances. They can also create a deadweight loss by giving firms an incentive to free ride on the subsidy even when conditions improve. And, if the downturn has permanent adverse effects on the fortunes of certain firms and industries, these subsidies can also obstruct a necessary reallocation of resources to other industries. During a severe recession and in early stages of a recovery, these costs are usually of secondary importance; however, they are likely to become more salient in recovery periods, suggesting that the subsidies should start to be phased out in 2011. Further provision of unemployment insurance benefits should be tied to requiring job training and social work, so that the unemployed maintain some attachment to the labour force.

Jobs recovery: It is difficult to design hiring subsidies that are effective at the right margin: subsidies could be given to jobs that would have been created anyway (deadweight loss), or to jobs that should not be created or maintained in the future. However, in the immediate aftermath of deep recessions, the potential inefficiencies arising from hiring subsidies are arguably less severe than the costs of persistent unemployment. The specific targeting strategies that most countries have followed should serve to reduce potential misallocation of subsidies by spurring hiring for groups that are most adversely affected and least likely to be rehired in the absence of the subsidies.

3. Building an employment-oriented framework for strong, sustainable and balanced growth

The serious deterioration in employment since late-2008 has heightened international concern about the uneven pattern of globalization and the inability of the global economy to generate enough decent work opportunities in all countries, both developing and developed.

Over the past three decades, inequalities have widened in many countries, driven by various factors, including the diminishing share of wages in national income and increasing

inequality within wage income, as well as technological change. This, in turn, has fed back into the globalization process and the structure of demand, contributing to the emergence of imbalances nationally and internationally and raising multiple issues of fairness. Achieving a job-rich recovery and broad based income gains is vital not only for equity and social cohesion but also to lay the foundations for sustained growth made possible by an expansion of potential output matched by adequate effective demand. .

Key global labour market evolutions

In the ten years to 2009, global employment grew from 2.74 billion to 3.21 billion, with well over half of the world's workers (56.3 per cent located in Asia. Global unemployment, which had been over 6 per cent for several years before decreasing between 2004 and 2007, increased dramatically in 2009. Now in 2010, around 210 million are unemployed – a rise of more than 30 million since 2007.

With annual labour force growth of 1.6 per cent adding more than 45 million job seekers per year to the global labour force, the challenges exacerbated by the crisis are unlikely to diminish. In the next ten years, more than 440 million new jobs will be needed to absorb new entrants into the labour force, and still more to reverse the unemployment caused by the crisis. In addition, developing countries need to grow rapidly to absorb their expanding labour force and to meet the demand for jobs from migrants leaving rural areas.

Youth currently represent one-quarter of the world's labour force, at 619 million. Despite a number of years of rapid economic growth, youth unemployment has remained stubbornly high, rising to 13.0 per cent in 2009, or 81 million.

Many advanced countries face the challenge of ageing populations and increased dependency ratios. Reducing unemployment and improving employment participation among the working-age population is vital.

Improving the quality of employment – more productive jobs offering better earnings – is also essential to sustain poverty reduction and development. The pressures of globalization have increased the vulnerability of workers through increased intensity of work, a shift towards more flexible contracts, diminishing social protections, and a decline in workers' bargaining power and voice.

Despite impressive gains in recent years, approximately 1.2 billion women and men, or 40 per cent of the world's labour force, still did not earn enough to keep themselves and their families above the \$2-a-day poverty level in 2008. Both informal employment and working poverty levels had fallen, but these are estimated to have increased again since the crisis. Over the past twenty years, poverty (based on a 50-per-cent median income threshold) has also risen in two-thirds of industrialized countries.

At the same time as there have been changes in the structure of employment, inequality in the distribution of wages and incomes has widened in many countries. Wage and income inequality have increased in a majority of countries, driven largely by increased income for those at the very top of the income distribution. With real wages growing, on average, by only 0.75 per cent for every 1 per cent expansion of GDP, there has been a marked decline in wage shares in many developed and developing countries in recent years.

Macroeconomic management, the recovery, inequality and growth

In the immediate future, with global private sector recovery still fragile, fiscal and monetary policies in many countries will continue to have to be supportive of effective demand. In this uncertain environment, households and businesses in a number of advanced countries, are increasing their savings to pay off their debts that ballooned in the run-up to the crisis. The deleveraging process inside the private sector will take some time. The increase in public debt has accompanied this process. While public spending increases have contributed to

increased public deficits and the stock of debt, the sharp recession-induced fall in tax revenues is the main reason government borrowing requirements have grown.

Many countries, particularly among advanced economies, clearly face the need to stabilize or reduce levels of public indebtedness. However, a premature fiscal retrenchment could damage growth and lead to even larger deficits and debts. Abrupt shifts in fiscal policy stances, in many countries at the same time, could destabilize recovery and weaken future growth. A credible and gradual return to fiscal stability over several years is likely to be a more successful strategy, not only for recovery and growth, but also for deficit and debt reduction. A politically and socially viable process of fiscal consolidation needs to take place in the context of a stable recovery of global growth. Social dialogue is essential to avoiding an explosion of social unrest. It is vital to ensure that well-sequenced coordinated short-term exit strategies and deficit reduction policies are linked to a progressive recovery of the real economy and jobs and are fair in the sharing of the benefits and burdens of adjustment, especially in the protection of the most vulnerable.

Looking towards the longer term, sustainable growth requires a combination of structural change, and total factor productivity growth with the quantity and quality of employment increasing at the same time. Growing inequality and declining wage shares in many developed and developing countries show however that, in recent years, workers in many countries have not shared significantly in productivity gains. At the same time, the declining employment intensity of growth is a cause of growing concern. With a continued large increase in the labour force in the years ahead, and the need to reduce the existing stock of unemployed, this is troubling for many countries.

The world's labour force represents a key supply-side component of growth. At the same time, its earnings drive consumption, which in turn is the main force on the demand side of growth. For growth to be strong, sustainable and balanced, employment and productivity growth and the shares of income going to capital and labour must also be well balanced.

In the wake of the current crisis there is an emerging view about the importance of growing inequality as one of the causes of global crises past and present. The rise in recent decades of inequality and its relationship to growth performance within countries has been widely remarked and studied. The internal imbalances due to inequality and extreme concentrations of income have had different consequences depending on the institutional and political circumstances of different countries. In some countries, and particularly in the United States, increasing inequality may have led to increased indebtedness of the household sector and thus an important factor in explaining the subprime mortgage crisis. Consumption was propped up by periodically very low interest rates, and financial products that encouraged high indebtedness. In other countries, most notably in China, lagging household income and large corporate profits have resulted in high national savings and a strong export orientation to compensate for relatively weak domestic demand.

A synthesis of the debate over the causes of widening inequality suggests that the pressures of intensified global competition and technological change are stretching the earnings distribution and hollowing its middle range, and that the ability of employment and social protection institutions to counteract these trends was weakened over the same period of accelerating globalization.

Whether an economy tends to generate close to full employment critically depends on whether effective demand expands at a rate close to the expansion of productive capacity, which is itself determined by the growth of the labour force and the increase in labour productivity. While for a single country net exports are an addition to effective demand, world imports and exports must sum to zero. In the context of the employment challenge, the much discussed "global imbalances" must therefore be analysed within a framework that links global and national effective demand and supply.

Long-term sustainable growth requires structural change away from low labour productivity sectors towards high productivity sectors such as industry and dynamic services, which have strong linkages throughout the economy. Analysis of successful growth strategies show that rapid labour productivity increases are consistent with rapid employment growth when these are made possible by rapid output growth. The combination of productivity and employment growth can also facilitate substantial real wage increases. The effectiveness of mechanisms to ensure that wages and household incomes keep pace with productivity is a critical component of a sustainable growth path.

Declining wage shares, rising inequality and weak growth in formal employment thus contribute to national and international imbalances. Both threaten to produce a period of weak world growth and continued high unemployment and reduce the effectiveness of traditional fiscal and monetary policy tools. It may be time to consider policies focused on labour markets and income distribution to supplement fiscal and monetary policies.

Rebalancing will require policy shifts in both surplus and deficit countries to support the growth of productive employment, together with a broad-based growth of wage and household incomes. This means developing mechanisms to ensure that the gains from rising productivity are widely distributed in the form of increasing wages and improved social protection systems. Greater regional integration, as well encouraging longer term capital flows to the developing countries may also be helpful in moderating the global imbalances problem. A strong mutual commitment to coordinated policies is needed by countries to manage and strengthen the recovery, as there are large spillover effects and policy externalities in the increasingly interdependent world economy. This need for cooperation was recognized by the G-20 summits and it is critically important that the process of mutual assessment and multilateral consultations launched in 2009 becomes a permanent feature of international cooperation.

Employment and social policies in the framework for strong, sustainable and balanced growth

Sustainable growth, sustainable jobs and sustainable communities will only be generated through sound macroeconomic policies and sound employment and social policies working together. The promotion of job-rich growth strategies requires strengthening labour market institutions to address three interconnected priorities:

- Improving mechanisms for wage determination in order to ensure improved living standards and purchasing power for working families – that which the ILO Constitution calls “a just share of the fruits of progress to all, and a minimum living wage to all employed and in need of such protection” (Declaration of Philadelphia, Article III(d)).
- Promoting productivity growth through support to worker mobility and micro- and small-business development.
- Narrowing income inequalities through more inclusive labour markets and stronger social protection systems.

The effective functioning and adaptation of labour market institutions depend to a large extent on the support they attract from all actors in the world of work. Fairness matters a great deal, especially at a time when many feel that their lives have been damaged through no fault of their own.

Strong labour market institutions help ensure that trade-offs and trade-ins in employment and social policies are identified and addressed, and if mistakes are made, that they are quickly corrected. Active engagement of representative organizations of workers and employers through mechanisms of social dialogue, based on respect for fundamental principles and rights at work, can ensure that practical knowledge of the impact of policies is well appreciated and that the key actors in the labour market have a commitment to making policies work on the ground. Increasingly, national choices about labour market institutional

arrangements are informed by experience from other countries and can draw on international labour standards for guidance.

A central issue is the construction of a framework of labour market institutions and regulations that will help produce wage and employment outcomes in the public and private sector that are conducive to sustainable growth and establish efficient and equitable pay relationships. Minimum-wage-setting mechanisms play an important role in this process, including by affecting the employment prospects for low-skilled workers, as do social dialogue and collective bargaining at various levels of the economy.

The policy challenge is to establish institutions which signal effectively to employers and workers the scope for sustainable wage improvements that the economy as a whole can support, and how that scope might evolve into the future.

As structural change shifts employment opportunities towards more productive sectors such as dynamic services and industries, workers must have both the skills and the mobility to fill these new jobs. Strategies to achieve this mobility and preparedness include boosting training and skills development, and supporting smaller businesses. Small start-ups are a vital element in structural change as they are where much economic experimentation occurs.

Well-functioning labour market institutions have multiple benefits, including a more efficient allocation of labour, balanced development of employment and productivity, and a level playing field between incumbent workers and other groups, particularly vulnerable groups such as the unemployed. Activation, or mutual obligation, strategies, which combine effective re-employment services with strong job-search incentives, have become increasingly widely used. Job subsidies paid to employers and income subsidies paid to low-wage workers have also been effective in retaining workers and encouraging the hiring of people in at-risk groups, such as youth, older workers and long-term or hard-to-place unemployed.

Public employment or public works programmes targeting depressed communities and vulnerable groups can be effective and socially and economically justified. These often combine elements of basic income support with infrastructure investment and, in some countries, they have been expanded to include work in the social sector, environmental services and multisectoral, community-driven programmes. These programmes are also helping to create employment opportunities for women.

Social protection policies, including unemployment benefits, health care, childcare and income security for the elderly and persons with disabilities, play a major role in cushioning populations from economic shocks and in improving social cohesion. They also serve as an important countercyclical policy response that can help maintain consumption, reduce precautionary savings and boost aggregate demand. In the long term, evidence shows that social protection helps to build human capital and labour productivity, contributing to the sustainability of economic growth. Unemployment benefits not only provide income security, they also enable unemployed workers to search for jobs that better match their abilities, thereby increasing the efficiency of the job-matching process.

With 80 per cent of people worldwide having no access to social protection, it is urgent for countries to develop and improve, according to their means, a basic floor of social protection for those living in poverty and vulnerable situations. International cooperation can play a key role in helping least developed countries implement this policy.

The strength and quality of labour market institutions can make a substantial contribution to international efforts to generate sustainable growth and development. Although each country's labour market institutions have a particular history and character, countries face many common challenges in shaping policies that create decent work opportunities for all. A consensus is building for the coordination of efforts to prioritize employment growth,

because strong and steady growth in jobs and household incomes in many countries at the same time will buttress global demand, creating still more jobs.

**1. THE HUMAN COST OF RECESSIONS:
ASSESSING IT, REDUCING IT**

INTERNATIONAL MONETARY FUND

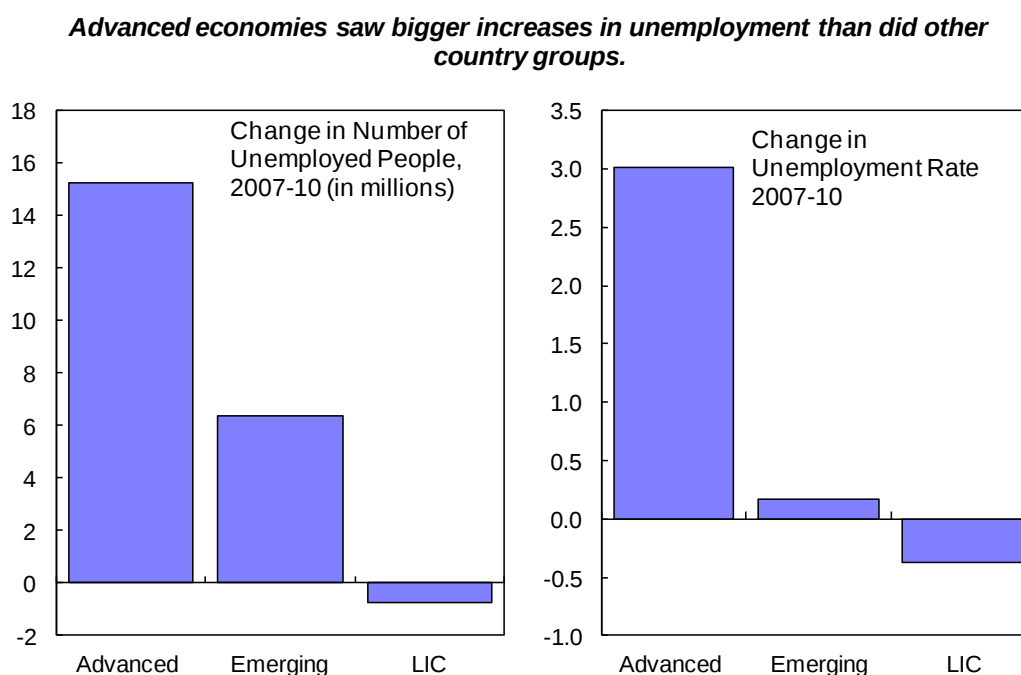
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I. Introduction

Recessions leave scars on the labour market; the Great Recession of 2007-09 has left gaping wounds. Over 200 million people across the globe are estimated to be unemployed at present. Among countries with unemployment data in the IMF's *World Economic Outlook (WEO)* database, there has been an increase of over 20 million unemployed people since 2007. The ILO estimates that globally the increase is over 30 million. As shown in the left panel of Figure 1, three-fourths of this increase in the number of unemployed people has occurred in the 'advanced' economies (the term used in the *WEO* to denote high per capita income countries) and the remainder among emerging market economies. The unemployment rate has increased by 3 percentage points in advanced countries since 2007 and by 0.25 percentage points in emerging markets (Figure 1, right panel). In contrast, in low-income countries (LIC) on the whole, unemployment fell during the Great Recession.

Figure 1. Unemployment During the Great Recession



The classification of countries into groups is the one used in the IMF's *World Economic Outlook*.

Source: Authors' calculations based on WEO database.

Section II of this paper assesses the human cost of the increase in unemployment by surveying what we know about the effects of past recessions. If past is prologue, the cost to those who get unemployed could be a loss in earnings not just today but persisting 15-20 years into the future; reduced life expectancy of 1 to 1.5 years; and lower academic achievement and earnings for their children. And unemployment is likely to reduce social cohesion, a cost that all will bear.

To their credit, most countries mounted a strong policy response to try to minimize these costs. These policy actions were notable also for their consistency and coherence across

countries, an outcome achieved in part through the deliberations of the G-20 nations during the crisis.

Broadly speaking, the response had three parts, which are discussed in Sections III to V of the paper:

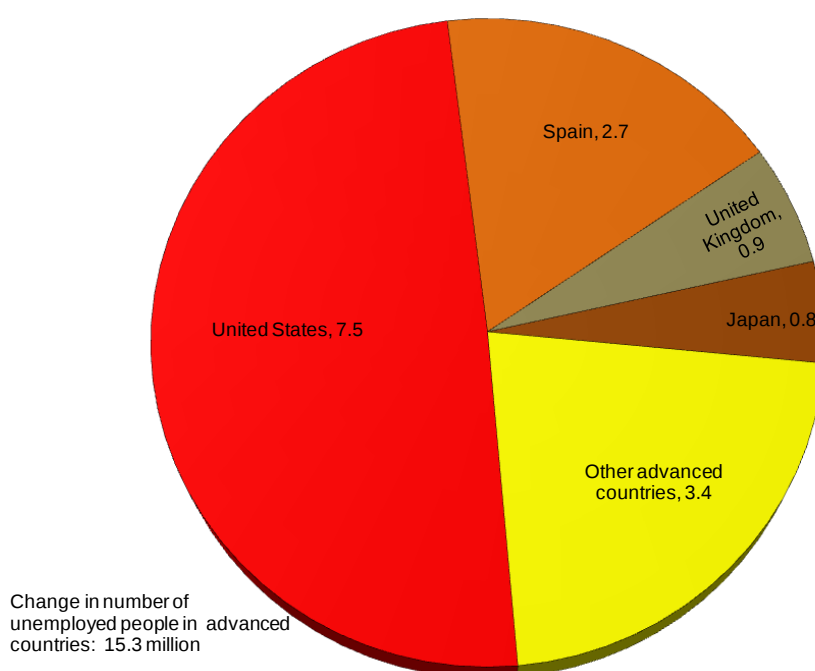
- *support aggregate demand* through monetary and fiscal policy actions (section III);
- *ease the pain* in labour markets through short-term work programs and provision of unemployment insurance benefits (section IV);
- *accelerate jobs recovery* through the provision of subsidies of various kinds (section V).

In each of these sections, we assess the policy responses during the crisis and the policy options for the next couple of years.

The focus of the discussion is on advanced economies. Issues in labour markets elsewhere in the world are very important but they are often very different; to cover both in one paper would risk doing justice to neither. As Figure 1 shows, the scale of the unemployment problem in advanced economies is serious enough to merit consideration in its own right. Within the advanced countries, particular attention is paid to the United States—the epicenter of the Great Recession—and the country with the highest increase in the number of unemployed (Figure 2).

Figure 2. Advanced Countries: Change in Number of Unemployed People, 2007-10 (in millions)

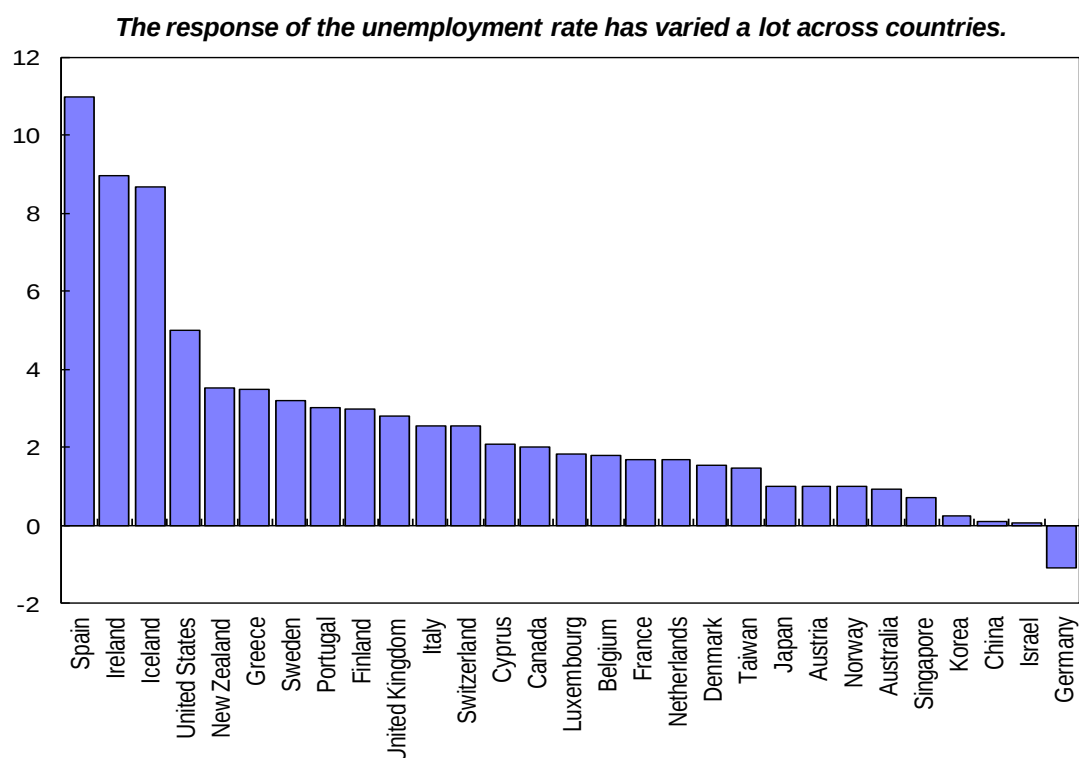
The U.S. and Spain account for two-thirds of the increase in unemployed people in advanced countries.



Source: Authors' calculations based on WEO database.

Some of the largest increases in the unemployment *rate* have occurred in Spain, the United States, New Zealand and Taiwan, Province of China (Figure 3). The increase in Spain is particularly dramatic, nearly 10 percentage points. The German case is also discussed at length in the paper; despite experiencing a demand shock of similar magnitude to many other advanced countries, the German unemployment rate even decreased slightly. Norway, Australia and Korea only had small increases in their unemployment rates.

Figure 3. Change in Unemployment Rate 2007-10, by Country



Source: Authors' calculations based on WEO database.

II. The Human Cost of Recessions

The human and social costs of unemployment are more far-reaching than the immediate temporary loss of income. These longer run impacts pose a burden on the individuals, their families, and society as a whole. They include loss of lifetime earnings, loss of human capital, worker discouragement, adverse health outcomes, and loss of social cohesion. Moreover, parents' unemployment can even affect the health and education outcomes of their children. The costs can be particularly high for certain groups, such as youth and the long-term unemployed (see Katz, 2010; von Wachter, 2010a, 2010b; Holzer, 2010).

A. Cost to Individuals and Families

Loss of earnings: There is empirical evidence that layoffs are associated with substantial loss of earnings both over the short and long run. That is, even when workers are re-employed shortly after displacement, they suffer a decline in wages compared to the pre-displacement job and compared to similar workers that were not displaced. The decline in earnings is on average observed for job losers in any period, but is most pronounced for job losers during a

recession (see Farber, 2005). Studies for the US show that these earnings losses persist even in the long run: 15-20 years after a job loss in a recession, the earnings loss amounts on average to 20% (see e.g. Jacobson et al., 1993; von Wachter et al., 2009).

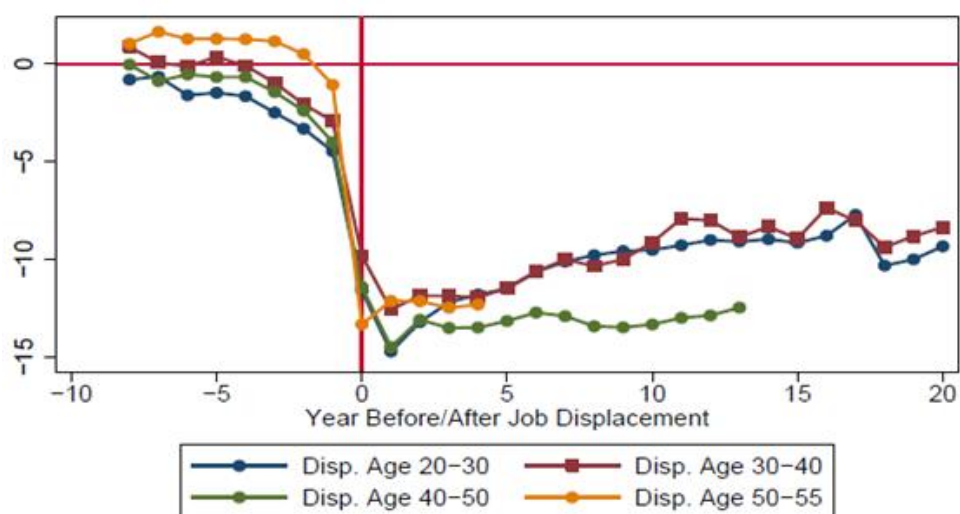
An illustration of an average earnings path before and after job separation during the recession in 1980's using US administrative data is taken from von Wachter et al. (2009) and reproduced in Figure 4. These sustained earnings losses stem from the decline in value of certain occupation or industry-specific skills that become obsolete, but also from the time-intensive process of finding an appropriate job, in particular for a mature worker. There is also evidence that the adverse effects on lifetime earnings are most pronounced for unemployment spells experienced at youth, especially upon college graduation, making the rising youth unemployment rate a particularly serious concern (see Kahn, 2010).

Impact on health: The hardship of job loss is also shown to have serious negative impacts on health. In the short run, layoffs are associated with higher risk of heart attacks and other stress-related illnesses (Burgard et al., 2007). But even in the long term, the mortality rate of workers that have been laid off is on average higher than that of comparable workers that did not lose their jobs, controlling for other relevant individual and aggregate characteristics. Based on social security data for the US, Sullivan and von Wachter (2009) estimate that the increased mortality rate due to unemployment persists up to 20 years after the job loss and leads to an average loss of life expectancy from 1 to 1.5 years (see Figure 5).

Moreover, this study shows that it is primarily the displaced worker's loss in earnings that drives the increase in mortality odds: workers that are displaced but are lucky enough not to suffer a loss in subsequent earnings are *not* found to have higher rate of mortality (Figure 6). This finding suggests that financial resources serve as an important determinant of individual health. They influence the individual's ability to invest in good health care (and access to health insurance) and a healthy lifestyle, while a shortage of resources leads to poor lifestyle choices and can also be the reason for stress and depression.

Figure 4. Earnings Losses Due to Job Loss

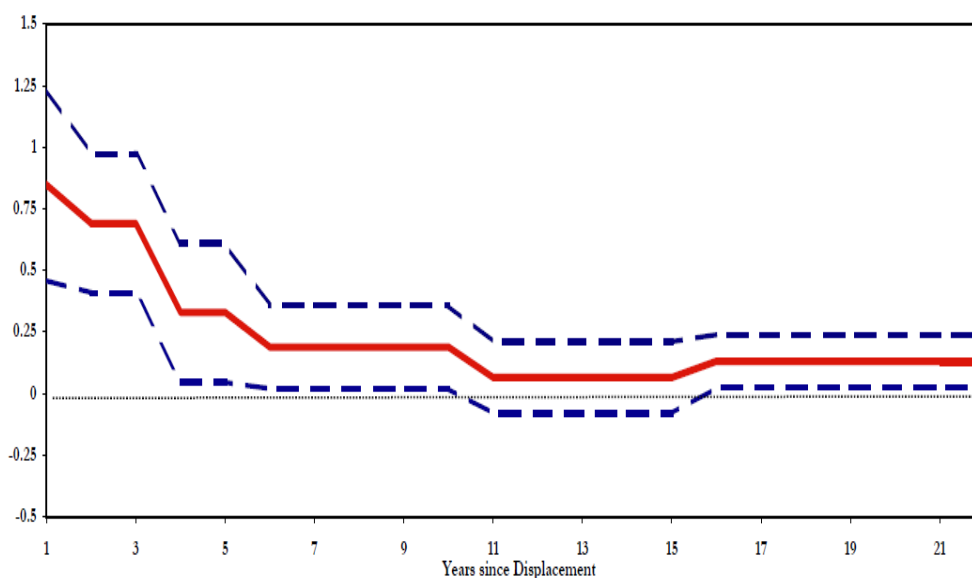
Job losers suffer a persistent loss in earnings relative to comparable workers who keep their jobs.



Earnings Losses of men in stable jobs at and around job separation ($t=0$) in 1000 USD. 1% files of Social Security administrative data. Earnings in 2000 dollars. Source: von Wachter et al. (2009).

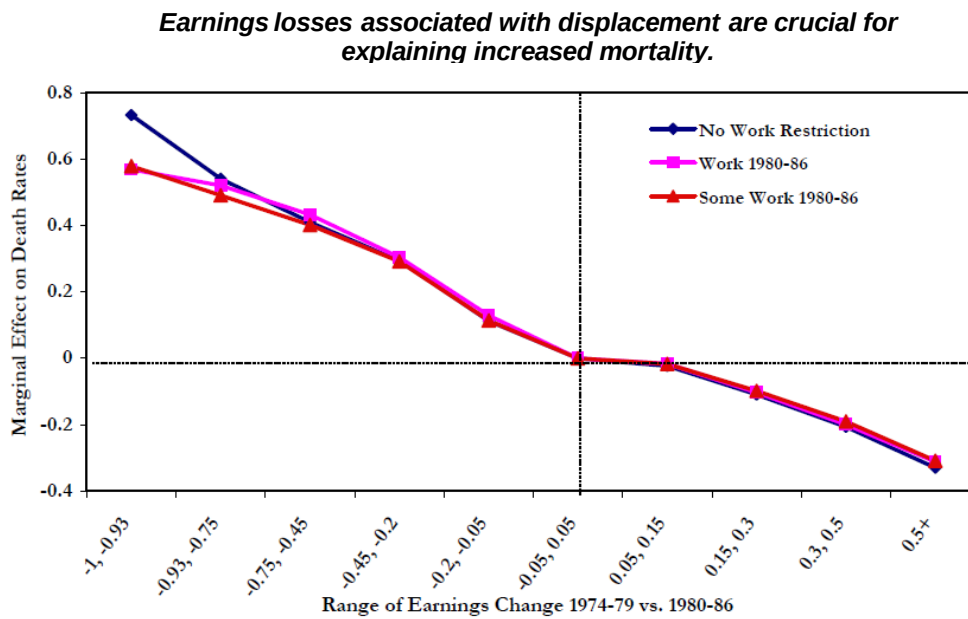
Figure 5. Impact of Job Loss on Mortality

Job loss leads to increased mortality rates relative to comparable workers who keep their jobs.



Marginal effect of displacement on odds of mortality, with 2 SE bands. Source: Sullivan and von Wachter (2009).

Figure 6. Channel of Displacement on Mortality



Relative change in average earnings after job loss and its marginal effect on mortality.
Source: Sullivan and von Wachter (2009).

Impact on children: The short and long-run costs of unemployment do not appear to be limited to the individual or generation directly affected. Several studies have found that children of laid-off parents also suffer: in the short-run, parental job loss tends to reduce the schooling achievement of their children. Stevens and Schaller (2009) find that parental job loss increases the probability that a child repeats a grade in school by nearly 15 percent. In the long-run, a father's income loss also reduces the earnings prospects of their sons. For example, Oreopoulos et al. (2008) estimate using Canadian administrative data that children whose fathers were displaced have annual earnings about 9% lower than similar children whose fathers did not experience an employment shock. These effects on children are already conditional on the income of the family, which also tends to be lower for unemployed parents.

Although most studies carried out in this field so far focus on North America, where more high-quality micro data is available, evidence for costs of parental economic condition borne later by children is also found in other countries. For example, Palme and Sandgren (2008) study the relationship between parental economic resources during childhood and mortality later in life using detailed individual data from Sweden. They find that lower parental income significantly increases children's mortality later in life, even after controlling for children's lifetime income and education attainment.

Summing up, the literature presents compelling evidence that in addition to adverse short-run effects on children, parental job and income loss has a negative and persistent effect on children's well-being in the future, underlining the importance of early investment in education and health of children.

B. Loss of Social Cohesion

Economic hardship and unemployment in particular also have far-reaching consequences on social cohesion that go beyond the costs experienced by each individual or her family alone. Using data from the General Social Survey on the development of American society from 1972 to 2006, Giuliano and Spilimbergo (2009) find that individuals who have experienced a recession in the formative age of 18-25 years tend to believe less in personal effort, perceive stronger inequalities, and have less confidence in public institutions. This finding, which is based on data prior to the current crisis, sheds alarming light on today's situation of high long-term and youth unemployment rates. In fact, due to population aging, the youth cohort in Europe today forms the largest share of total population at least for the next 20 years. Considering the effects of recession and unemployment on personal beliefs, this means that the labour market experience of today's youth will have deep adverse impacts on the faith in public institutions of future generations.

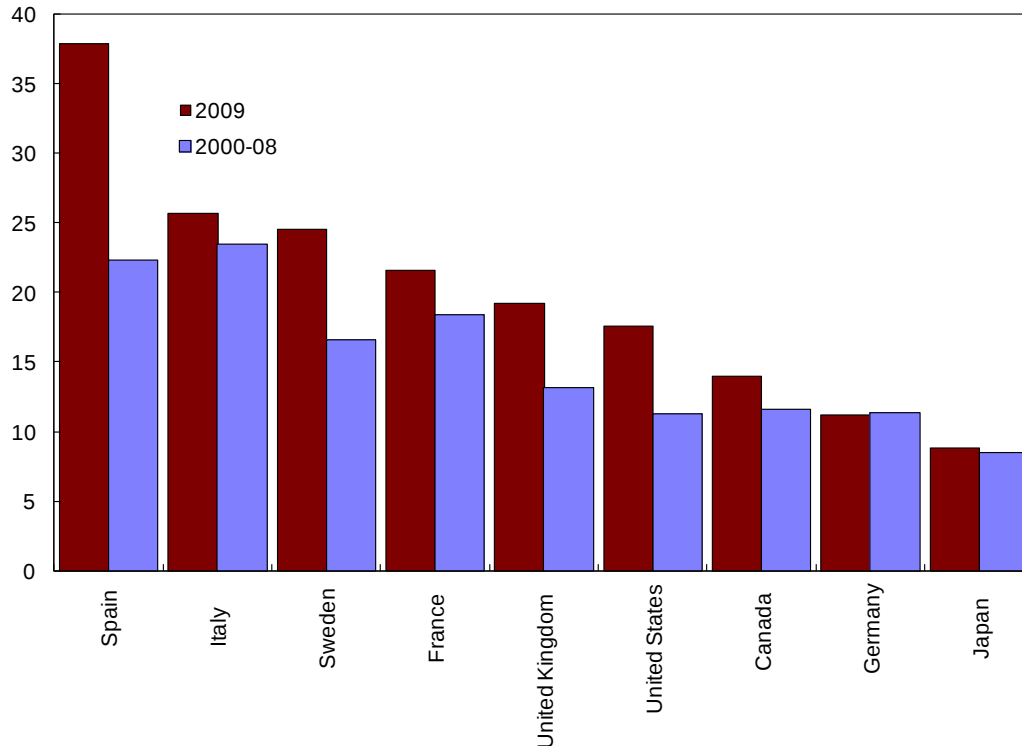
This empirical finding on the impact of recessions on beliefs in society is not limited to the United States. A study by Altindag and Mocan (2010) using survey data for 69 countries across the world (including developing countries) indicates that personal joblessness experience translates into negative opinions about the effectiveness of democracy and increases the desire for a rogue leader. This effect is found to be more pronounced for the long-term unemployed and extends to individuals who do not experience unemployment themselves, but live in a country and period with high unemployment. High and long-lasting unemployment therefore represents risks to the stability of existing democracies and hinder the development of new democracies in countries undergoing political transitions.

C. Cost of Youth Unemployment

Historically and across all countries, the unemployment rate for youth (age 15-24) has on average always been higher than for other age cohorts, and increasingly so. In OECD countries, the ratio between the under-25 and over-25 year old unemployment rate is on average around 2.5 to 1. Figure 7 shows the youth unemployment rate before the crisis and its increase in 2009 for a sample of OECD countries. The rise in youth unemployment rate is substantial for all countries except those that experienced little change in the overall unemployment rate (Germany, Japan). The largest rise in youth unemployment is observed for Spain (almost 40 percent). Though youth unemployment typically increases sharply during recessions, the increase this time has been greater than in the past: for a set of eight countries for which long time-series of youth unemployment are available, the increase in the youth unemployment rate averaged 6 ½ percentage points during the Great Recession, compared with 4 percent in previous recessions.

Figure 7. Youth Unemployment Rate

Youth unemployment has increased in many countries and more so than in past recessions.



Youth are defined as those 15-24 years old.
Source: OECD.

A look at micro data also reveals a change in youth unemployment before and during the crisis. Bell and Blanchflower (2010) estimate the individual unemployment probability using data from the Eurobarometer surveys in 2006 and 2009. They find that the group of coefficients that have changed most in the last 3 years are those associated with age: the increase in probability of unemployment for youth aged 15-24 has been much greater than the impact of living in a particular country, and is also greater than the effect of different education level and gender.

As noted above, the adverse effects on lifetime earnings are most pronounced for unemployment spells experienced at youth, especially upon college graduation. And the high and increasing burden of unemployment on young people poses risks to social cohesion.

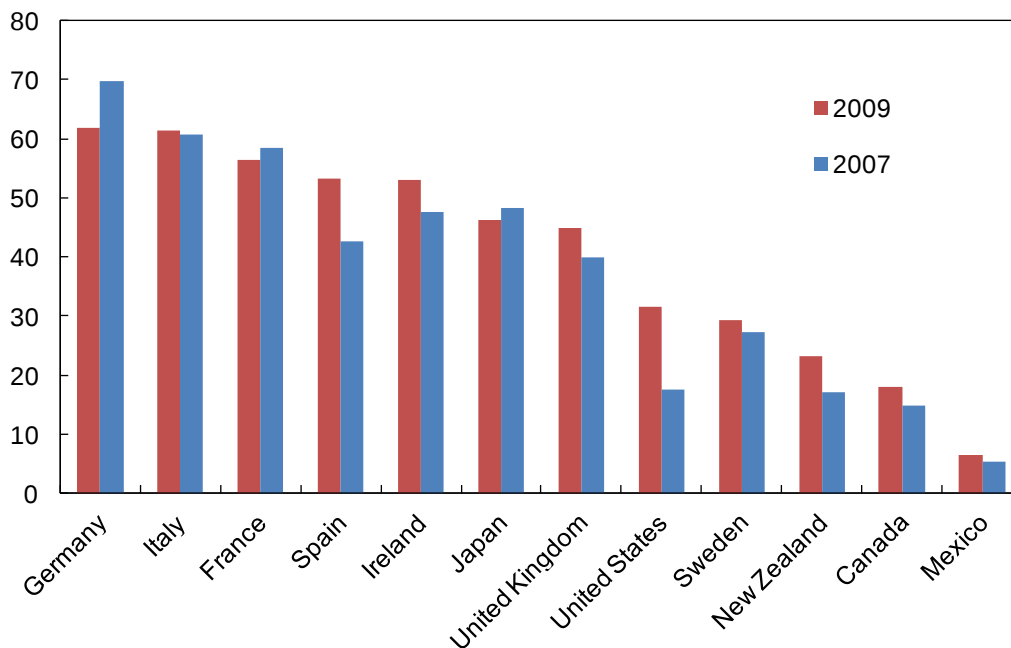
D. Cost of Long-Term Unemployment

Another metric that has direct implication for the costs of unemployment is the duration of unemployment spells. A longer unemployment spell carries the risk of entrenching cyclical unemployment into a structural phenomenon as workers lose human capital and become detached from the labour force (Blanchard and Summers, 1986).

Figure 8 summarizes the change in unemployment composition in selected OECD countries during the crisis. The share of long-term unemployed has increased in most of these countries between 2007 and 2009. In cases where it has not increased—such as Germany, France, Italy and Japan—the share has been persistently very high even before the crisis. This indicates that there are structural factors hindering the re-employment prospects in these countries that have been present before the crisis and need to be addressed.

Figure 8. Long-Term Unemployed as Share of all Unemployed

Long term unemployment is at alarming levels in many countries.



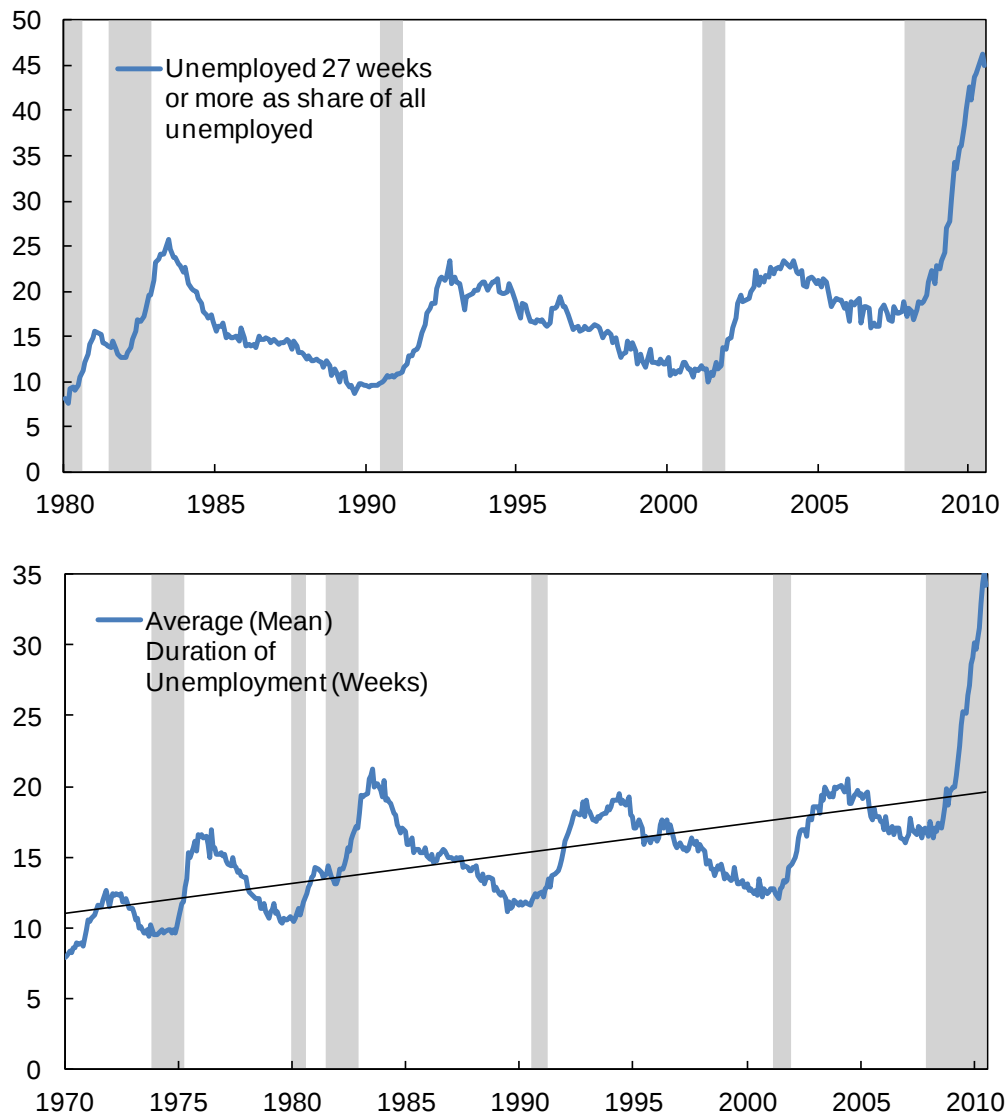
Long-term unemployed are those unemployed six months or more.
Source: OECD.

Figure 9 (top panel) shows the share of workers who have been unemployed for 27 weeks or more as a share of the total unemployment pool in the US since 1980. While the share has been rising with every recession, the increase during the Great Recession to about 45% is dramatic.

The rising share of long-term unemployment is reflected in an increase in the average duration of unemployment (Figure 9, bottom panel). Although there are obvious cyclical patterns, it is clear that there has been a secular upward trend in the duration of unemployment. Historically, the average duration started to decline within the same year that the recession ended. Starting in the 1990s, however, the unemployment duration has only declined as late as three years after the end of each recession and it has not reverted to the level prior to the recession.

Figure 9. U.S. Long-Term Unemployment and Duration of Unemployment

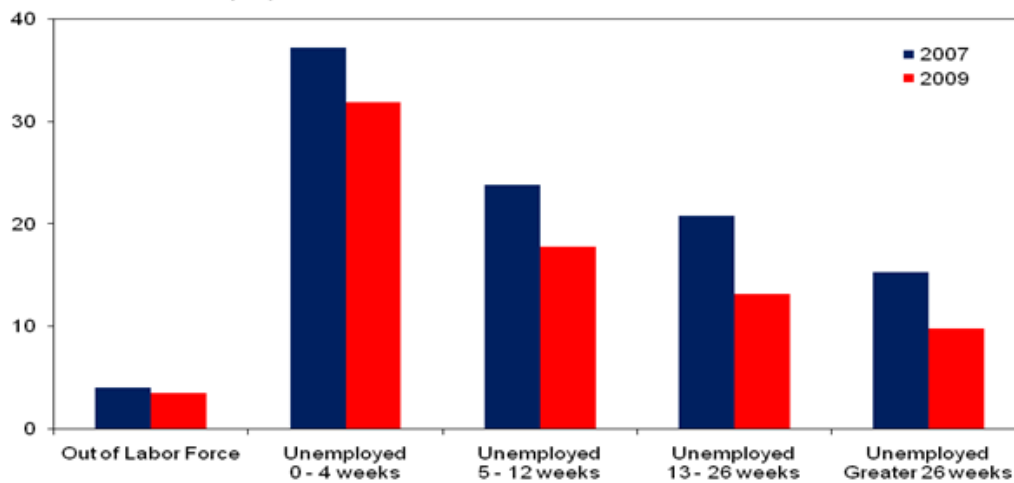
Nearly half of U.S. unemployed workers have been out of work for over six months and the average duration of unemployment is nine months.



Source: Bureau of Labor Statistics.

Figure 10. Impact of Duration of Unemployment on Odds of Finding a Job

The chances of finding a job decline sharply the longer a person has been out of work.



Probability of employment next month by labor force status this month (percent, seasonally adjusted). Includes civilians over age 20 present in successive months of data. Includes data from the last quarter of each year.

Source: Department of Commerce (Census Bureau), Current Population Survey.

Of course, the negative earnings impacts of job loss are exacerbated with longer duration of unemployment. Long-term unemployment also reduces the average probability of being rehired and hence increases the risks of hysteresis in unemployment. For example, data from the US Census Bureau in Figure 10 show that for Q4 2009, the probability of being rehired in the next month for a person who was unemployed for 26 weeks or more is less than 10 percent, compared to over 30 percent for someone who was unemployed for less than 4 weeks (see BLS, 2010).

The increased duration of unemployment observed in the US and elsewhere points to especially serious losses of skills and labour market attachment for a large group of workers.

III. Policy Responses: Maintaining Aggregate Demand

A. Cross-Country Differences in Unemployment Responses

During the Great Recession, unemployment rates increased almost everywhere but by quite varied amounts. Spain and the United States experienced large increases but the unemployment rates in Norway and Germany barely budged. What explains this differential response?

Three sets of factors are at play. The first is the extent of the fall in aggregate demand. “Okun’s Law” relates the increase in unemployment to the fall in aggregate demand. The second is the co-incidence of the aggregate demand decline with acute stresses in other sectors, such as the financial and housing sectors (IMF, 2010a). The third is the extent to which countries resorted to active labour market policies. OECD (2010) suggests that in countries where the demand shock was felt mostly through exports, governments were more inclined to treat the shock as a temporary and try to use active policies to shield employment.

Table 1 shows some regressions that incorporate these factors. The dependent variable in the first three regressions is the change in the unemployment rate, between 2007 and 2009 in the first two and between 2006 and 2009 in the third. Each regression contains either the real GDP decline or the change in the output gap over the corresponding period. This “Okun’s coefficient” is significant in all specifications, suggesting that the change in aggregate demand was an important determinant of the cross-country variation in unemployment responses.

Table 1. Determinants of unemployment during the crisis in the OECD

Variable	(1)	(2)	(3)	(4)
	Peak to trough	Peak to trough	2006 to 2009	Panel 1983-2004
GDP growth	-0.29** (0.08)			-0.45*** (0.03)
Output gap change		-0.40*** (0.10)	-0.40** [0.01]	
Decline in house price	3.01*** (1.06)	2.0 (1.2)		
Export shock	-1.03** (0.41)	-1.29*** (0.43)		
Index for ALMP	-0.52 (0.41)	-0.35 (0.35)	-1.58** [0.04]	
Index for PMR			-8.23*** [0.01]	
Wage-capital cost diff.				0.04*** (0.01)
Financial stress index (t-2)				0.07** (0.03)
<i>Other variables</i>				
			LM rigidity, Employment protection, interaction terms	Lending rate, Country/Time dummies
Obs.	29	29	29	223
(Adj.) R2	0.61	0.63	0.35	0.76

Notes: Columns (1) and (2) contain authors' regressions based on qualitative findings in OECD (2010a), column (3) is taken from IMF (2010b) and column (4) from Batini et al. (2010). Figures in parentheses are heteroskedasticity robust standard errors, and figures in brackets represent p-values. Stars respectively represent 1 percent (***), 5 percent (**) and 10 percent (*) significance level.

The regression in column (1) includes a (0,1) index for the intensity of problems in the housing sector: countries where these problems were intense had greater increases in the unemployment rate. Countries which experienced a severe export shock had smaller unemployment increases, consistent with the idea that they were more likely to use active labour market policies. The third regression, taken from IMF (2010b), uses an index of the extent to which countries used ALMPs to explain the cross-country variation in unemployment rates: countries that used more of these policies had smaller increases in unemployment.

The last regression in the table, taken from Batini et al. (2010), is a panel regression over a longer time period, 1983 to 2004, but for fewer countries. The novel feature here is that the regression includes a measure of the relative price of labour to capital: the greater the wage moderation relative to the rental rates for capital, the lower is the increase in unemployment.

These regressions show that, while not the only factor, real GDP growth does matter for unemployment. Hence, supporting the recovery in real GDP—in the short run, maintaining aggregate demand—is one of the most direct ways to help the labour market. What potential is there for policies to stimulate aggregate demand in 2010–11?

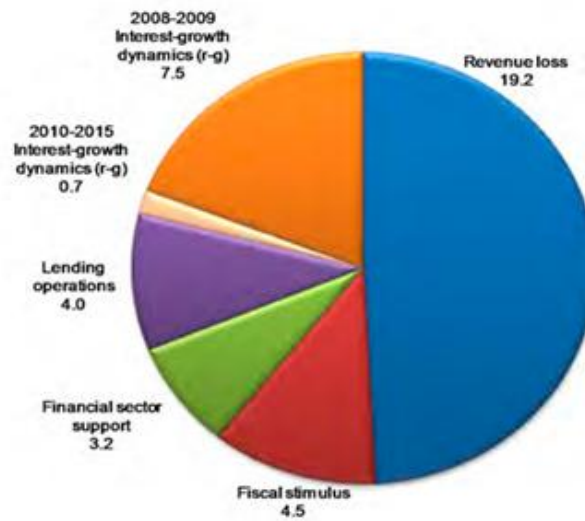
B. Fiscal Policy

The output collapse in 2008-09 led to a sharp decline in tax revenues, which in turn has pushed projected public debt to GDP ratios to levels that raise issues of sustainability.¹ In the G-20 advanced economies, for instance, the increase in the debt-to-GDP ratio between 2008 and 2015 is expected to be nearly 40 percentage points of GDP. As shown in Figure 11, about two-thirds of that increase is attributable to revenue loss and the adverse impact of the fall in GDP on the interest rate-growth differential during 2008-09. The fiscal stimulus (based on plans as of May 2010) makes a much more modest contribution to the projected increase in the debt-to-GDP ratios and is of the same order of magnitude as the support that governments provided to their financial sectors.

¹ See « The Austerity Debate » at <http://www.ft.com/cms/s/0/dc3ac844-9010-11df-91b6-00144feab49a.html>. See also Cochrane (2010) and Levy and Thiruvadanthai (2010).

Figure 11. Advanced Economies: Sources of Increase in Public Debt, 2008-15

The majority of the projected 39 percentage points of GDP increase in public debt is due to cyclical weakness in economies.



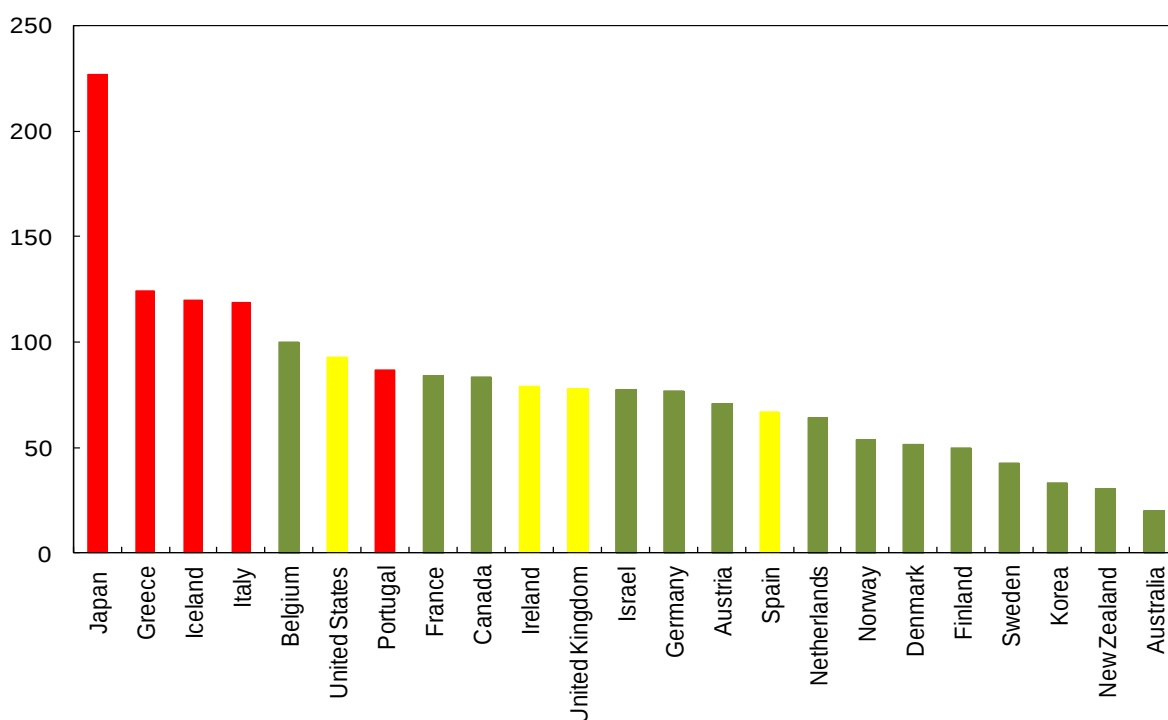
Source: IMF Fiscal Monitor, May 2010.

How should fiscal policy proceed against this backdrop? As a **general strategy**, most advanced economies should not tighten fiscal policies before 2011, because tightening sooner could undermine the recovery. The consolidation plans that these countries have for 2011, which imply an average change in the structural balance of 1¼ percentage points of GDP, are broadly appropriate. Leigh et al (2010) find that for OECD economies over the past 30 years, fiscal consolidations of 1 percent of GDP have typically reduced domestic demand—consumption and investment—by about 1 percent and raised the unemployment rate by about 0.3 percentage points over a two-year period. Hence, an overly severe consolidation would stifle still-weak domestic demand. A fiscal target that demands too much too soon can damage the economy and thus the prospects for success of the fiscal target itself.

Clearly, however, the fiscal situation—and therefore the ability of a country to carry about the general strategy—varies across countries. As shown in Figure 12, the current debt-to-GDP ratio varies widely across countries. Ghosh et al. (2010) define a “debt limit,” which is the debt-to-GDP ratio beyond which a country’s *normal* fiscal response—which is estimated from the country’s historical track record—to rising debt becomes insufficient to maintain debt sustainability. The difference between the debt limit and the projected ratio in 2015 provides an estimate of the fiscal space available to the country. Because the normal fiscal response is estimated with uncertainty, there are probability bounds around the resulting estimates of fiscal space. In the figure, countries where the probability is quite low that there is fiscal space of 50 percent of GDP or more are shown in red; Japan, Greece, Iceland and Italy fall in this category. Countries where there is a moderate possibility of fiscal space of 50 percent of GDP or more are shown in yellow; the U.S., U.K., Ireland and Spain are in this category.

Figure 12. Public Debt and Fiscal Space

Fiscal space depends not just on public debt ratios but on countries' track record of fiscal adjustment.



Bars show public debt as a percent of GDP in 2010.

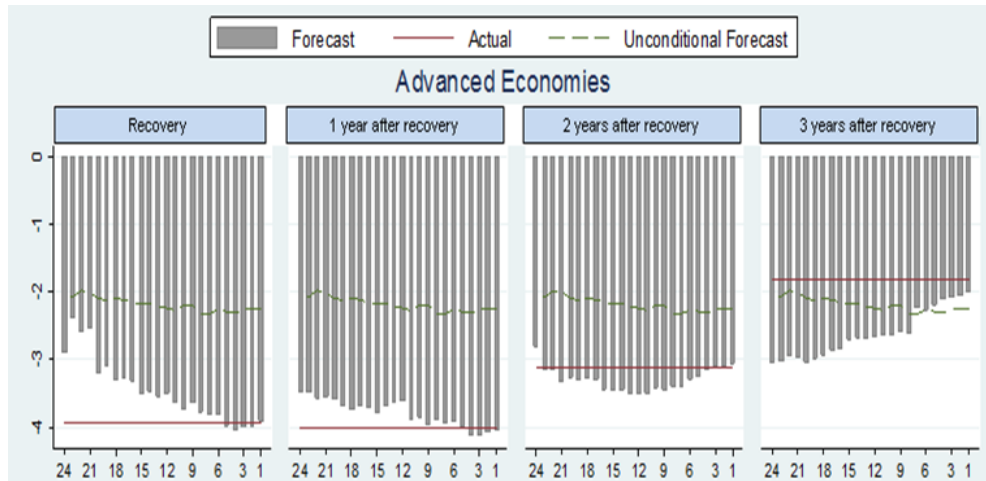
Source: Authors' calculations based on WEO database; and Ghosh et al. (2010).

The question is whether countries that have to undertake fiscal consolidation will actually carry them out. Cottarelli et al. (2010) suggest that pessimism on this score may be unwarranted. Based on a study of past large-scale fiscal adjustments they conclude that “fiscal adjustment on the requisite scale is not historically unprecedented” and that “such a major adjustment is difficult, but possible.” Iskander, Jalles and Loungani (2010) find that Consensus Forecasts of fiscal balances during recovery periods tend to be pessimistic about the extent of the improvement in balances that occurs. Figure 13 shows that, on average across OECD countries for which fiscal forecasts are available, the budget deficit has been 4 percent of GDP in recovery years, and has declined to 2 percent of GDP three years after the start of the recovery. In each panel, the forecasts shown are for various horizons, starting 24 months before the end of the year. The forecasts made one and two years after the start of the recovery are quite accurate. However, the forecasts made 3 years after the start of the recovery are pessimistic—forecasters start out forecasting a 3 percent of GDP deficit and only slowly adjust that forecast in the direction of the outcome of a 2 percent of GDP deficit. One difference this time from past episodes is that a number of advanced countries have to make a simultaneous and large adjustment in their fiscal balances. Leigh et al. (2010) present some simulations to show that the output losses to a country from fiscal consolidation can double if the ‘rest of the world’ is also carrying out a fiscal consolidation at the same time, particularly when policy interest rates are near a zero bound. This suggests that, just as the

fiscal stimulus was coordinated across countries during the Great Recession through the G-20 and other forums, the process of fiscal consolidation would benefit from some coordination as well.

Figure 13. Actual and Forecasted Budget Balances During Recoveries

Forecasts tend to underestimate medium-run improvements in fiscal balances during recovery periods.



Actual and Forecasts are expressed as a % of GDP.

Source: Iskander, Jalles and Loungani (2010), based on Consensus Forecasts.

To make their medium run plans credible, countries could include legislation creating binding multiyear targets. How the consolidation takes place is important too. If the steps taken reduce the fiscal burden for the future and boost the economy's supply potential, they can mitigate the adverse short-term effects on domestic demand that fiscal consolidation has commonly caused in the past. Reducing the fiscal burden for the future means that plans should emphasize policy measures that reform pension entitlements and public health care systems (Velculescu, 2010). Boosting the supply potential requires that plans improve tax structures and strengthen fiscal institutions.²

Fiscal plans should be fair. There should be specific measures to protect the most vulnerable from the effects of the consolidation. Box 1 provides evidence that fiscal consolidations in the past, particularly expenditure-based ones, have widened inequality in advanced economies, and discusses how targeting of social benefits can guard against this outcome.

² See Blanchard and Cottarelli (2010). Cottarelli and Schaechter (2010) look at the evolution of public debt levels in the G7 economies in the decades leading up to the recent crisis and the outlook for cutting debt ratios in the years ahead. Beyond the 2008-09 crisis, the indebtedness reflects persistent upwards trend in debt ratios since 1974. Rising healthcare and pension spending accounts for most of the increase in primary balances. They conclude that to avoid undermining the fragile economic recovery while providing reassurance to capital markets, fiscal adjustment should be clearly defined with a focus on the medium term rather than the near term. .

Coordination of policies across advanced and emerging countries helped during the recession and it would help during the recovery. A policy scenario developed as part of the G-20 Mutual Assessment Process shows that collaborative actions can produce outcomes that make everyone better off. What is needed is for emerging markets with large external surpluses to adopt policies that nurture domestic demand so as to offset the loss of demand from fiscal policy actions in advanced economies. If combined with structural reform policies that alleviate supply constraints, particularly in the advanced G-20 economies, this rebalancing of demand raises global GDP, which would also be good news for job creation.

C. Fiscal Policy in the Presence of Hysteresis

The preceding discussion of fiscal policy does not take into account the impact it can have in the presence on hysteresis, that is, when the natural rate of unemployment has increased as a result of persistent cyclical weakness in the economy. With hysteresis, government policies that stimulate demand confer larger benefits than otherwise if they can counteract the increase in the natural rate and bring output back to potential. . A cross-country study by Ball (2009) presents evidence that long-lasting demand expansions in the past have indeed permanently driven down the natural rate of unemployment. Under some illustrative calculations, the increased tax revenues from the return to a higher potential can lower the debt-to-GDP ratio over the medium-run.

There is a risk of hysteresis in some countries, particularly in the United States and Spain, given the sharp increase in the duration of unemployment and the persistent nature of the shocks (e.g. to the housing sector) that lie behind the cyclical weakness in the economy and hence the increase in unemployment (see Benes et al., 2010 and Vitek, 2010). Hence to the extent that countries have fiscal space, exploiting it when there is a risk of hysteresis may create jobs in the short run without hurting the medium-run fiscal outlook.

D. Monetary policy

Monetary policy remains an important policy lever to support aggregate demand. Inflation pressures are subdued—headline inflation is expected to remain around 1¼-1½ percent in 2010 and 2011. In fact, in a number of advanced economies, the risks of deflation remains pertinent given the relatively weak outlook for growth and the persistence of considerable economic slack. Monetary conditions can thus remain highly accommodative for the foreseeable future in most advanced economies.

Moreover, if downside risks to growth materialize, monetary policy should be the first line of defence in many advanced economies. In such a scenario, with policy interest rates already near zero in several major economies, central banks may need to again rely more strongly on using their balance sheets to further ease monetary conditions.

Some observers such as Gagnon (2009) have called for further monetary ease, arguing that getting fiscal policies “through the legislative and executive hurdles takes time” so that “without additional [monetary] stimulus, unemployment rates are likely to remain above

equilibrium levels for many years at great cost to the world economy in terms of lost income and personal hardship.” With very recent signs of weakness in the U.S. economy, other observers have moved in this direction. Hamilton (2010), Makin (2010) and Palley (2010) suggest that it may be time to review the options the Fed has to provide further stimulus.

E. Wage Moderation

The regression reported in Table 1 show that wage moderation would limit unemployment losses. In normal times, this could be explained by the positive effect of lower wage growth on labour demand. But is it desirable to have lower nominal wage growth in the current context? For relatively closed economies like the United States, the answer is “no”. Wage moderation would either add to deflationary pressures or lower aggregate demand, neither of which is desirable at present. For more open economies, wage moderation could impart a boost to competitiveness and thus spur greater external demand. This avenue is particularly appealing for countries that are part of a currency area so that gaining competitiveness through a nominal depreciation of the exchange rate is not an option. Even in these cases, it would be preferable if the wage moderation came about as a result of a collective agreement. As an example, IMF (2010c) notes that in New Zealand, “the labour market adjusted through declines in real wages and hours worked” over the course of the Great Recession. These changes benefited from “a tradition of excellent cooperation between employers and employees” and “took place primarily through direct negotiations between social partners and firm-level agreement, without the need for active government intervention.”

While general wage moderation should be used with caution, targeted cuts in some sectors may be appropriate. An example is the very high public sector wages in some countries.

IV. Policy Responses: Easing the Pain

To support labour demand in the face of declining aggregate activity during the Great Recession, many governments implemented policies to allow firms to retain workers but reduce their working hours and wages. And all governments allowed the automatic stabilizer of unemployment insurance (UI) benefits provision to work to ease the short-term costs of unemployment. Many countries already had in place extended periods for provision of UI benefits; others extended it as the recession dragged on—in the US, for instance, the provision was extended from 26 to 99 weeks. This section assesses these policies and whether they should be continued over the next couple of years.

A. Short-Time Work

Under these programs, governments typically subsidize firms for parts of the wage bill, sometimes combined with subsidies for on-the-job training for employees (e.g. Sweden). When implemented successfully, short-time work programs can spread the burden of the downturn more evenly across workers and employers; contribute to supporting aggregate demand by preventing wage deflation; and reduce future hiring costs as well as loss of workers’ human capital until the labour market recovers.

During the Great Recession, short-time work programs were most extensively used in Germany, Italy and Japan and are often credited for having played a crucial role in dampening the increase in unemployment in these countries. But the usage of short-time work programs as well as their contribution to the dampening of unemployment has varied considerably across countries (see IMF, 2010), implying that the design of the program was vital for its success.

Systematic empirical studies on the merits of short-time work during the crisis are still to be done. In general, a careful evaluation of the short-time work program requires looking beyond the rate of enrolment in the short-time scheme in a country. For the case of Germany, a recent investigation by Möller (2010) challenges the view that the benign labour market experience can be mostly explained by the short-time work program. Instead, he suggests that the nature of the shock (which hit mostly export-oriented manufacturing firms) as well as the initial condition prior to the crisis, particularly a shortage of trained workforce, led to strong incentives for labour hoarding on the part of German firms. However, even if it was not the main driving force behind the behaviour of firms, the short-time work scheme does appear to have supported this employment-friendly incentive in a beneficial way.

Should these programs continue over the next year? Subsidies to short-time work are costly not only because of the strain on public finances. They create a deadweight loss by giving firms an incentive to free-ride on the subsidy even when conditions improve. More importantly, if the downturn affects certain firms and industries in a permanent way, the program can also obstruct a necessary reallocation of resources to other industries, hence slowing down the recovery through structural adjustment. During a severe recession, the deadweight loss and cost of diminished reallocation are likely to be of second order importance. However, these potential efficiency costs are likely to become more relevant in recovery periods, suggesting that these programs should start to be phased out as recovery takes hold.

It is important to stress that short-time work is intended to help prevent destruction of jobs that are viable in the long term. Whether this has in fact been achieved across all implementing countries is not clear. In Germany, short-time work usage has been appropriately concentrated in sectors that have experienced an adverse but temporary demand shock (mainly export-oriented manufacturing). In contrast, short-time work usage in Italy has been persistently higher in some sectors (mechanical and textiles, leather) for several years prior to the crisis already (see IMF, 2010). This persistent use of short-time work in some sectors in Italy suggests that the program has likely served to delay structural layoffs in declining industries instead of smoothing out temporary demand shocks to viable jobs.

B. Unemployment Benefits

Unemployment benefits provision is the most direct policy tool with which governments can help the unemployed worker maintain a certain level of consumption and welfare during the initial period following a lay-off. Due to the low level of savings and lack of credit available to the unemployed, the propensity to consume out of UI benefits is close to one and the

provision of UI benefits thus also provides vital demand stabilization during recessions.³ Moreover, UI benefits allow the laid off worker to spend time and efforts searching for a suitable new job and hence improve the potential job match.

There are of course also costs associated with UI benefits provision, and the one most commonly mentioned is the potential disincentive effect on the worker to search and accept a job while being eligible to receive UI benefits. Indeed, it has often been observed that longer and higher UI benefits are associated with longer spells of unemployment (e.g. Krueger and Meyer, 2002). However, recent research has shown that this correlation is not necessarily driven by the disincentive effect on labour supply or search effort as has commonly been claimed. Chetty (2008) finds that for the US, the increase in unemployment duration with longer UI benefits only holds for households which have very low level of wealth and are therefore credit constrained. This implies that it is not primarily the disincentive on labour supply that drives longer unemployment spells, but a liquidity constraint which UI benefits help to alleviate. If this is the case, then the longer time spent unemployed is not a costly distortion but in fact a socially beneficial effect: UI benefits ease the distortionary credit constraint and allow households to allocate their time and resources more efficiently (on child care, health care, job search etc.). Other studies using data for Germany (Schmieder et al. 2010) have shown that the increase in unemployment caused by extensions of UI benefits is in fact small, and Card et al. (2007) show using Austrian data that most of the effect is driven by the beneficial liquidity channel.

In a severe recession, any remaining negative effect of UI benefits provision on employment is likely to be small: When vacancies are scarce relative to the pool of unemployed workers, any job not taken up by one worker (be it because of UI benefits or some other reason) should be quickly filled by another. Finally, with respect to fiscal costs, estimates for the US by the *Congressional Budget Office* suggest that increasing aid to the unemployed carries the highest cost effectiveness due to its direct and immediate impact on consumption and aggregate demand.⁴

Beyond a certain level of unemployment duration (say six months), the provision of UI benefits should be tied to individuals carrying out some part-time work or engaging in job training so that they maintain some attachment to the labour force (Nickell, 2010).

V. Policy Responses: Accelerating Recovery in Jobs

A. Dual Employment System

Over the past 20 years, a number of OECD countries tried to increase labour market flexibility by encouraging temporary work contracts that were not subject to the strict

³ In the US for instance, median unemployed person in the US has less than \$250 in liquid net savings prior to job loss (see Chetty, 2010).

⁴ Between 8 and 19 years of full-time equivalent employment are predicted to be created per million Dollar of budgetary cost (see CBO, 2010).

employment protection that applied to permanent contracts. This led to a fast expansion of temporary employment. In Spain about 30 percent of employed persons were under temporary contracts, the highest level in the OECD — see Box 2 for a discussion of the determinants of the share of temporary workers.

Due to this increased flexibility, employment in countries with a pervasive dual employment system should be more responsive to output changes. This can indeed explain the situation in Spain, where employment declined by 20 percent during the Great Recession, with the vast majority of the job losses having occurred in the temporary workforce (IMF 2010a). A review of Spain's employment experience relative to that of other countries concluded that “temporary contracts became the weak link in labour markets during the recent crisis, leading to large employment losses, affecting disproportionately some sectors, and making other possible shock absorbing mechanisms almost irrelevant” (IMF 2010b).

In principle, the dual employment should deliver benefits during the recovery as firms should be more willing to hire back people on temporary contracts than to add permanent workers. Whether this turns out to be the case remains to be seen. But even if this were to happen, there are concerns about the longer run fairness of the system. Countries that have a higher share of temporary workers tend, not surprisingly, to have more disparity (in terms of wage and benefits) between the permanent and temporary workforce. These disparities risk becoming entrenched as the temporary workforce has less access to on-the-job training and thus acquires less human capital than their permanent peers, which in turn worsens their prospective employment opportunities.

In addition to equity concerns, there is also compelling theoretical and empirical evidence (e.g. Blanchard and Landier, 2002; Jaumotte, 2010; and Box 2 in this paper) that the co-existence of a flexible temporary workforce and a highly protected permanent workforce can in fact increase unemployment and thus turn out to be inefficient. This perverse effect of a two-tier system on unemployment is due to a high turnover of low-productivity jobs that, on aggregate, lower output and employment.

B. Job Subsidies

This tool aimed at directly stimulating labour demand was widely used in many advanced countries starting in 2009 in response to the crisis. In particular, the subsidies (given as direct job, wage subsidy or reduction in payroll taxes) were targeted at specific groups of the labour force that are most vulnerable to joblessness: the long-term unemployed and/or youth (e.g. in Austria, Finland, Portugal, Sweden, Switzerland). Some countries also targeted job creation in certain hard-hit regions (Korea, Mexico) or specific sectors (e.g. services in Japan).

While these measures are potentially effective at preventing mass lay-offs (or smooth them out over time) and stimulate net employment growth, it is important that they remain targeted and temporary. This is because it is inherently difficult to design hiring subsidies that are effective at the right margin: subsidies could be given to jobs that would have been created anyway (deadweight loss), or to jobs that should not be created or maintained in the future.

In the long run, job destruction in certain firms and industries are inevitable and necessary for a productive factor allocation.⁵ However, as is the case with short-time work, in deep recessions, the potential inefficiencies arising from hiring subsidies are arguably less severe than the consequences of increasing or persistent unemployment. The specific targeting strategies that most countries have followed also serve to reduce potential misallocation of subsidies as they should spur hiring for groups that are most adversely affected and least likely to be rehired in the absence of the subsidies. Arguments in favour of hiring subsidies, in particular for low-wage workers, have also been put forward by Phelps (2006).

In a comparison between short-time work and job subsidies, if massive job destruction can be avoided with short-time work, it is arguably preferable in the short run as it spreads the costs and benefits across workers, firms and the government. Short-time work is also more preferable in circumstances where employers expect the downturn to be rather temporary, as it was the case in Germany. However, if the expectations of a downturn are more entrenched and the incentives to retain workers weak, then a direct job subsidy might be the only effective policy against mass lay-offs.

In some countries, such as the United States and Spain, jobs recovery is tied to tackling simultaneously problems in housing and construction—see Box 3 for a discussion.

VI. Conclusions

Labour markets are in a dire state. Over 200 million people across the globe are estimated to be unemployed at the moment. Nearly three-fourths of the increase in the number of unemployed people during the Great Recession has occurred in the ‘advanced’ (i.e. high-income) economies. The problem is particularly severe in the United States—the epicentre of the Great Recession—and the country with the largest increase in the number of unemployed: an increase of 7.5 million unemployed people since 2007. Some of the largest increases in the unemployment *rate* have occurred in Spain—where the rate increased by nearly 10 percentage points—the United States, New Zealand and Taiwan, Province of China

Youth unemployment has increased substantially in most advanced countries during the Great Recession. The largest increase was in Spain, where youth unemployment doubled from under 20 percent to almost 40 percent. The share of long-term unemployed has also increased in most OECD countries since 2007. In the few cases where it did not—such as Germany, France, Italy and Japan—the share had been persistently very high even before the crisis. In the United States the share of workers who have been unemployed for 27 weeks or more (as a share of the total number of unemployed) has been rising with every recession, but the increase during the Great Recession is alarming: nearly 1 in every 2 unemployed person has been out of work 27 weeks or more.

If the effects of past recessions are a guide, these developments can exact a heavy human toll. The cost to those who get unemployed could be a persistent loss in earnings, reduced life

⁵ A summary of the various subsidy schemes in OECD countries is given in OECD (2010), Ch 1.

expectancy, and lower academic achievement and earnings for their children. And unemployment is likely to affect attitudes in a manner that reduces social cohesion, a cost that all will bear.

To their credit, most countries mounted a strong three-part policy response to try to minimize these costs. Broadly speaking, the response had three parts: (i) *support aggregate demand* through monetary and fiscal policy actions; (ii) *ease the pain* in labour markets through short-term work programs and provision of unemployment insurance benefits; (iii) *accelerate jobs recovery* through the provision of subsidies of various kinds.

Over the remainder of this year and next, the three-part strategy adopted during the crisis should remain in place, though the relative importance of the parts should shift over time as—and if—recovery takes hold. And the relative importance should differ across countries depending on their specific circumstances.

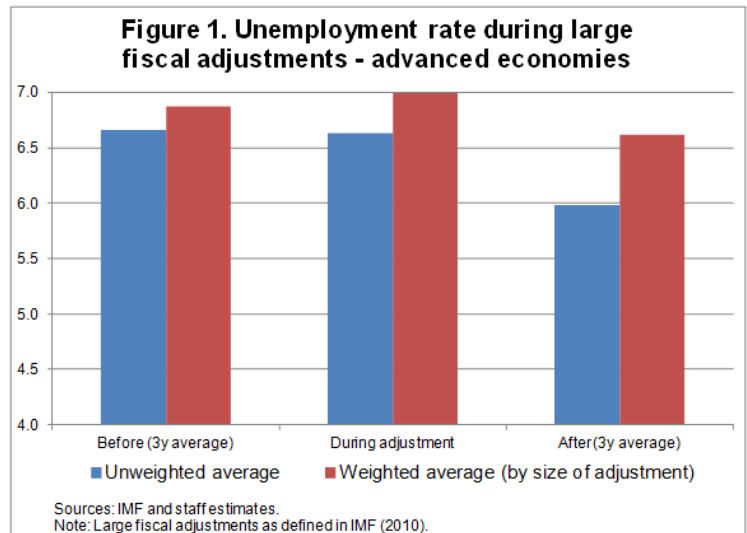
- ***Maintaining support for aggregate demand:*** A recovery in aggregate demand is the single best cure for unemployment. Hence as a *general strategy*, most advanced economies should not tighten fiscal policies before 2011, because tightening sooner could undermine the recovery. The consolidation plans that these countries have for 2011 imply an average change in the structural balance of 1¼ percentage points of GDP. A more severe consolidation would stifle still-weak domestic demand. Clearly, however, the fiscal situation varies across countries, requiring adaptation of this general strategy to the available fiscal space. Monetary policy remains an important policy lever to support aggregate demand. Inflation pressures are subdued—headline inflation is expected to remain around 1¼-1½ percent in 2010 and 2011. Monetary conditions can thus remain accommodative for the foreseeable future in most advanced economies.
- ***Easing the pain:*** As recovery takes hold, subsidies to short-time work could be phased out over the coming year. Provision of UI benefits should be tied to requiring job training and social work, so that the unemployed maintain some attachment to the labour force.
- ***Jobs recovery:*** The potential costs and inefficiencies of hiring subsidies are arguably less severe than the costs of persistent unemployment. The specific targeting strategies that most countries have followed should serve to reduce potential misallocation of subsidies by spurring hiring for groups that are most adversely affected and least likely to be rehired in the absence of the subsidies.

Box 1. Fiscal Adjustment and Income Distribution in Advanced and Emerging Economies

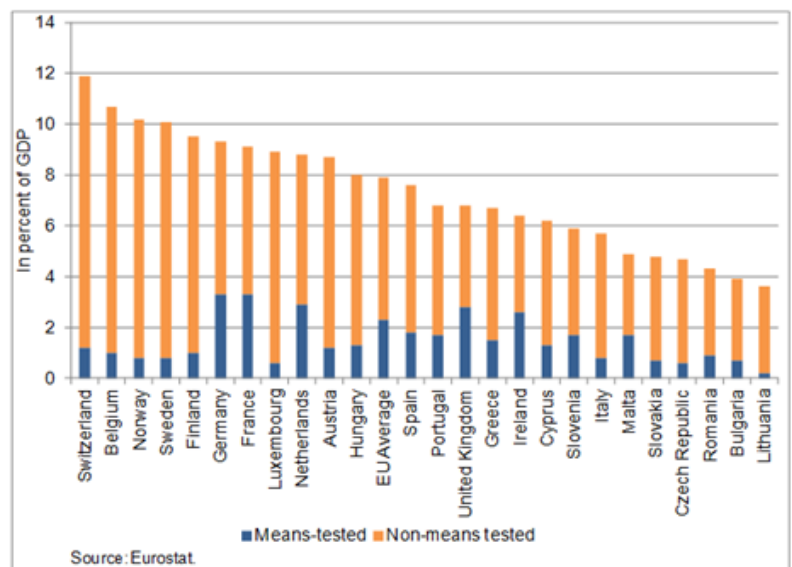
Fiscal consolidation can increase income inequality in the short term, but the duration and magnitude of this effect depends on the growth response and the composition of fiscal adjustment. Adverse short-term effects are attributable mainly to rising unemployment. However, adjustment-induced changes in government expenditure and revenue policies that redistribute income can also play a critical role. The impact of these transmission channels on inequality has varied across advanced and emerging economies, reflecting differences in the size of multipliers and the incidence of revenue and spending adjustments.

Advanced economies

Fiscal adjustment reduces output and increases unemployment in the short run due to positive fiscal multipliers, but these effects are reversed over the longer term (Blanchard and Perotti 2002; Spilimbergo and others, 2009). Consistent with the stylized facts on the business cycle, fiscal consolidation may lead to a decline in the share of wages within a few quarters by lowering demand and output, thus putting upward pressure on unemployment and downward pressure on wages (Rotemberg and Woodford, 1999). Inequality of labor income widens if low-wage workers are hit harder (Agenor, 2002) or employers start hoarding skilled labor (Mukoyama and Sahin, 2006). The duration of these effects will depend on how quickly and strongly private demand responds to fiscal shocks. In episodes of large fiscal adjustment, consolidation has been associated with increases in unemployment during the early years. Larger adjustments are associated with greater persistence in unemployment (Figure 1), especially if during the downturn there is an increase in structural unemployment (Mocan 1999, Galbraith 2009). Over the longer term, the effects of fiscal consolidation on unemployment are reversed (Clinton and others, 2010).



Improved targeting of expenditures can help reduce the effects of fiscal adjustment on income distribution. Large and durable fiscal adjustments have often been associated with significant expenditure cuts, including in public cash transfers (Alesina and Perotti 1995, Alesina and Ardagna, 2009). In Europe, these transfers have been shown to lower income inequality (as measured by the Gini coefficient) by about 9 percentage points (OECD, 2008), so reductions in these outlays may contribute to widening income inequality during adjustment episodes.¹ However, substantial fiscal adjustment can be associated with relatively small changes in income inequality if expenditure reductions are accompanied by efforts to better target these benefits—as in Denmark, Germany, and Sweden.² The fact that a small share of social spending in the EU is means-tested (Figure 2) suggests that there may be ample scope for reducing spending without adverse effects on inequality. In contrast to expenditure cuts, revenue measures, in particular those related to income and wealth, are likely to reduce income disparities due to progressive tax systems in advanced economies (OECD, 2008).³ However, if taxes are already high, efficiency considerations place a limit on how much adjustment should be achieved through tax adjustment.



¹ In the United States, Japan, and Canada, by comparison, social spending plays a less critical role in equalizing incomes.

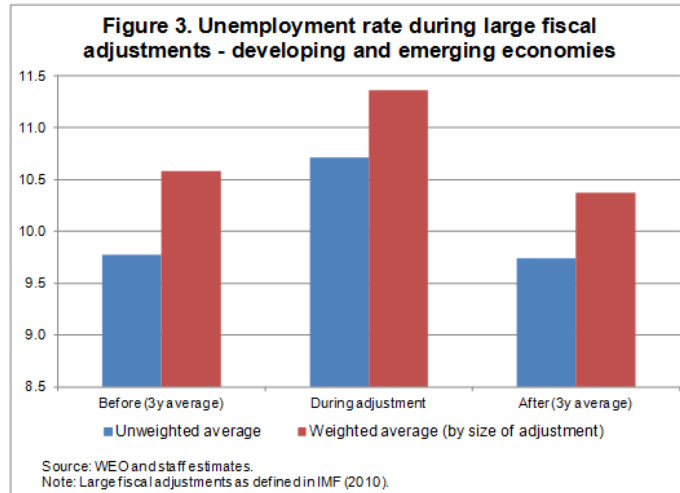
² In Denmark and Germany, changes in household income distribution data (OECD, 2008) suggest an increase in the progressivity of transfers during large fiscal adjustments. For a description of targeting efforts in Sweden, see IMF (2001).

³ The equalizing effects of revenue-based adjustments in the advanced economies has, to some extent, been offset by reductions in marginal tax rates. Top marginal personal income tax rates in OECD countries have been reduced considerably over the past decades (Mankiw and others, 2009).

Box 1 Cont... Fiscal Adjustment and Income Distribution in Advanced and Emerging Economies

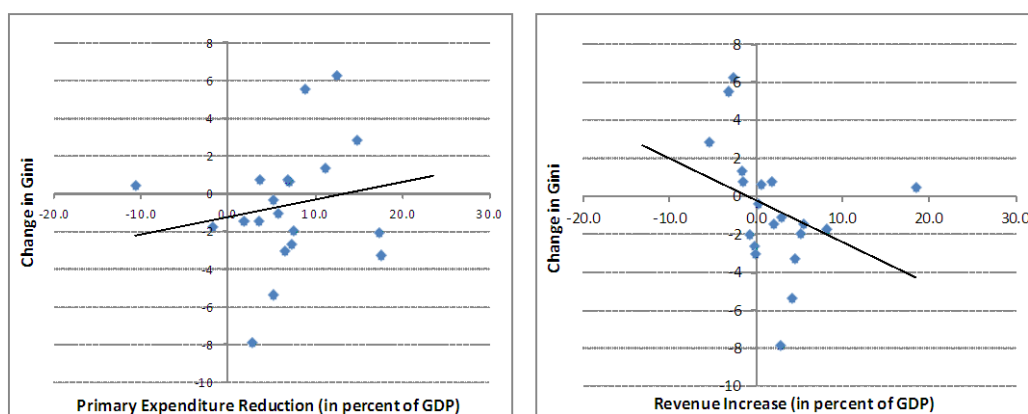
Emerging Economies

Compared to advanced countries, large fiscal adjustments in emerging economies have been of similar size but of much shorter duration. Despite smaller multipliers, fiscal shocks can still have a significant impact on the real economy and unemployment (Figure 3). At the same time, contrary to advanced economies, the size of consolidation does not seem to be associated with higher unemployment persistence, contributing to better income distribution outcomes in the post-adjustment period. In addition, fiscal consolidation is often essential to reduce high inflation, which has adverse effects on inequality (Agenor, 2004; Easterly and Fisher, 2001), and can help to offset other macroeconomic imbalances leading to improved employment prospects.



Fiscal adjustment has typically had an inequality-reducing effect over the longer term (Figure 4). Expenditure reductions implemented during fiscal adjustment can potentially improve equity, given that a large share of government spending in emerging economies is not progressive (Alesina, 1998; Chu, Davoodi, and Gupta, 2004). One exception to this pattern has been emerging Europe, where large consolidations have been associated with increased inequality. To be sustainable, fiscal adjustment in emerging economies is also likely to require revenue measures (Bevan, 2010; Gupta and others, 2005). The impact of tax measures on inequality can be mitigated if these are accompanied by tax reforms that enhance the efficiency and equity of the tax system.

Figure 4. Large Fiscal Adjustments - Emerging Markets



Source: IMF staff estimates. Data on large fiscal adjustments reported in IMF (2010), data on Gini coefficients is taken from WIDER database.
Note: Positive values for a change in Gini coefficient denote an increase in income inequality.

The material in this box was contributed by Javier Arze, Benedict Clements, David Coady, and Alvar Kangur of the Fiscal Affairs Department.

Box 2: What Determines the Use of Temporary Workers?

Labour market institutions and policies are likely to be important determinants of the share of temporary workers. To verify this, the share of temporary workers is regressed on various institutions and policies, a lag of the share of temporary workers, and country and time fixed effects:

$$Tempsh = \gamma \cdot Tempsh_{-1} + \alpha_1 \cdot Coord + \alpha_2 \cdot Coord^2 + \beta \cdot Undens + \delta_1 \cdot EPR + \delta_2 \cdot EPT + \theta \cdot UB + \vartheta \cdot TW + \pi \cdot PMR + \rho \cdot Gap + \mu + \tau + \epsilon,$$

where *Tempsh* denotes the share of temporary workers, *Coord* denotes the degree of coordination of wage bargaining, *Undens* is the union density, *EPR* is the employment protection legislation for permanent workers, *EPT* is the strictness of regulation of fixed-term contracts and temporary agency work, *UB* is the gross replacement rate of unemployment benefits, *TW* is the tax wedge, *PMR* is the indicator of product market regulation, *Gap* is the output gap, μ is the country fixed effect, and τ is the time fixed effect. The model is estimated on a sample of 20 OECD countries during the period 1985-2007 (or maximum years available).

The estimates show the following:

The share of temporary workers is boosted by higher unemployment benefits and a higher tax wedge. Presumably, because these variables lower labour demand, employers are more able to impose flexible labour contracts.

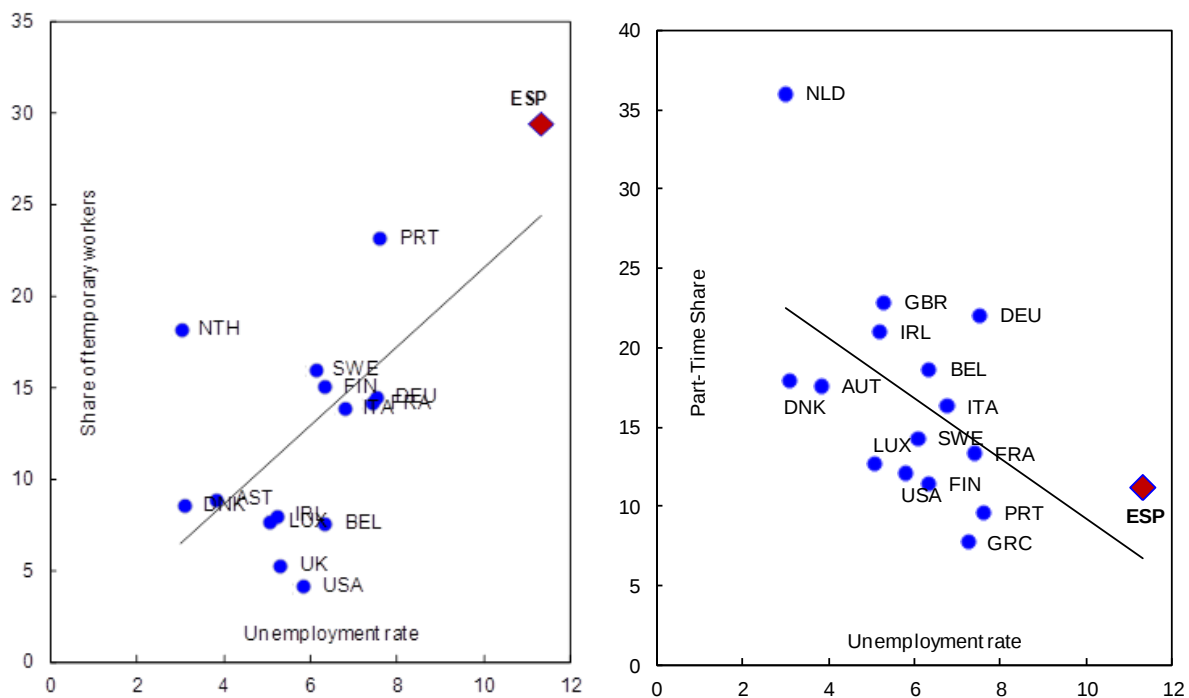
Lower product market regulation increases the share of temporary workers. This may happen because product market deregulation: (i) increases competition and the need for firms to be able to adjust quickly, making it more tempting to hire temporary workers; (ii) tends to favor the expansion of services sectors, where temporary work is more frequent; (iii) may induce lower rents, which may prompt firms to reduce labour costs by hiring temporary workers (with lower wages and dismissal costs).

High employment protection of permanent workers increases the share of temporary workers. This is true whether one uses the overall indicator of employment protection for permanent workers or its subcomponents (procedural inconvenience, notice period and severance payments for fair dismissals, and difficulty of dismissal). The most robust effect though comes from the difficulty of dismissal, which mostly refers to unfair dismissals (definition of justified or unfair dismissal, compensation following unfair dismissal, possibility of reinstatement following unfair dismissal, and length of trial period). Nunziata and Staffolani (2007) reach similar conclusions using a panel of European countries over the period 1983-1999.

The results thus suggest that reducing employment protection of permanent workers could substantially reduce the share of temporary workers. For instance in Spain, bringing the three components of employment protection of permanent workers to the minimum level observed in the EU15 would reduce the share of temporary workers by a total of 13.5 percentage points.

Box 2 cont...: What Determines the Use of Temporary Workers?

Are reducing the unemployment rate and the share of temporary workers compatible or is a trade-off involved? A simple plot of the data (see the left panel of the figure) shows the two to be positively correlated, suggesting that they could likely be reduced simultaneously. The positive association may reflect various factors: (i) an adverse labour demand that leads both to a high unemployment rate and a high share of temporary workers; (ii) the attempt of countries that have a high unemployment rate to reduce it (not very successfully) by allowing new types of contracts; or (iii) the higher rotation of workers when the share of temporary contracts is larger, leading to higher frictional unemployment, see Blanchard and Landier (2002) and Cahuc and Postel-Vinay (2002).

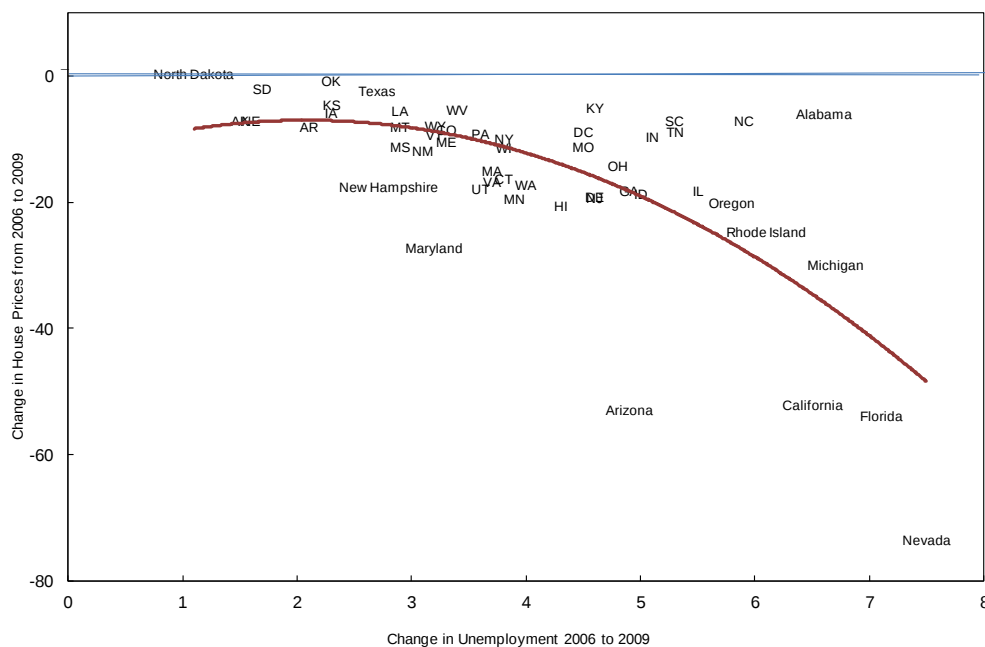


Box 3: The Interaction of Unemployment and Housing Problems

In the United States, labour mobility across states has historically been a strong force in tempering the effects of adverse shocks. Blanchard and Katz (1992) documented that U.S. regional relative unemployment rates return to the long-term means rapidly because workers migrate quickly into states that are doing relatively better; in Europe, migration tends to be a weaker equilibrating force (Decressin and Fatas, 1995). However, in this recession, US states where the house price bust has been more pronounced are also the ones where unemployment has increased the most (see figure). This relationship likely reflects the importance of the construction sector in the state's economy, but could also reflect lower mobility as a result of problems in the housing sector. Households are unable to rework their balance sheets by selling their homes, and thus find it difficult to move to locations where they may have job opportunities. As Katz (2010) notes, labour mobility declined sharply during the Great Recession. Conversely, lack of overall job growth makes resolution of housing problems difficult.

In countries such as Spain and Ireland too there is reason to expect slow recovery in labour markets because of interactions with developments in the housing sector. The feedback loop between credit and collateral prices created construction booms in these countries, significantly distorting the allocation of economic activity. As a result, the construction sector grew disproportionately to other sectors of the economy and became the engine of growth in these economies. The share of construction in total value added stood at 12 percent in Spain and 10 percent in Ireland by the end of 2006, compared to the Eurozone average of 6.8 percent. The housing bust thus brought severe contraction in construction output and employment. Reallocation of labour away from construction is likely to be spread over a considerable period of time and keep unemployment rates high (Aspachs-Bracons and Rabanal, 2009).

Figure 1.x.4. Double Whammy: No Equity, No Jobs



APPENDIX:

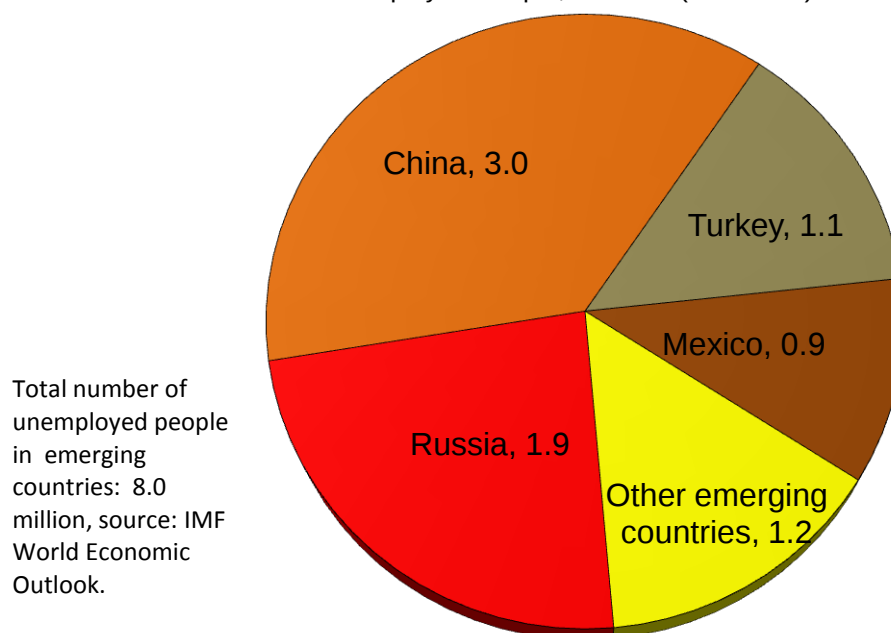
THE GLOBAL CRISIS AND HUMAN COSTS IN MIDDLE AND LOW-INCOME COUNTRIES

This appendix looks at data on unemployment in some middle and low-income countries and briefly discusses the potential human costs of the crisis in the developing world. The main drawback facing an analysis as presented for the advanced countries in our paper is the lack of high-frequency, up-to-date data on unemployment particularly in many middle and low-income countries as well as their quality and scope of coverage.

A look at unemployment data

First let us look at emerging market or middle income countries (MICs). Due to the size of the labour force, the largest increase in the number of unemployed took place in China and Russia (Figure A1). However, relative to the national labour force, the increase in unemployment in Russia and elsewhere is much more severe than in China, as is discussed below.

Figure A1: Emerging Market Countries/MICs: Change in Number of Unemployed People, 2007-09 (in millions)



Looking at data in a sample of MICs, the top chart of Figure A2 shows that the pattern of unemployment rate dynamics during the crisis is less homogenous here than in advanced countries. Among them, the Baltic States stand out most as they saw the largest drop in GDP and increase in unemployment. The primary reason for this is the strong external exposure of the financial sector in these countries and therefore the degree of financial contagion resulting from the global credit crunch. Another group of strongly affected countries are the CIS, being strongly dependent on the Russian economy which was hit hard during the crisis.

Mexico, Russia and China experienced a notable rise in their unemployment starting in March 2009, thus the response is delayed compared to the advanced countries group. The dominant channel of transmission of the crisis to MICs is through the contraction in external demand for their exports (Russia, China), capital outflow (Russia) and drop in remittances (Mexico). The large effect for Mexico is arguably due to its strong economic dependence on the US. However, the increase in unemployment in these countries started to come down earlier than in the advanced block (starting end 2009). Some MICs such as Brazil and China only show a slight and temporary increase in their unemployment rate during the period.

Due to lack of unemployment data, the labour market situation in low income countries (LICs) is much harder to quantify and evaluate. The bottom chart of Figure A2 shows the evolution of the unemployment rate in a sample of low income countries (LICs) for which data is available through 2009. Unemployment has been on a downward trend for this sample of LICs since the early 2000s, reflecting the positive economic development prior to the crisis. Unlike the advanced or some of the emerging market countries, the unemployment rate in LICs does not seem to have picked up by nearly as much. Unlike the middle income group, the most immediate impact of the crisis in LICs is felt through a dry up of aid and remittances (see ILO, 2009). However, apart from the lack of complete and up to date data, the unemployment statistics in the developing world may not be an appropriate measure for the true labour market conditions or welfare in general. Due to poor social insurance systems as well as the pervasiveness of the informal sector in LICs, employment is often a mere means of survival, and barely above the poverty line. When the economic condition worsens, more family members (women, children) are forced to find work in low-paid and precarious activities. This might not show up in an increase of the unemployment rate, but nevertheless entails great human costs as families have to struggle to make ends meet, children have to forego education, and families' loss of income leads to poorer nutrition and health. Therefore, with less export demand, foreign aid and FDI inflows to sustain growth, the hardship suffered by workers in poor countries likely increased a lot in spite of a stable unemployment rate.

Other measures of human costs

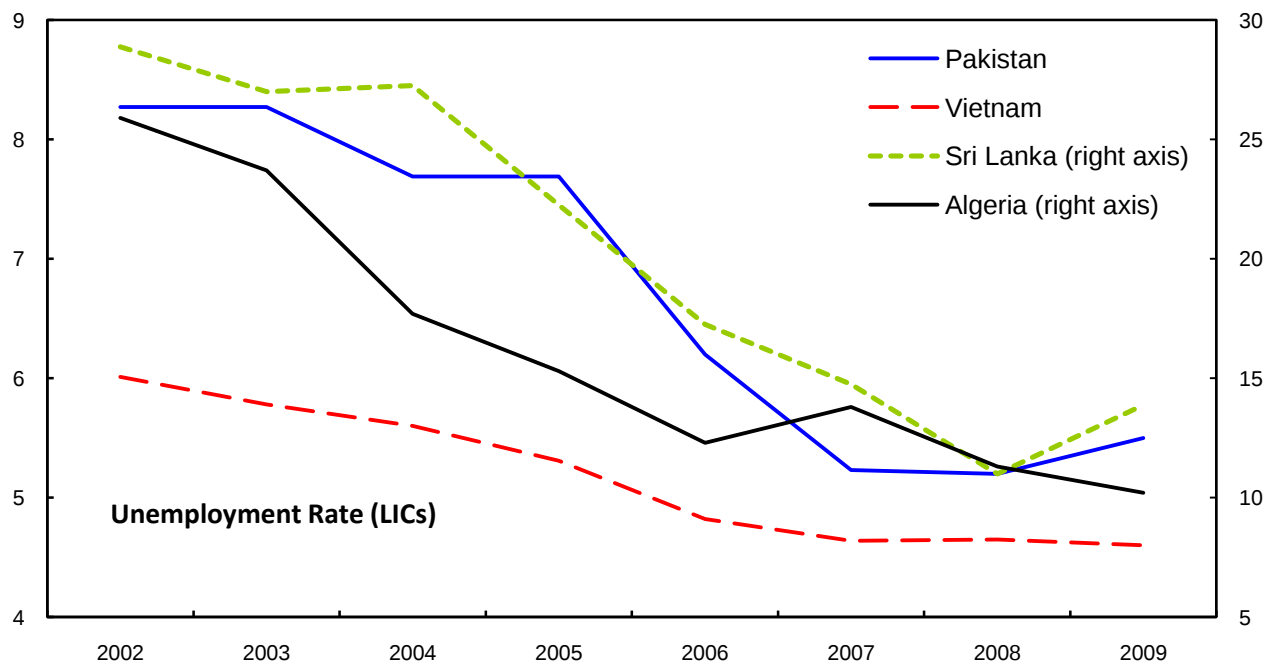
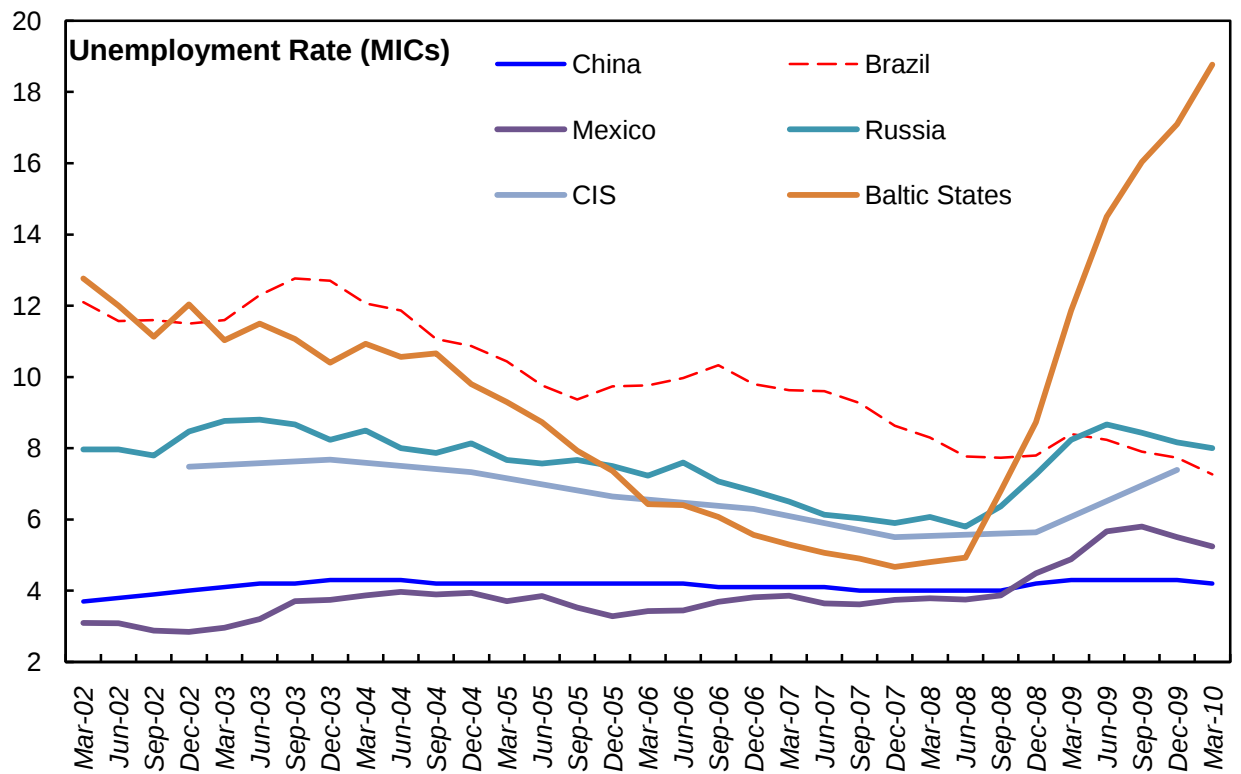
A complementary way to assess the degree of human cost of the crisis in LICs going beyond the scarce official macro data is to drill down to the household level and production unit by direct case studies. A study conducted by Oxfam (2010) uses household surveys, interviews, and focus group discussions to assess the human impact of the crisis in 11 LICs across the world. The findings reveal a very diverse picture with pockets of workers and industries in many countries being extremely hard hit, in particular women in export dependent manufacturing (Cambodia, Indonesia, Thailand), and at the same time, there is a general

pattern of resilience observed for other groups of households/workers in LICs. An important factor behind this resilience is the favourable fiscal space with which some governments entered the crisis and the creation/extension of social policies to protect the poor (e.g. in Brazil, India, Sri Lanka). However, due to the micro-based research design, these findings cannot give a precise picture of the true aggregate state of LICs due to lack of real-time macro data. Other studies which resort to simulations and past estimates of poverty elasticity to growth reveal a more worrisome picture: between 50 and 100 million people may have been pushed into extreme poverty in 2009 as a result of the crisis, and inequality is projected to increase in countries where labour income has been hit hard such as Mexico (see Oxfam, 2010 and World Bank, 2010).

Policy responses

Due to financial and institutional constraints, the use of active labour market policies in the groups of MICs and LICs has been much more limited than in advanced countries. The majority of the tools discussed in the text which were widely used in advanced countries are also not likely to be as effective in developing countries since only a small share of workers (often less than 10 percent) are employed in the formal economy where regulations apply. Instead, the policies chosen in developing countries during the latest crisis are primarily vocational training, entrepreneurship incentives (through expanded micro credit schemes) and public work programs (notably in India). A summary of different countries' policy choices is given in ILO (2009).

Figure A2: The unemployment rate in selected middle-income and low-income countries, in percent



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2. Building an employment-oriented framework for strong, sustainable and balanced growth

INTERNATIONAL LABOUR ORGANIZATION

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Introduction: Creating decent work opportunities

The serious deterioration in employment since late-2008, with the onset of the global financial crisis, has heightened international concern about the inability of the global economy to generate enough decent work opportunities in all countries.

The past three decades have also been a period during which inequalities have widened in many countries, driven by various factors, including the diminishing share of wages in national income and increasing inequality within wage income, as well as technological change. This, in turn, has fed back into the globalization process and the structure of demand. It has contributed to the emergence of imbalances nationally and internationally, imbalances which were an important underlying cause of the financial crisis and the Great Recession. In his analysis of the United States economy, Rajan argues that “American overconsumption is driven by policies that were framed in reaction to growing public perception of inequality and insecurity and these policies have contributed to financial sector excess”.⁶

Concern about the quality, as well as the quantity, of job creation gave impetus to the development of the ILO Decent Work Agenda. Decent work is a source of personal dignity, of stability for families and households and peace in the community. Furthermore, it is a foundation for trust in government and business and the overall credibility of the institutions that govern our societies.

The decent work approach has gained wide support and has become one of the policy pillars of United Nations international development strategies, and it is acknowledged as equally relevant to developed countries (Box 1). As the United Nations and the international community take stock of progress towards the Millennium Development Goals (MDGs), the centrality of decent work to improving the lives of families, communities and nations, and thus to strategies for sustainable development, is a recurrent theme in international and national policy debates.⁷

In June 2009, in response to the global financial crisis, the ILO adopted the Global Jobs Pact, built on the Decent Work Agenda. The Pact addresses the unprecedented increase in global unemployment, underemployment and informal work that compounded pre-existing labour market problems and that is designed to reduce the time lag between economic recovery and a recovery with decent work opportunities. This was endorsed by the United Nations Economic and Social Council in July 2009, by the G20 Leaders’ Statement at the Pittsburgh Summit in September 2009, and by a large number of international and regional organizations. The G20 Leaders welcomed the Global Jobs Pact, and committed “our nations to adopt key elements of its general framework to advance the social dimension of globalization”.

The severe human costs of the Great Recession’s rapid increases in unemployment and underemployment are described in the IMF contribution to this discussion document. It is increasingly evident that a return to pre-crisis unbalanced growth patterns could sow the seeds for future and perhaps even more damaging crises. Accelerating a job-rich recovery is vital and it is important to lay the foundations for a better quality of growth in the future, through more coherent growth policies focussed on the goals of quality jobs and social cohesion.

⁶ R.G. Rajan: *Fault lines: How hidden fractures still threaten the world economy* (Princeton, NJ, Princeton University Press, 2010), p. 210.

⁷ United Nations: *The Millennium Development Goals Report 2010* (United Nations Department of Economic and Social Affairs, 2010), <http://www.un.org/millenniumgoals/pdf/MDG%20Report%202010%20En%20r15%20-low%20res%2020100615%20-.pdf> (accessed 22 Aug. 2010).

Box 1. World leaders support full and productive employment and decent work for all

The decent work concept was formulated by the ILO's constituents – governments and employers' and workers' organizations – as a means to identify the Organization's major priorities and to modernize its approach for the twenty-first century. It is based on the understanding that work is a source of personal dignity, family stability, peace in the community, democracies that deliver for people, and economic growth that expands opportunities for productive jobs and enterprise development. It is based on four pillars – employment and enterprise development, social protection, social dialogue, and rights at work.

In 2005, world leaders at the United Nations General Assembly session to review progress on the Millennium Development Goals firmly endorsed this approach:

We strongly support fair globalization and resolve to make the goals of full and productive employment and decent work for all, including for women and young people, a central objective of our relevant national and international policies as well as national development strategies, including poverty reduction strategies, as part of our efforts to achieve the Millennium Development Goals. These measures should also encompass the elimination of the worst forms of child labour, as defined in ILO Convention No.182, and forced labour. We also resolve to ensure full respect for the Fundamental Principles and Rights at Work.

The General Assembly also gave support to the 2004 report of the ILO-sponsored World Commission on the Social Dimension of Globalization, which had stated that:

Decent work for all should be made a global goal and be pursued through coherent policies within the multilateral system. This would respond to a major political demand in all countries and demonstrate the capacity of the multilateral system to find creative solutions to this critical problem.

The Decent Work Agenda is acknowledged as highly relevant to the challenges facing the developed world. The European Commission, for example, has said that “*playing an active part in promoting decent work forms an integral part of the European Social Agenda and of the EU's efforts to promote its values and share its experience and its model of integrated economic and social development*”.⁸

With the onset of the crisis, the ILO Global Jobs Pact,⁹ elaborated and adopted at the 98th Session (2009) of the International Labour Conference, was similarly supported and became part of the international approach to shortening the potential lag between recovery in output and jobs experienced in earlier crises. In 2009, the United Nations Economic and Social Council encouraged:

Member States to promote and make full use of the Global Jobs Pact as a general framework within which each country can formulate a policy package specific to its situation and priorities, through a portfolio of appropriate policy options, which may include, inter alia, multisectoral development policies, technical assistance and international cooperation, joined with the effort to promote sustainable recovery from the crisis when measures are being developed to promote and protect employment in recovery plans, according to its specific needs and circumstances.

The Pittsburgh G20 Summit in September 2009 welcomed the ILO Global Jobs Pact and agreed on the importance of building an employment-oriented framework for future economic growth:

Our new Framework for Strong, Sustainable, and Balanced Growth requires structural reforms to create more inclusive labour markets, active labour market policies, and quality education and training programs.

The Pact sets out a portfolio of policy tools which many countries are using to construct their recovery strategies. One important consequence of these developments is renewed attention to the macroeconomic interaction of employment and social protection policies with fiscal and monetary policies as a central focus of strategies for strong sustainable and balanced growth.

⁸ Commission of the European Communities: *Promoting decent work for all: The EU contribution to the implementation of the decent work agenda in the world* (Brussels, 2006).

⁹ ILO: *Recovering from the crisis: A global jobs pact* (Geneva, 2009), <http://www.ilo.org/jobspact/lang-en/index.htm> (accessed 22 Aug. 2010).

The ILO contribution to this background discussion document reviews the relationship between overall economic performance and labour market developments, and the employment and social policies that could help generate the quantity and quality of jobs needed for strong, sustainable and balanced growth. One of the central elements in the growth process is the way in which increases in productivity and employment enable a rise in household incomes and are, in turn, stimulated by the increased demand made possible by rising real wages. It is important to harness the potential for these interactions to create a virtuous upward spiral by focussing attention on the way in which work is organized and the capacity of societies to mobilize the productive potential of their members.

Declining wage shares, rising inequality and weak growth in formal employment are contributing to national and international imbalances that threaten to produce a period of weak world growth that will leave unemployment, underemployment and poverty at high levels that are unacceptable. Moving beyond the crisis to build an employment-oriented framework for future economic growth that generates decent work opportunities requires an understanding of trends both before and during the crisis, specifically with regard to unemployment, labour force participation, worker vulnerability and inequality.

A. Key global labour market evolutions

Structural change and the emergence of a global labour market

Growing world labour force

In the ten years to 2009, the global labour force grew from 2.74 billion to 3.21 billion, with well over half of the world's workers (56.3 per cent) located in Asia.¹⁰ Four out of five workers live in developing countries, where almost all the growth in the world's labour supply is occurring. Prior to 1990, half of the world's workforce lived in countries that participated only marginally in international trade and investment. Richard Freeman has argued that liberalization by these countries in effect doubled the size of an emerging global labour market.¹¹

Global labour force participation rates declined from 2000 to 2009, from 65.3 to 64.7 per cent. This was driven by the decline in male labour force participation rates. Female rates held steady, implying some, albeit small, closing in the gender gap in labour force participation.¹²

Global unemployment, which had been over 6 per cent for several years before decreasing between 2004 and 2007, increased dramatically in 2009.¹³ Now in 2010, more than 209 million out of an estimated global labour force of 3.21 billion are unemployed - a rise of more than 31 million since 2007.

With annual labour force growth of 1.6 per cent adding more than 45 million jobseekers per year to the global labour force, the challenges exacerbated by the crisis are unlikely to diminish. In the next 10 years, more than 440 million new jobs will be needed to absorb new

¹⁰ ILO: *Trends econometric models: A review of the methodology* (Geneva, 2010).

¹¹ ILO: *Employment policies for social justice and a fair globalization*, Report VI, International Labour Conference, 99th Session, 2010 (Geneva), Chapter 2, http://www.ilo.org/wcmsp5/groups/public/---ed_norm/---relconf/documents/meetingdocument/wcms_126682.pdf (accessed 22 Aug. 2010), and R. Freeman: *The great doubling: The challenge of the new global labour market* (2006), http://emlab.berkeley.edu/users/webfac/eichengreen/e183_sp07/great_doub.pdf (accessed 22 Aug. 2010).

¹² As of 2009, the global labour force participation rate was 77.7 per cent for males and 51.6 per cent for females, ILO: *Global employment trends for youth: Special issue on the impact of the global economic crisis on youth* (Geneva, 2010).

¹³ ILO: *Global employment trends for youth*, op.cit.

entrants into the labour force.¹⁴ Even greater employment growth is required to reverse the heightened unemployment caused by the crisis. Labour force growth is fastest, and will decline slowest, in low-income countries, especially in Africa.

Working poverty and informal work

Over the past decade, the incidence of working poverty at the \$2-a-day level decreased by 17 percentage points. Despite these impressive gains, approximately 1.2 billion women and men, or around 40 per cent of the world's labour force, still did not earn enough to keep themselves and their families above the \$2-a-day poverty level in 2008.¹⁵ The steady decrease in these figures has halted as a result of the crisis.

Similarly, vulnerable employment, consisting of own-account workers and unpaid family members, fell from over 53 per cent of global employment to under 50 per cent.¹⁶ Vast numbers of vulnerable workers work in the informal economy in developing countries and constitute the bulk of the working poor.

High youth unemployment

The youth labour force¹⁷ grew to 619 million by 2009, an increase of 6 per cent over the previous ten years. This is one-fifth of the world's labour force. Despite a number of years of rapid economic growth, youth unemployment has remained stubbornly high, at around 12 per cent. Between 2007 and 2009, youth unemployment rose by 7.8 million worldwide, with an unemployment rate among youth moving from 11.9 per cent to 13.0 per cent.¹⁸ For emerging and developing countries, data from six Latin American countries confirm an increase in informal employment among youth during periods of economic crisis, especially compared to adult workers.¹⁹

The least educated youth are most likely to experience unemployment in developed economies, highlighting the importance of education and vocational training to combat the scarring effects of joblessness among young workers. Long-term unemployment among youth, already a concern before the crisis, has also increased, with many educated youth now also facing periods of job searching that exceed one year. Decreasing youth labour force participation rates in some countries suggest that many young women and men have become discouraged by a fruitless search for work. Unless educational enrolment increases to match declines in labour force participation, future growth will suffer from a weakened skill base.²⁰

In developing economies, where the majority of the world's youth live, many young men and women still cannot afford to be unemployed for long periods of time. As an alternative, the youth who do not benefit from social protection or sufficient family income take up whatever work they can find, typically own-account work in the informal sector. For the majority of the world's youth, therefore, the main concern is not so much unemployment, but the continuation of decent work deficits and entrapment in the cycle of working poverty.

¹⁴ The growth of the global labour force is expected to decline slowly over the next ten years, reaching 3.65 billion by 2020.

¹⁵ ILO: *Global employment trends*, January 2010 (Geneva, 2010).

¹⁶ ILO: *Global employment trends*, op.cit.

¹⁷ Young people, for the purposes of this paper and as in the case of labour force surveys, are defined as those aged 15–24, except where otherwise indicated.

¹⁸ ILO: *Global employment trends*, op.cit.

¹⁹ ILO: *Panorama Laboural: América Latina y el Caribe* (Lima, 2009), p. 52.

²⁰ International Institute for Labour Studies (IILS): *Youth employment in crisis*, Discussion paper 201 (Geneva, ILO, 2010).

Rural–urban migration

An additional feature of changes in the global labour market is the long-term shift away from agriculture and rural areas to the industrial and services employment to be found primarily in urban areas. This migration averages around 30 million women and men each year. Developing countries thus need to attain a high rate of employment growth to meet the demand for jobs from those migrating in search of better work, as well as from new entrants to the labour force. For example, in 1997–2007, China, a country that has experienced very high levels of rural–urban migration, grew at an average of 9.6 per cent a year, but only just managed to stay ahead of the demand for new jobs as employment expanded by only 1 per cent a year. Many developing countries face very similar challenges of absorbing a substantial increase in the numbers of jobseekers at the same time as wishing to raise productivity levels to support higher living standards. While productivity in manufacturing enterprises in developing and emerging countries is surging, it is the low productivity informal economy in many countries that absorbs much of the growth in labour supply.

International migration is also significant and rising, although labour movements remain subject to strict controls. By 2010, 214 million people, or 3.1 per cent of the world's population, lived outside their country of birth, according to United Nations' estimates. Some 60 per cent of immigrants are in advanced countries, where 10.3 per cent of the population are foreign born, compared to developing countries, where 1.5 per cent of the population are foreign born.²¹ The ILO estimates that a little under half are economically active in their country of destination.

High unemployment and an ageing population in advanced countries

In stark contrast to much of the developing world, most industrial countries are moving into a period of population stagnation or fall, with the consequent effect of an ageing of the workforce and a rise in dependency ratios. For the EU25, the old-age dependency ratio is projected to increase from 26.3 per cent in 2010 to 40.3 per cent in 2030, and to 52.8 per cent in 2050.²² Prior to the onset of the crisis, most OECD countries were focussing policies on increasing participation rates, especially among groups with below average labour market attachment. The OECD employment–population ratio increased from 63.9 per cent in 1995 to 66.5 per cent in 2008. It has, however, fallen back to 64.8 per cent in 2009. As dependency rates rise, it is ever more important to attain high levels of participation in employment to support the increased share of the population who are non-working. This issue will also become increasingly urgent for some developing countries, notably China, in the decade ahead.

The rise in unemployment in advanced OECD countries, which reached a post-war high of 8.7 per cent in March 2010, adds to the longer-term challenge of increasing participation in employment. While most likely near its peak, advanced country unemployment is projected to decline only slowly and remain above 8 per cent at the end of 2011.

Furthermore, the overall slack in the labour market exceeds conventionally measured unemployment by a significant margin. It is more than twice as large if one takes a broader measure that encompasses both inactive persons who wish to work and involuntary part-time workers. In addition, the OECD has estimated that, across its member countries, working hours fell by an average of one hour per worker between the last quarters of 2007 and 2009, which represents over 2 per cent of average total hours worked.²³ A prolonged period of high unemployment, including a rise in the numbers unemployed for longer periods and a rise in

²¹ United Nations: *International immigration 2009*, Department of Economics and Social Affairs (New York, NY), http://www.un.org/esa/population/publications/2009Migration_Chart/2009Immig_chart.htm (accessed 22 Aug. 2010).

²² Eurostat, 2007. Statistics for the EU25 do not include new members Bulgaria and Romania.

²³ OECD: *OECD Employment outlook: Moving beyond the jobs crisis* (Paris, 2010).

the numbers of discouraged workers, will substantially increase the difficulty in assuring good life-long standards of living in the future.

Widening inequality

At the same time as there have been changes in the structure of employment, inequality in the distribution of wages and incomes has widened in many countries.

Increasing wage inequality

Wage inequality, calculated as the ratio of the top decile of wage distribution (D9) to that of the bottom (D1), widened in over two-thirds of the countries analysed by the ILO from 1995 to 2008.²⁴

Not all countries showed the same pattern of increased inequality, however. In the United States and the United Kingdom, for example, most of the increase has occurred as a result of income concentration in the very top deciles, as evidenced by an increasing D9/D5 ratio. In Germany, however, inequality widened more from the middle to lowest deciles (widening D5/D1 ratio) as a result of weak wage growth among the lowest wage earners.²⁵

Countries where wage inequality has lessened since the mid-1990s include France, owing to a decreasing D5/D1 ratio, and Brazil, where the D9/D5 ratio has decreased as a result of rising median wages.²⁶ Many developing and transition economies experienced rises in wage inequality principally through falling earnings for lower-waged workers (a rising D5/D1 ratio).

Income gaps widen in many countries

Over the past twenty years, both income inequality and the poverty headcount (based on a 50-per-cent median income threshold) have risen, according to a recent OECD study of its 30 member countries. The increase is fairly widespread, affecting two-thirds of all countries.²⁷ The study found that countries with a larger inequality in the distribution of income also have higher relative income poverty, with only a few exceptions.

Overall, inequality has generally risen because rich households have done particularly well in comparison to middle-class families and those at the bottom of the income distribution. Capital income and self-employment income are very unequally distributed, and have become even more so over the past decade. These trends are a major cause of wider income inequalities. In addition to wage income inequality, a shift towards profits as a share of national income has played an important part in the strong concentration of income at the top. In the United States, the share of the top 1 per cent reached 23.5 per cent of total income by 2007, almost tripling from about 9 per cent in 1976.²⁸

Similar to the findings of the ILO's wages study, the OECD also concludes that earnings of full-time workers have also become more unequal in the most advanced countries. This is due to high earners becoming even more so. Globalization, skill-biased technical change and weaker labour market institutions and policies have all contributed to this outcome.

²⁴ ILO: *Global wage report 2008/09: Minimum wages and collective bargaining: Towards policy coherence* (Geneva, 2008).

²⁵ ILO: *Global wage report: Update 2009* (Geneva, 2009).

²⁶ ILO: *Global wage report 2008/09*, op.cit.

²⁷ OECD: *Growing unequal? Income distribution and poverty in OECD countries* (Paris, 2008).

²⁸ A.B. Atkinson, T. Piketty and E. Saez: *Top incomes in the long run of history*, NBER Working paper No. 15408 (Cambridge, MA, National Bureau of Economic Research, 2009), <http://www.nber.org/papers/w15408> (accessed 22 Aug. 2010), cited by R.G. Rajan, 2010, op.cit, p. 8

Work is nevertheless a very effective means of tackling poverty. Poverty rates among jobless families in OECD countries are almost six times higher than those among working families. However, work is not sufficient to avoid poverty. More than half of all poor people in the OECD countries belong to households with low earnings resulting from low number of hours worked during the year and/or low wages. Reducing in-work poverty often requires in-work benefits that supplement earnings. Social mobility is generally higher in countries with lower income inequality, and vice versa. This implies that, in practice, achieving greater equality of opportunity goes hand in hand with more equitable outcomes.

As measured by the Gini index, income inequality increased in many developing countries in recent years, particularly in Asia and the Pacific, and in Latin America and the Caribbean. Particularly notable were increases in China and India, which also experienced increases in income inequality as measured by D9/D1 ratios.²⁹

Rise of insecure work

Globalization, and the associated need to constantly improve productivity and competitiveness to maintain market share, is also reflected in an increased intensity of work characterized by tighter deadlines and faster production processes, among other things.³⁰ Patterns of working time have always been subject to change, but the pace of change is now more rapid than ever before.³¹ Often, but certainly not always, overly flexible and insecure working arrangements have adverse consequences for family life and local communities.³²

In recent decades, many enterprises have sought to reduce labour costs and enhance their international competitiveness through an expansion in atypical forms of work, including part-time, casual, and short-term work.³³ Also on the increase is home work, contract labour and agency work.³⁴ There are also various other forms of disguised employment relationships, where workers are re-labelled as “self-employed”, yet they remain in an economically dependent and/or subordinate relationship with the management of a company.³⁵ These workers do not have many of the rights and benefits that apply to regular employees doing the same types of work, such as remedies for unfair dismissal or redundancy pay, sick pay or maternity pay. They also often have less protection with regard to occupational health and safety, social security, freedom of association and collective bargaining.³⁶

Wage share declines

In recent years, there has been a marked decline in the wage shares of total income in many developed and developing countries. An IMF report showed that labour’s share of income declined steadily in advanced countries since around 1980, and it concluded that

²⁹ ILO: *World of work report 2008: Income inequalities in the age of financial globalization* (Geneva, 2008).

³⁰ F. Green: *Demanding work: The paradox of job quality in the affluent economy* (Princeton, NJ, Princeton University Press, 2006), and G. Bosch: “Towards a new standard employment relationship in Western Europe”, in *British Journal of Industrial Relations* (London, Blackwell Publishing Limited/London School of Economics, 2004), Vol. 42, Issue 4, Dec., pp. 617–626.

³¹ ILO: *Working time and workers’ preferences in industrialised countries: Finding the balance* (London, Routledge, 2004).

³² M. Marchington et al. (eds): *Fragmenting work: Blurring organizational boundaries and disordering hierarchies* (Oxford, Oxford University Press, 2005).

³³ L.F. Vosko: *Temporary work: The gendered rise of a precarious employment relationship* (Toronto, University of Toronto Press, 2000).

³⁴ R. Feenstra and G. Hanson: “Globalisation, outsourcing and wage inequality”, in *American Economic Review* (Pittsburgh, PA, 1996), Vol. 86, No. 2, pp. 240–245.

³⁵ ILO: *The scope of the employment relationship*, Report V, International Labour Conference, 91st Session, Geneva, 2003 (Geneva).

³⁶ ILO: *The scope of the employment relationship*, op.cit.

technological change was an important cause.³⁷ The ILO *Global wage report: 2008/09* also noted that the wage share fell in three-quarters of 38 mainly developed countries with readily available data between 1995 and 2000 and between 2001 and 2007.³⁸ A second sample of mainly developing countries showed a similar pattern with two-thirds recording declines. In 2002, an earlier study by Harrison found that from 1993 to the early-2000s, labour's share of income declined by 0.3 percentage points per year in a group of developing countries and by 0.4 percentage points per year in a group of developed countries.³⁹

The ILO *Global wage report: 2008/09* noted that the countries in which trade was growing as a percentage of GDP were also the countries with the fastest decline in wage share. One possible explanation for the link between increased trade and lower wage share is that the intensification of competition – particularly the presence of large low-wage exporters in the market for labour-intensive products – has worked as a wage moderation factor. The report also recorded that real wages have failed to keep pace with GDP gains. Of 83 countries studied by the ILO, wage growth averaged 0.75 per cent for every 1 per cent of growth in GDP per capita during 1995–2007.⁴⁰ A lower wage share has also been found to be associated with a more unequal distribution of personal income.⁴¹

Kenneth Rogoff has summed up these trends in wages and profits as follows:

Corporate profits are bursting at the seams of investors' expectations in virtually every corner of the world...Many policymakers seem to be under the impression that surging profits are a purely cyclical phenomenon as economies continue to grow out of the recession. Wait a bit, they predict, and wages will fully catch up later in the cycle. Not likely. Capital's piece of the pie has been getting bigger for more than 20 years, and the trend looks set to continue (Rogoff, 2005).

B. Macroeconomic management, the recovery, inequality and growth

Immediate macroeconomic policy challenges

In the immediate future, with global private sector recovery still fragile, fiscal and monetary policies in many countries will continue to have to be supportive of effective demand. Some governments, mainly in southern Europe, have come under strong pressure from financial markets to start reducing deficits sharply and immediately. They face particularly difficult fiscal circumstances and also competitiveness problems reflected in large current account deficits and their inability to use the exchange rate instrument because they are in the Eurozone.

In many countries, indebtedness of the private sector is another big constraint on the recovery. In the United States, gross private domestic debt is four times larger than the debt of both the federal and the state and local governments.⁴² In this uncertain environment, households and businesses in a number of advanced countries, rather than investing, are

³⁷ IMF: "The globalization of labour", in *World economic outlook: April 2007* (Washington, DC, 2007), Chapter 5., <http://www.imf.org/external/pubs/ft/weo/2007/01/pdf/c5.pdf> (accessed 22 Aug. 2010).

³⁸ ILO: *Global wage report 2008/09*, op.cit.

³⁹ A.E. Harrison: *Has globalization eroded labour's share? Some cross-country evidence*, Mimeo (Berkeley, CA, University of California at Berkeley and National Bureau of Economic Research, 2002).

⁴⁰ ILO: *Global wage report 2008/09*, op.cit.

⁴¹ R. van der Hoeven: "Income inequality and employment revisited: Can one make sense of economic policy?", in *Journal of Human Development and Capabilities* (London, Routledge, 2010), Vol. 11, No. 1 p. 67–84, and E. Daudey and C. Garcia-Peñalosa: "The personal and the factor distributions of income in a cross-section of countries", in *Journal of Development Studies* (London, Routledge, 2007), Vol. 43, No. 5, pp. 812–829.

⁴² Federal Reserve Bank: <http://www.federalreserve.gov/releases/z1/Current/z1r-2.pdf> (accessed 22 Aug. 2010), Table D.2. Borrowing by sector.

increasing their savings to pay off their debts that ballooned in the run-up to the crisis. The deleveraging process inside the private sector will take some time. The increase in public debt has accompanied this process.⁴³

While public spending increases have contributed to increased public deficits and the stock of debt, the sharp recession-induced fall in tax revenues is the main reason government borrowing requirements have grown.⁴⁴ And yet, most governments, particularly in the largest economies, have faced little difficulty selling their bonds at prices which yield a very low rate of interest. Public borrowing is not crowding out private borrowing at present in countries such as Germany, Japan, the United States, and many others.

The most effective way to reduce deficits and debt ratios is likely to be through sustainable growth. A strong and sustained expansion would boost tax revenues and lead to lower expenditure on unemployment benefits and other social protection expenditures. However, a premature fiscal consolidation could damage growth and lead to even larger deficits and debts.⁴⁵ After all, it is both the numerator and the denominator that determines the size of debt to GDP ratios. In some countries, very rapid fiscal mobilization efforts have unfortunately become unavoidable because of serious excess spending and lack of tax collection in the past. But in many other countries, securing recovery and transition to a strong, sustainable and balanced growth path will generally require a carefully timed shift in fiscal policy from expansion to consolidation, in step with a pickup in private sector investment and consumption. Abrupt shifts in fiscal policy stances, in many countries at the same time, could destabilize recovery and weaken future growth. A credible and gradual return to fiscal stability over several years is likely to be a more successful strategy, not only for recovery and growth, but also for deficit and debt reduction.⁴⁶

At whatever point a country chooses to initiate a fiscal consolidation process, it must be done in a way that maximizes fairness in its overall impact and is particularly sensitive to the most vulnerable. This includes not only reducing expenditures, but also ensuring increases in revenue. This will also require international tax cooperation to be stepped up. It is necessary to ensure the highest possible level of acceptance by public opinion and thus reduce social tensions. There is much understandable anger by many who feel they are paying the costs in their own lives of a crisis that is not of their making.

On the key issue of how to pace and time a return to a more sound fiscal position that is consistent with securing recovery and growth, a convergence of policies is required:

- Significantly reducing debt indicators requires a long timeframe in order to make space for the immediate measures needed to stimulate sustainable growth and jobs. A politically and socially viable process of fiscal consolidation needs to take place in the context of a stable recovery of global growth. Social dialogue is essential to avoiding an explosion of social unrest.
- It is vital to ensure that well-sequenced, coordinated short-term exit strategies and deficit reduction policies are linked to a progressive recovery of the real economy and

⁴³ M. Wolf: "This global game of 'pass the parcel' cannot end well", in *Financial Times* (London), 29 June 2010.

⁴⁴ IMF: *IMF Fiscal Monitor series: Navigating the fiscal challenges ahead*, World Economic and Financial Surveys (Washington, DC, May, 2010), 14 May, <http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf> (accessed 22 Aug. 2010).

⁴⁵ ILS: *Promoting employment recovery while meeting fiscal goals*, Policy brief (Geneva, ILO, 2010).

⁴⁶ ILO: Recovery and growth with decent work, Report of the Director-General, International Labour Conference, 99th Session, Geneva, 2010, http://www.ilo.org/global/What_we_do/Officialmeetings/ilc/ILCSessions/99thSession/reports/lang--en/docName--WCMS_140738/index.htm (accessed 22 Aug. 2010).

jobs, and the protection of the most vulnerable. Measures should be tailored to specific country situations. There are significant differences between and within the countries of Europe, other developed countries, emerging economies, and least developed countries. It is essential to put in place multilateral policies to support an orderly, long-term management of debt repayments and cost-sharing at a pace that does not damage recovery.

- Along with a fiscal strategy for recovery and growth, key issues in policies relating to financial markets need to be addressed. Re-establishing normal credit flows, especially in countries hit hardest by the financial crash, is not yet complete, and is increasingly urgent. For more balanced growth into the medium term, reforms need to create incentives for a financial system at the service of the real economy, to act as a driving force for a strong, sustainable and balanced pattern of growth, channelling savings to lending for innovation, investment, trade and consumption.

Looking to the medium term, many countries, initially in the developed world, will need to review fiscal policies in the light of an increase in the dependant share of the population as a result of the demographic phenomenon of ageing. A key part of strategies for strong, sustainable and balanced growth during a period when dependency ratios are increasing in a number of countries will be increased participation in employment among the working-age population and rising productivity levels.

Capital mobility heightens the importance of coordinating such strategies to avoid the risk that the collective result of individual countries' decisions does not stop global recovery. Countries most exposed to a sudden halt in foreign purchases of their sovereign bonds will need international support to create the time needed for effective adjustment measures. Investors in sovereign bonds who did not exercise sufficient care in the past should also share in the costs of such adjustment measures.

A further concern is that, with the private sector still weak, governments may not feel able to raise taxes except perhaps on the wealthy. The difficulty will be finding cuts that avoid damaging those most at risk in the recession. For example, cuts in unemployment benefits would hurt those already carrying the cost of recession and would weaken demand still further.

Longer-term challenges for economic policy

Looking towards the longer term, sustainable growth requires structural change and productivity growth.⁴⁷ A common feature of sustainable job-rich growth in many countries is investment in industries characterized by economies of scale and potential for productivity growth, as well as strong production and technological linkages throughout the economy.⁴⁸

For a number of developing countries, the industrial sector has historically been a key driver of overall productivity and employment growth.⁴⁹ More recent work has also demonstrated that the service sector contributed positively to total productivity growth for the rapid-

⁴⁷ This is the central argument of the structuralist macroeconomic perspective, see J.A. Ocampo, C. Rada and L. Taylor: *Growth and policy in developing countries: A structuralist approach* (New York, NY, Columbia University Press, 2009), C. Rada: "Stagnation or transformation of a dual economy through endogenous growth productivity," in *Cambridge Journal of Economics* (Oxford, Oxford University Press, 2007), Vol. 31, No. 5, pp. 711–740, and C. Rada and L. Taylor: *Developing and transition economies in the late 20th century: Diverging growth rates, economic structures, and sources of demand*, DESA Working Paper No. 34 (New York, NY, United Nations Department of Economic and Social Affairs, 2006).

⁴⁸ J.A. Ocampo et al: *Growth and policy in developing countries*, op.cit.

⁴⁹ U. Pieper: "Deindustrialization and the social and economic sustainability nexus in developing countries: Cross-country evidence on productivity and employment", in *Journal of Development Studies* (London, Routledge, 2000), Vol. 36, No. 4, pp. 66–99.

growing regions.⁵⁰ This combination characterized the most successful and dynamic late-developing countries, concentrated in East Asia, which relied heavily on exports to generate output growth.

It is possible to have a combination of structural change, productivity and employment growth that leads to substantial real wage increases, with the quantity and quality of employment increasing at the same time. Growing inequality and declining wage shares in many developed and developing countries suggests, however, that workers in many countries have not shared significantly in productivity gains in recent years. At the same time, the declining employment intensity of growth is a cause of growing concern.⁵¹ That is, any given increase in GDP translates into fewer jobs today than in the past. With a continued large increase in the labour force in the years ahead, and the existing stock of unemployed, this is troubling for many countries.

The counterpart of a decline in the employment intensity of growth is a rise in contribution of productivity to growth.⁵² This can lead to a broad increase in living standards, provided that increases in labour productivity are accompanied by increases in wages and household incomes. However, if wages lag behind productivity growth for prolonged periods, that and the declining employment intensity of growth will lead to a relatively weak increase in household incomes. In such circumstances, economies have to rely on either exports or increased household borrowing to sustain consumption as drivers of effective demand. Yet exporting cannot be a global strategy even if it can be important for individual countries, and the crisis has demonstrated starkly that debt-fuelled growth is not sustainable. The mechanisms through which productivity gains are allocated are thus an important component of policies to support a sustainable growth path.

Exporting will, of course, remain a vital component of the growth strategies of many countries, especially developing countries and those with relatively small domestic markets. As the size of major emerging market exporters has grown, the “fallacy of composition” argument against excessively export-oriented growth strategies has, however, become stronger. Current international financial arrangements place strong pressure on deficit countries to adjust by deflation, but surplus countries do not face equivalent obligations to stimulate domestic demand. The main issue, therefore, is how to develop markets for increased global output that are more diversified within a framework of international policy coordination that takes into account that globally net exports have to sum to zero. In the absence of coordination, there is a risk of a deflationary bias in the world economy as a result of national policies that are globally inconsistent.⁵³

Inequalities and economic instability

The world’s labour force represents a key supply-side component of growth. At the same time, its earnings drive consumption, the main force on the demand side of growth. For growth to be strong, sustainable and balanced, the sharing of the gains from productivity

⁵⁰ C. Rada and L. Taylor: *Developing and transition economies in the late 20th century*, op.cit.

⁵¹ S. Kapsos: *The employment intensity of growth: Trends and macroeconomic determinants*, Employment Strategy Department (Geneva, ILO, 2005), ILO: *A broad reckoning of GDP and employment gaps over 2008 to 2011*, Economic and Labour Market Analysis Department, Mimeo (Geneva, 2010), and ILO: *Key indicators of the labour market (KILM)*, 4th ed. (Geneva, 2006).

⁵² Productivity as a concept is derived from definitions of production for the purpose of generating national accounts. These definitions do not include or undervalue the “social productivity” of the care economy. There is growing interest in trying to find better ways of capturing socially valuable activity, as highlighted in the recent report by the Commission on the Measurement of Economic Performance and Social Progress chaired by Joe Stiglitz, Amartya Sen and Jean-Paul Fitoussi, <http://www.stiglitz-sen-fitoussi.fr/en/index.htm> (accessed 22 Aug. 2010).

⁵³ It is important to distinguish “export orientation” from “trade orientation”. Increasing shares in the sum of exports and imports can, of course, occur in all countries and be globally consistent.

growth must also be well balanced. The distribution of income is not just a matter of social equity; if concentrated at the very top, it can also be a potential source of economic instability.

In the wake of the current crisis, there is an emerging view about the significance of growing inequality as one of the causes of global crises past and present. The rise in recent decades of inequality and its relationship to growth performance within countries has been widely remarked and studied.⁵⁴ Branko Milanovic describes the patterns of inequality leading up to the Great Depression and the current crisis:

To go to the origins of the crisis, one needs to go to rising income inequality within practically all countries in the world, and the United States in particular, over the last thirty years. In the United States, the top 1 per cent of the population doubled its share in national income from around 8 per cent in the mid-1970s to almost 16 per cent in the early 2000s. That eerily replicated the situation that existed just prior to the crash of 1929, when the top 1 per cent share reached its previous high watermark. American income inequality over the last hundred years thus basically charted a gigantic U, going down from its 1929 peak all the way to the late-1970s, and then rising again for thirty years (2009)... So, a huge pool of available financial capital – the product of increased income inequality – went in search of profitable opportunities into which to invest... Overwhelmed with such an amount of funds, and short of good opportunities to invest the capital as well as enticed by large fees attending each transaction, the financial sector became more and more reckless, basically throwing money at anyone who would take it (Milanovic, 2009).⁵⁵

In his extended inquiry into the causes of the current crisis, Rajan refers to a set of interacting “fault lines” in the global economy. One arises from domestic economic and political dynamics, particularly in the United States, and another arises from the trade imbalances resulting from domestic imbalances. An additional set of fault lines is formed from how these trade imbalances are sustained by financial systems of fundamentally different workings. Rajan writes that “The most important example of the first kind of fault line...is rising inequality in the United States and the political pressure this has created for easy credit”.⁵⁶

These accounts share a broadly similar line of argument. Lower- and middle-income groups spend more of their incomes on day-to-day needs, and higher income groups are less constrained in when and how they spend. In this context, growing inequalities, as well as stagnant real wages, tend to weaken aggregate demand. Yet, in spite of earnings stagnation and inequality trends, national household consumption rates in the United States increased and household savings rates declined,⁵⁷ to an extent which some economists have long argued exceeded the limits of sustainability.

⁵⁴ United Nations: *Report of the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System* (New York, NY, 2009), p. 18, and R. Reich: “Unjust spoils”, in *The Nation* (New York, NY, 2010), 19 July, <http://www.thenation.com/article/36893/unjust-spoils> (accessed 10 Aug. 2010). See also R. Rancière: “Les inégalités ont préparé la crise financière”, in *Libération* (Paris, 2010), 29 June.

⁵⁵ B. Milanovic: “Two views on the cause of the global crisis”, in *YaleGlobal* (Washington, DC, Carnegie Endowment for International Peace), 4 May 2009, <http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=23053> (accessed 22 Aug. 2010). For data on top income earners for the United States and other countries, see A.B. Atkinson, T. Piketty and E. Saez: *Top incomes in the long run of history*, op.cit.

⁵⁶ R.G. Rajan: *Fault lines*, op.cit., pp.7–8.

⁵⁷ W. Godley: *Seven unsustainable processes: Medium-term prospects and policies for the United States and the world*, Special Report (New York, NY, The Levy Economics Institute of Bard College, 1999), and D.B. Papadimitriou et al: *Is personal debt sustainable?*, Strategic Analysis (New York, NY, The Levy Economics Institute of Bard College, 2002).

This was made possible by the combination of innovations in financial risk management, low interest rates, increased consumer debt, and large increases in housing prices creating perceptions of much greater household wealth. In other words, increasingly indebted United States households acted as “the global consumer of last resort”, enabling rapid global growth but also giving rise to widening current account imbalances,⁵⁸ despite the lack of broad-based growth in household real incomes. And a number of observers argue that these imbalances were an important cause of the global crisis.⁵⁹ While global growth may have been relatively rapid in recent years, it was not growth accompanied by balanced and sustainable demand structures and a broad-based rise in living standards in many countries.

The role of growing inequality in current account deficit and current account surplus countries has, however, had different consequences: growing inequality was accompanied by low savings rates in current account deficit countries, but at the same time it is thought to have been an important cause of high savings in current account surplus countries.⁶⁰ Inequality as one of the causes of high savings in Asia has also been widely discussed.⁶¹

In the USA, many private households have reacted to stagnating real incomes by increasingly extending their borrowing. This was facilitated by a deregulated financial system.... The opposite holds for Germany: here the weak wage dynamics and social spending cuts have induced consumption restraint rather than higher debt, thus causing an extended period of weak domestic growth. High capital exports and a strong (and risky) foreign market involvement of the banking sector...were the flip side of the extreme export hikes of the German economy, which were enhanced by weak wage increases. In the current financial crisis the limits of these opposite growth models become evident: both are based on the necessity to compensate the sluggish trend resulting from an increasing income inequality with other sources of demand. These consisted either in increased household borrowing (USA, UK, Spain) or in export-led growth (Germany, Japan, China) (Horn et al., 2009).

The United Nations Commission of Experts report on the global crisis gives a useful account of the causes of inequality:

There were many forces contributing to this growth in inequality, including asymmetric globalization especially, that facilitated the greater ease of the movement of capital than of labour, the weakening of labour unions, deficiencies in corporate governance, and a breakdown of social conventions which resulted in greater disparities in compensation between top executives and other workers. Finally, it was believed that increasing after-tax remuneration and providing other economic incentives, like non-monetary benefits, would increase savings, labour supply, investment, and thus growth. These problems were exacerbated by the reduction of progressivity in tax structures in some countries (United Nations: Report of the Commission of Experts, 2009, p. 26).

A broad literature now attributes a significant part of growing inequality in the United States, the United Kingdom, Germany and other countries to the weakening of trade unions and

⁵⁸ I. Goldfajn: “Rebalancing the global economy: A view from the BRICs”, in S. Claessens, S. Evenett and B. Hoekman (eds): *Rebalancing the global economy: A primer for policymaking* (London, Centre for Economic Policy Research, 2010), p. 114.

⁵⁹ S. Claessens, S. Evenett and B. Hoekman (eds): *Rebalancing the global economy*, op.cit.

⁶⁰ G. Horn et al: *From the financial crisis to the world economic crisis: The role of inequality*, IMK Policy Brief, Oct. (Duesseldorf, Hans Boeckler Foundation, Macroeconomic Policy Institute (IMK), 2009).

⁶¹ J.-W. Lee: “Asia’s role in global rebalancing”, in S. Claessens, S. Evenett and B. Hoekman (eds): *Rebalancing the global economy*, op.cit., and L.Y.C Lim: “Rebalancing in East Asia”, in S. Claessens, S. Evenett and B. Hoekman (eds): *Rebalancing the global economy*, op.cit.

collective bargaining.⁶² Other authors additionally point to the falling real value of the minimum wage and weakened social protection as causes of inequality in the United States.⁶³

The causes of inequality vary across countries and over time, and other analysts have placed different weight on the several forces at work. The effect of skill-biased technical change is central to Rajan's and many other accounts of growing inequality in the United States.⁶⁴ The basic line of argument is that the falling relative demand for low-skilled workers (relative to high-skilled workers) more than offsets the falling relative supply of low-skilled workers, leading to downward pressure on their wages. Skill-biased technical change is commonly associated with the increased use of computers in the workplace.

This view is contested particularly by those who see a weakening of redistributive policies as a more important factor. A 2002 survey argues that the evidence for skill-biased technical change is debatable on several grounds, notably that growing inequality was concentrated in the 1980s whereas the computerization of the workplace did not take off until the 1990s, and moreover that the falling relative supply of low-skilled workers would seem to have overwhelmed the falling relative demand, rather than the other way around.⁶⁵ Yet another study finds that upper-tail wage inequality (measured by the ratio of wages at the D9 and D5 deciles) continued to increase after the 1980s, and that this increase may be consistent with a modified version of the skill-biased technical change hypothesis. In this version, information technology is argued to complement the tasks of the most highly-skilled workers, but to substitute for the tasks of medium-skilled workers, leading to a hollowing out of middle jobs.⁶⁶

A synthesis of the debate over the causes of widening inequality suggests that the pressures of intensified global competition and technological change are stretching the earnings distribution and hollowing its middle range, and that the ability of employment and social protection institutions to counteract these trends was weakened over the same period of accelerating globalization.

Global imbalances and policy responses

Whether an economy tends to generate close to full employment or whether it is characterized by frequent and substantial amounts of unemployment critically depends on whether effective demand expands at a rate close to potential output. "Desired" consumption, investment and net exports must expand at a rate equal to the expansion of productive

⁶² See, for example, A. Gosling and T. Lemieux: *Labour market reforms and changes in wage inequality in the United Kingdom and the United States*, NBER Working Paper No. 8413 (Cambridge, MA, National Bureau of Economic Research, 2001); D. Card: "The effect of unions on wage inequality in the U.S. labour market", in *Industrial and Labour Relations Review* (Ithaca, NY, Cornell University, 2001), Vol. 54, No. 2, pp. 296–315, C. Dustmann, J. Ludsteck and U. Schönberg: *Revisiting the German wage structure*, IZA Discussion Paper No. 2685 (Bonn, Institute for the Study of Labour (IZA), 2007), and S. Hayter and B. Weinberg: forthcoming.

⁶³ D. Card and J.E. DiNardo: "Skill-biased technological change and rising wage inequality: Some problems and puzzles", in *Journal of Labour Economics* (Chicago, IL, University of Chicago Press, 2002), Vol. 20, No. 4, pp. 733–783, and R. Reich: "Unjust spoils", op.cit.

⁶⁴ F. Jaumotte, S. Lall and C. Papageorgiou: *Rising income inequality: Technology, or trade and financial globalization?*, IMF Working Paper No. 185, Research Department (Washington, DC, International Monetary Fund, 2008).

⁶⁵ D.R. Howell: *Increasing earnings inequality and unemployment in developed countries: Markets, institutions and the 'unified theory'*, SCEPA Working Paper 2002-01 (New York, NY, Schwartz Center for Economic Policy Analysis, 2002).

⁶⁶ D.H. Autor, L.F. Katz and M.S. Kearney: "Trends in U.S. wage inequality: Revising the revisionists", in *The Review of Economics and Statistics* (Cambridge, MA, MIT Press, 2008), Vol. 90, No. 2, pp. 300–323.

capacity, itself determined by the growth of the labour force and the increase in labour productivity.⁶⁷

Because net exports are a component of aggregate effective demand, it is possible for a particular country to reduce a gap between its potential output and the effective demand for that output by increasing net exports to other countries, thereby reducing domestic unemployment. However, because aggregate worldwide net exports must sum to zero, it is not possible for all countries simultaneously to increase their net exports as an employment enhancing strategy.

It is possible to envision a global growth path along which the “desired” positive net exports of some countries are matched by the “desired” net imports of other countries. On such a growth path there could be large current account surpluses matched by large current account deficits, but these would reflect effective demand matching effective supply for the outputs of each country, as well as aggregate world demand matching aggregate world supply. The problem arises when, for some countries at least, desired demand falls short of potential supply, so that worldwide demand does not add up to worldwide supply. This leads to deflationary pressures that result in supply and demand balancing at lower levels of output and employment. In the context of the employment challenge, the much discussed “global imbalances” must therefore be analysed within a framework that links global and national effective demand and supply.

In normal times, variations in interest rates coupled with adjustments to fiscal policies may be sufficient to ensure that there is sufficient effective demand to allow GDP to grow close to the rate of expansion of potential output. But interest rate variations may not always be able to bring about equilibrium. Apart from leads and lags delaying adjustment, there are Keynesian “liquidity trap” periods during which interest rates lose their power, as there is insufficient effective demand even at near-zero interest rates.

Another set of constraints on conventional macroeconomic policies arises from capital mobility in open economies. A prolonged period of low-interest rates runs the risk of creating speculative bubbles of asset inflation which, as recent experience shows, can eventually have disastrous consequences. Very low interest rates also fuel large-scale international speculative flows, in which borrowing takes place in low-interest countries with reasonably stable exchange rates for investment in more attractive markets. This can lead to large in- and out-flows of capital, with destabilizing effects both nationally and at the global level.⁶⁸

Declining wage shares, rising inequality and weak growth in formal employment thus contribute to national and international imbalances. Both threaten to produce a period of weak world growth and continued high unemployment. Additional policy tools focussed on labour markets and income distribution, will be needed in the longer run to supplement fiscal and monetary policies (see Part C) .

While a complex interplay of factors led to the global financial crisis of 2007–09, there is the widely shared view that global imbalances over the past ten years – the juxtaposition of large

⁶⁷ The increase in labour productivity in turn is determined by the growth of productive knowledge and various forms of capital accumulation, including human capital accumulation.

⁶⁸ The U.S. was a notable exception for a long period in the run-up to the global crisis, when the country was able to combine low interest rates with large capital inflows, which were driven by capital gains earnings resulting from the asset bubble as well as the US-dollar status as the world reserve currency. The United States also had large capital inflows in early-2010, with the weakening of the Euro. See S.C. Johnson: “U.S. sees record capital inflow”, in *Reuters*, 17 May 2010, <http://www.reuters.com/article/idUSTRE64G4DL20100517> (accessed 22 Aug. 2010).

current account deficits and surpluses in the world economy – played an important role.⁶⁹ Action on several fronts is needed, including reform of global economic and financial governance, even if such complex global collective action may take time to unfold. While factors such as exchange-rate misalignments cannot be ignored, it is equally important to remedy the roots of global imbalances and inequalities, which ultimately lie in national imbalances that underpin saving–investment gaps in both deficit and surplus countries, as discussed above.⁷⁰

The Great Recession of 2008–09 has demonstrated, in stark fashion, the enormous costs of complacency in addressing global imbalances. It will certainly be important to develop an approach that does not add to deflationary pressures. Slowing imports in deficit countries, for example, would narrow imbalances, as would slower growth in surplus countries exports, but perhaps at the price of renewed global recession, and with serious consequences on poverty and unemployment.

Alternatives that generate growth in domestic demand, particularly in surplus countries, would enable an adjustment in recovery and also reduce the adjustment burden on deficit countries. Similarly, facilitating flows from surplus countries to developing countries suffering from a dearth of capital and a need to accelerate progress in the reduction of poverty would also point towards growth, at the same time as reducing imbalances.⁷¹ The clearest path to economic development for smaller, poorer developing countries remains through strengthening linkages with the global economy, for these countries have limited domestic demand potential.

However, as the Asian Development Bank points out, this strategy requires markets capable of absorbing large quantities of manufactured goods. The global financial crisis has made evident that the persistence of such markets is not inevitable.⁷² The counterpart to the export growth model was the debt-driven growth model of some major importing countries. Exports are an important part of the development dynamic, but equal focus needs to be paid to ensuring that markets grow sustainably, which in large measure is a question of ensuring that household incomes mainly derived from wages also grow. Rebalancing will require policy shifts in both surplus and deficit countries in order to support the growth of productive employment, together with a broad-based growth of wage incomes.

National initiatives for “rebalancing” also depend crucially on accelerating regional cooperation. Rebalancing requires a strong mutual commitment: in the absence of effective cooperation, individual countries might hesitate to adopt the appropriate corrective action because of the concern that other countries might not play their part. Given the importance of growing trade within regions, this suggests an important policy coordination role for regional bodies, prominent among them the European Union, the Asia-Pacific Economic Cooperation (APEC), the North American Free Trade Agreement (NAFTA), the Southern Common Market (MERCOSUR), the Association of Southeast Asian Nations (ASEAN) Free Trade Area (AFTA), and the Common Market for Eastern and Southern Africa (COMESA), as well as other regional integration groups.

⁶⁹ J.A. Frieden: *Global imbalances, national rebalancing, and the political economy of recovery*, Center for Geoeconomic Studies and International Institutions and Global Governance Program Working Paper, Oct. (New York, NY, Council on Foreign Relations, 2009).

⁷⁰ Some scholars reject the view that exchange-rate misalignments have played any major role in the evolution of global imbalances. See, for example, McKinnon and Schnabl (2006). This literature interprets global imbalances as the reflection of a persistent discrepancy between savings and investment in the United States and its mirror-image discrepancy in China. According to this view, a change in the exchange rate will not make a significant dent on savings or investment.

⁷¹ K. Derviş: “Growth after the storm: The longer-run perspective”, The Per Jacobson Foundation Lecture, Istanbul, 4 Oct. 2009, <http://www.perjacobsson.org/lectures/051810.pdf> (accessed 22 Aug. 2010).

⁷² Asian Development Bank (ADB): *Asian development outlook 2009: Rebalancing Asia's growth* (Manila, 2009).

This is particularly the case within the European Union and the Eurozone countries, and for countries aspiring to join the European Union. Countries with a common currency or fixed exchange rates do not have the option of devaluation as a means of adjusting to differences in competitiveness. They will therefore need to strengthen labour market policies, including mechanisms of social dialogue, to assure timely and effective adjustments to any emerging deterioration in unit labour costs. Members in persistent surplus should also develop mechanisms to maintain buoyant domestic demand, thereby avoiding the emergence of major payments imbalances.

From a global perspective, establishing a path of balanced global growth that is sufficiently stable to prevent future crises will require a policy framework that is focussed on ensuring that employment growth matches the expansion of labour supply and that wages broadly keep pace with productivity. Hard-won control of inflation should not be sacrificed while aiming to achieve a faster and steadier pace of growth.

These global objectives are the sum of very different national circumstances, which require different, but internationally consistent, strategies. Coordination around agreed goals and priorities is thus becoming increasingly important. A number of the issues that will need to be addressed revolve around the interplay of employment and social policies with international and national macroeconomic policy strategies. Although the labour market institutions that contribute to job-rich growth have evolved differently in each country, a number of key policy issues, outlined in Part C, are common to most countries. Increased exchange of information and policy dialogue on the way in which labour market policies and institutions interact with growth policies is an important dimension of international cooperation.

Rectifying global imbalances without causing a prolongation of the recession will require the development of larger domestic and regional markets that can support output increases that generate large numbers of decent work opportunities. This, in turn, means developing mechanisms to ensure that the gains from rising productivity are widely distributed in the form of increasing wages and improved social protection systems. A further consequence of such measures is a reduction in the need for the middle classes, particularly in the emerging and developing world, to build high levels of precautionary savings for old age and the risk of ill-health by forgoing consumption. Such rebalancing in both developing and advanced surplus countries, coupled with investments in infrastructure, education and protecting the environment, can help set the global economy on a sustainable development path.

C. Employment and social policies in the framework for strong, sustainable and balanced growth

Priorities for strengthening labour markets

Generating a job-rich recovery and transitioning to a sustainable growth path will require a combination of effective labour market policies and macroeconomic policies to support a balanced global expansion of demand. A new policy approach for strong, sustainable and balanced growth requires structural reforms to create more inclusive labour markets, active labour market policies, quality education and training programmes, and social protection, particularly for the most vulnerable. The analysis in Part B points to three interconnected priorities in strengthening labour market institutions:

- Assuring improved living standards and purchasing power for working families through improving mechanisms for wage determination.
- Promoting overall productivity growth through support to worker mobility and micro- and small-business development.

- Narrowing income inequalities through more inclusive labour markets, greater effective progressivity in tax systems, and stronger social protection systems.

The economic transformation brought about by a period of radical technological change, trade opening and the liberalization of capital markets has provoked substantial changes in the world of work.⁷³ These changes have accentuated the need to improve the institutional framework constantly to facilitate dynamic efficiency along with equity.

The effective functioning and adaptation of labour market institutions depend to a large extent on the support they attract from all actors in the world of work. Fairness matters a great deal, especially at a time when many feel that their lives have been damaged through no fault of their own. Social dialogue in its many forms is one of the main mechanisms that enables considerations of fairness and the drive for efficiency to be brought together in policy choices. While each country has its own set of institutions that evolved from its particular circumstances, social struggle and history, the suggested three interconnected priorities are common to a wide range of advanced, emerging and developing countries.

The prevailing orthodoxy of the economics profession towards the end of the twentieth century was that labour market institutions were causing rigidities that were holding back adjustment to change. However, the record of the wave of deregulation that this view stimulated has been mixed. In too many countries, inequalities have widened, good jobs were not generated in sufficient quantity to meet society's needs, and problems of unemployment, underemployment and poverty persisted.⁷⁴

A more nuanced and comprehensive view is taking hold of the need for effective and modernized labour market institutions in both advanced and developing countries.⁷⁵ As Albert Rees, the renowned labour economist who also served on United States government bodies and company boards dealing with pay remarked:

*In none of these roles did I find the theory I had taught for so long to be of any help. The factors involved in setting wages and salaries in the real world seemed to be very different from those specified in neoclassical theory. The one factor that seemed to be of overwhelming importance in all these situations was fairness.*⁷⁶

Efficient working relations require a high degree of trust that the parties will treat each other fairly – “a fair day's wages for a fair day's work” as the old adage put it – and that the relationship will not be severed arbitrarily.⁷⁷ Establishing mechanisms for setting wages and other conditions of employment that are accepted as reasonably fair encourage both parties to invest in learning how to do the job well, improve work performance, and enhance the value of the product.⁷⁸

⁷³ ILO: *Changing patterns in the world of work*, Report of the Director-General, International Labour Conference, 95th Session, Geneva, 2006.

⁷⁴ J. Stiglitz: “Needed: A new economic paradigm”, in *Financial Times* (New York, NY), 19 Aug. 2010.

⁷⁵ See T. Boeri and J. Van Ours: *The economics of imperfect labour markets* (Princeton, NJ, Princeton University Press, 2008), A. Manning: *Monopsony in motion: Imperfect competition in labour markets* (Princeton, NJ, Princeton University Press, 2005), J. Berg and D. Kucera (eds): *In defence of labour market institutions* (Basingstoke, Palgrave Macmillan, 2008), and S. Lee and D. McCann (eds): *Regulating for decent work: New directions in labour market regulation* (Basingstoke, Palgrave MacMillan, forthcoming).

⁷⁶ Cited in G.A. Akerlof and R.J. Shiller: *Animal spirits: How human psychology drives the economy and why it matters for global capitalism* (Princeton, NJ, Princeton University Press, 2009), p. 20.

⁷⁷ D. Marsden: *A theory of employment systems: Micro-foundations of societal diversity* (Oxford, Oxford University Press, 1999), p. 298.

⁷⁸ The Declaration of Philadelphia calls for “policies in regard to wages and earnings, hours and other conditions of work calculated to ensure a just share of the fruits of progress to all, and a minimum living wage to all employed and in need of such protection” (Article III(d)).

Modern economies are characterized by high levels of job creation and job destruction.⁷⁹ Such reallocation is central to productivity growth. Labour market institutions need to foster both good, stable employment relations and an efficient dynamic of labour mobility. By doing so, they can enhance the productive capacity of the economy to generate enough decent work opportunities to support and improve good living conditions for the population.

Concern is increasing that these strategic medium- to long-term considerations have been pushed aside by short-term pressures from finance markets on individual businesses to manage with an immediate financial performance perspective and avoid longer-term commitments to workers.⁸⁰

This section of the report discusses how a new approach to the role of labour market institutions could contribute to a strong, sustainable and balanced growth. It is imperative that reforms promote inclusive labour markets so that recovery is equitable and balanced, facilitating the participation of informal workers and other marginalized groups. This is particularly important in countries seeking to move away from deeply segmented labour markets.

A new approach is most likely to be successful by combining innovation and evolution, drawing on a wide range of experience in different countries. In this context, expanding South–South cooperation can be especially important.

Strong labour market institutions help ensure that trade-offs and trade-ins in the search for efficiency, equity and dynamism are identified and addressed, and if mistakes are made, that they are quickly corrected. Active engagement of representative organizations of workers and employers through mechanisms of social dialogue, based on respect for fundamental principles and rights at work, can ensure that practical knowledge of the impact of policies is well appreciated and that the key actors in the labour market have a commitment to making policies work on the ground. Increasingly, national choices about labour market institutional arrangements are informed by experience from other countries and can draw on international labour standards for guidance.

Strengthening mechanisms for wage determination

A central issue is the construction of a framework of labour market institutions which help produce wage outcomes that, from a macroeconomic perspective, are conducive to maintaining aggregate demand and sustainable growth and that, from a more microeconomic perspective, establish efficient and equitable pay relationships.

On the macroeconomic side, this entails a pattern of wage development that fosters growth in consumption, investment and employment. An added consideration is that unit labour costs should stay competitive with trading partners. Overall, this implies that real wages in aggregate should grow more or less in line with productivity. Wage increases should also be consistent with a stable and low level of inflation.

On the microeconomic side, the determination of wages should contribute to good working relations that foster productivity improvement and thus the sustainability of enterprises. Systems should also allow pay relativities for different sectors and occupations to shift over time. Wage levels and their interaction with social security systems should encourage businesses to hire unemployed workers who, in turn, should be able to see that work pays.

⁷⁹ P. Cahuc and A. Zylberberg: *The natural survival of work: job destruction and creation in a growing economy* (Cambridge, MA, MIT Press, 2006).

⁸⁰ R. Batt and E. Appelbaum: *Globalization, new financial actors and institutional change*, Paper delivered to the Colloquium on Work, Employment and Skills against the background of Globalization, Aix-en-Provence, 27–28 May, 2010.

The characteristics of systems of wage determination vary widely. In some countries, most private employers set wages unilaterally or in an individual negotiation with the employee. In others, wages for many workers are set by collective bargaining by employers or their organizations, with unions representing workers. And there are many and varied levels and structures for bargaining.

Government also plays an important role in wage developments by creating an enabling environment for collective bargaining, participating in the determination of minimum wages, and also as a major employer itself. Public sector pay determination can have a direct effect on the economy through its effects on the government budget and through its interaction with private sector pay.

Public sector pay is frequently determined through bargaining around comparability with the private sector. If the public sector “gets ahead” of the private sector, it can provoke private sector wage increases that undermine competitiveness. Likewise, if it lags behind, difficulties can emerge in attracting, motivating and retaining valued employees, difficulties that eventually have to be remedied by catch-up pay increases, which can destabilize the budget-making process. In some countries, prolonged periods of public sector pay restraint, and even non-payment of wages, have contributed to a severe deterioration in the provision of public services and in the standards of governance. An important component of a credible medium-term framework for fiscal stabilization is confidence in a system of pay determination that ensures a stable path for public sector salaries and conditions, including the prospect of career opportunities that lead to a decent pension.

From the perspective of macroeconomic management, some degree of coordinated influence on wage development is desirable and can help to avoid the pitfalls of over- or undershooting the range of pay rises consistent with productivity growth and inflation control. As noted in Part A, wages have lagged behind productivity in many countries in recent years, thereby contributing to the build-up of serious economic imbalances. Such macroeconomic trends are the aggregation of countless employment relationships in which wages are a key feature. The policy challenge is to establish institutions which signal effectively to employers and workers the scope for wage improvements that the economy as a whole can support, and how that scope might evolve in the future.

Minimum wages

In many countries, widening wage inequality has led to a renewed interest and experimentation with minimum-wage-fixing mechanisms. Ninety per cent of ILO member States have some form of minimum wage. A recent analysis of trends in 100 countries shows a clustering of minimum wage levels in most countries at around 40 per cent of the average wages. Countries have also been upgrading minimum wages between 2001 and 2007, with substantial real gains for those earning minimum wages in both developed economies (+3.8 per cent) and developing countries (+6.5 per cent).⁸¹ While some countries have decided to hold minimum wage increases in the crisis, others, notably Brazil, have adjusted upwards without adverse consequences for employment. The experience of the United Kingdom over the past decade, where the introduction of a national minimum wage contributed to a reduction in poverty without major job losses in marginal industries and occupations is also informative.⁸²

Minimum wages are part of policies to attack poverty, but they need to work in tandem with social protection systems, including in-work benefits to vulnerable households. An important foundation for wage setting at the lower end of the pay scale would thus appear to be a legal minimum wage. The Minimum Wage Fixing Convention, 1970 (No. 131), provides a

⁸¹ ILO: *Global wage report 2008/09*, op.cit.

⁸² Low Pay Commission: *National minimum wage: Low Pay Commission report 2010*, Cm 7823 (London, The Stationery Office, 2010), para. 2.76.

framework that is widely used to guide legislation and is supported by considerable research on the practical experience of a range of countries.

The lessons of recent experience suggest that mechanisms for setting minimum wages should aim to:

- Avoid long periods without adjustments during which the real value is likely to diminish, weakening the beneficial effects on vulnerable workers' incomes and eventually requiring sizeable "catch-up" increases.
- Avoid large and abrupt upward movements to diminish the risk of adverse effects on employment.
- Set a wage level or levels with the close engagement of employers and unions so as to reach a well-balanced conclusion.
- Provide the wage-setting body with adequate information and research.
- Keep the system manageable and simple, as multiple tiers of minimum wage rates do not necessarily yield better results.
- Ensure well-targeted compliance measures to ensure that legally binding minimum wages are applied in practice.⁸³

In addition to protecting the most vulnerable workers, many of whom are women, minimum wage upgrades can provide a reference for the scope for wage developments more generally. This can be particularly important at a time of deficient demand in order to stave off the risks of deflation and to boost consumer demand.

Social dialogue and collective bargaining

The decline in the wage share in national income and the widening of wage inequalities has coincided with a weakening of trade unions and collective bargaining in many countries.⁸⁴ Explanations for this include changes in legislation or a rollback in policy support, and the increased mobility of capital and structural changes that reduced employment in sectors that were strongly unionized and increased employment in sectors of low unionization. Overall, the effect is a weakening of the bargaining power of labour in its relations with employers, which has contributed to the tendency for wages to lag behind productivity. The promotion of union representation and collective bargaining in the changed employment environment would help to prevent imbalances in labour markets that have contributed to economic instability. International labour standards provide for a wide variety of collective bargaining structures appropriate to national circumstances.⁸⁵

In this regard, interesting and potentially important steps are being taken in China to improve the legislative framework for labour relations. Since the first half of 2008, several new laws aimed at preventing the non-payment of wages and a range of other labour abuses were adopted. Further progress towards laws and practices that are consistent with international labour standards could help the Chinese government to achieve its objectives of increased

⁸³ There is some evidence that wages in the informal economy often adjust with changes in the minimum wage, even though they are unlikely to be legally enforced. See S. Devereux: "Can minimum wages contribute to poverty reduction in poor countries?", in *Journal of International Development* (Malden, MA, John Wiley & Sons, 2005), Vol. 17, No. 7.

⁸⁴ S. Hayter and B. Weinberg: forthcoming.

⁸⁵ The Right to Organise and Collective Bargaining Convention, 1949 (No. 98), specifies that "Measures appropriate to national conditions shall be taken, where necessary, to encourage and promote the full development and utilisation of machinery for voluntary negotiation between employers or employers' organisations and workers' organisations, with a view to the regulation of terms and conditions of employment by means of collective agreements." The Collective Bargaining Convention, 1981 (No. 154), and its accompanying Recommendation (No. 163) further elaborate on the means available to support the practice.

income equality, greater reliance on domestic demand and sustained high levels of economic growth.⁸⁶

As well as changes in laws, there have been important shifts in bargaining practice. Management and trade unions across a broad range of countries have strived to limit job cuts and reduce costs in credit-starved companies by negotiating agreements at the intersectoral, sectoral or company level on wage restraint (including wage freezes, reductions in wages and/or the postponement of one-off payments), the temporary reduction of working time, internal mobility, and voluntary retirement.⁸⁷ In a number of countries, public subsidies for short-time working arrangements are linked to agreements between unions and employers.⁸⁸

Some of the more innovative examples of crisis response agreements have widened the bargaining agenda and have led to increased cooperation between management and workers, aiming to reduce unit labour costs through productivity-enhancing improvements in work organization in exchange for job guarantees.⁸⁹ The topics for negotiation can include training, the transfer of workers into more productive units, multiskilling, investment in new products or technology, and functional flexibility.⁹⁰ Transnational framework agreements signed between multinationals and global union federations, particularly in Europe, have provided important frameworks for company-level agreements on restructuring.⁹¹

Research on whether any particular set of bargaining arrangements is more conducive to employment and output growth has produced divergent findings for different countries in different periods.⁹² One consistent finding is that collective bargaining structures that are more encompassing and coordinated are associated with less wage inequality.⁹³

After several years of neglect in many countries, it is time to give greater support to collective bargaining, including through strengthening coordinating mechanisms at national

⁸⁶ For a review of some further reforms that might be considered, see S. Cooney: “Making Chinese labour law work: The prospects for regulatory innovation in the People’s Republic of China”, in *Fordham International Law Journal* (New York, NY, Fordham University School of Law, 2007), Vol. 30, No. 4, and C.H. Lee: *Industrial relations and collective bargaining in China*, Industrial and Employment Relations Department, Working Paper No. 7 (Geneva, ILO, 2009).

⁸⁷ V. Glassner and M. Keune: *Negotiating the crisis? Collective bargaining in Europe during the economic downturn*, Industrial and Employment Relations Department, Working Paper No. 10 (Geneva, ILO, 2010), and S. Zagelmeyer: *Company-level bargaining in times of crisis: The case of Germany*, Industrial and Employment Relations Department, Working Paper No. 9 (Geneva, ILO, 2010).

⁸⁹ In South Africa, agreements reached by bargaining councils are extended to all firms in that sector operating in the formal and the informal economies. Collective bargaining agreements typically cover one-third of the labour market, with minimum wage determination addressing the remaining two-thirds (Budlender, 2009). In Uruguay, wage agreements that establish the minimum wage are negotiated in tripartite wage councils, which cover over 89 per cent of the labour market (Mazzuchi, 2009), and S. Hayter and B. Weinberg: forthcoming.

⁹⁰ T. Haipeter and S. Lehndorff: *Collective bargaining on employment*, Industrial and Employment Relations Department, Working Paper No. 3 (Geneva, ILO, 2009).

⁹¹ K. Papadakis: *Transnational company agreements on enterprise restructuring*, Industrial and Employment Relations Department, Briefing Note (Geneva, ILO, forthcoming).

⁹² A number of studies examine evidence for the “hump hypothesis” first put forward by Calmfors and Driffill (1988) and Freeman (1988). They find no evidence of a U-shaped bargaining relationship between bargaining coordination and economic performance. One consistent finding in the literature is that bargaining coordination is associated with less dispersion and lower 90/10 wage differentials. For a summary of the literature, see T. Aidt and Z. Tzannatos: *Unions and collective bargaining: Economic effects in a global environment* (Washington, DC, World Bank, 2002), and R.J. Flanagan: “Macroeconomic performance and collective bargaining: An international perspective”, in *Journal of Economic Literature* (Pittsburgh, PA, 1999), Vol. XXXVII, Sep., pp. 1150–1175.

⁹³ S. Hayter and B. Weinberg: forthcoming.

level, in order to connect macroeconomic considerations to decentralized determination of wages and conditions.

Tripartite consultations and negotiations on economic and social policies

Consultations and negotiations between governments and the social partners over broader economic and social issues tend to increase in periods of economic difficulty. In some cases, this has led to social pacts or some other form of centralized comprehensive agreement involving government, trade unions, employers' organizations and, in some countries, other groups from civil society.⁹⁴

The recent crisis over sovereign debt in member countries of the Eurozone placed considerable strain on often well-established practices of tripartite consultation and negotiation. Nevertheless, the social partners in Ireland reached a five-year agreement in June 2010 on how to handle fiscal retrenchment and significant reductions in public sector employment and pay. Although the negotiations were extended and several public service unions were not able to support the eventual agreement, a succession of successful social pacts in Ireland over the past two decades provided the experience and degree of trust required for successful negotiations even in the most difficult economic circumstances.⁹⁵

Since the recovery of democracy in the 1970s, Spain has also enjoyed a period of maturing social partnership, although maintaining that tradition has proven much more difficult in the present economic crisis. Spain initiated social dialogue when the severe downturn in the construction sector became apparent in the summer of 2008 and the social partners formulated an important agreement covering increased liquidity for companies, financial protection for housing construction, and reforms to the vocational training system. However, more recently, social dialogue broke down after dramatic cuts designed to cut labour costs and reform employment protection laws were initiated in fiscal expenditure proposals.

Experience with social dialogue over economic and social policies, in both normal and crisis times suggest four main conclusions.

First, tripartite institutions composed of senior political figures, such as members of the Cabinet and high-level representatives of the social partners, and with a mandate for negotiation (rather than just to consult), have proven to be the most effective. This type of arrangement works better than large advisory or consultative councils with heavy structures, complicated procedures, and little or no decision-making power.

Second, such negotiations work best where the agenda is reasonably comprehensive and scope exists for trade-offs and compromises between the groups involved. A narrow focus purely on labour cost reductions is unlikely to secure consensus.

Third, the agenda should include policies designed to protect and improve the situation of the most vulnerable workers, who are often unorganized, including those on temporary or atypical employment contracts and migrant workers.

Fourth, the parties need to commit to a long-term investment in the dialogue processes, as benefits may take time to be realized. It takes time to build trust in systems and partners. Trade unions and employers' organizations need to have confidence that institutional

⁹⁴ L. Rychly: *Social dialogue in times of crisis: Finding better solutions*, Industrial and Employment Relations Department, Working Paper No. 1 (Geneva, ILO, 2009), J. Freyssinet: *Les réponses tripartites à la crise économique dans les principaux pays d'Europe occidentale*, Industrial and Employment Relations Department, Working Paper No. 12 (Geneva, ILO, 2010), and Y. Ghellab: *Recovering from the crisis through social dialogue*, Industrial and Employment Relations Department, Brief No. 1 (Geneva, ILO, 2009).

⁹⁵ Dublin Department of Finance: *Public Service Agreement 2010–2014* (Dublin, 2010), <http://www.finance.gov.ie/documents/publications/other/2010/payagree/payagree1014final.pdf> (accessed 22 Aug. 2010).

arrangements are not merely being used to spread the political responsibility for short-term austerity measures and that they will remain involved in the process of dialogue and negotiation once conditions for improvements are created.

High-level tripartite engagement, which can take many forms, can help countries to ensure that a recovery transitions to sustainable growth and development by helping the key actors in the real economy to form mutually consistent expectations. It is, therefore, of increasing value in an interdependent world economy.

Promoting productivity through support for mobility, skills and small businesses

The labour market is in constant motion. In advanced countries, it is estimated that as much as 15 per cent of jobs disappear every year and 15 per cent of new jobs come into being.⁹⁶ This does not take into account the workers who stay with the same employer but change jobs within the firm. Yet there is also considerable job stability. In the United States, more than one-quarter of all workers have been with the same employer for more than ten years. In Europe, this figure is higher, reaching half of all workers in some countries. As yet we do not have similar research for developing countries, but it seems likely that as countries move away from agriculture and towards services and industrial employment similar patterns emerge.

Most people quit jobs voluntarily, and most have new jobs lined up. However, some are laid off and become unemployed before finding a new position. Involuntary quits increase during recessions and new hires fall. These job movements are very important to the individuals concerned. For the economy as a whole, this mobility is also vital as it is, in principle, the main way in which people move from less to more productive and secure employment. The policies that facilitate individual mobility can thus have a major macroeconomic benefit. But once a good job match has been found, suiting both worker and employer, both parties and the economy have much to gain from a long-term stable employment relationship in which workers can develop their skills and capacities.

Recent experience in several countries is, however, that much of the movement in the labour market consists of temporary workers finding new short-term jobs when the old ones end. This sort of “churning” is often unsatisfactory from the worker’s perspective and is unlikely to support skills development and an overall improvement in productivity.

A key policy issue is to create a policy environment that supports and encourages mobility, so that workers and employers can find good job matches, but that also gives incentives to both to invest in a long-term relationship to maximize the productivity gain from good job matches.

The role of employment protection legislation

In 2010, an ILO review of legislation on the termination of employment in 75 countries found that most countries provided safeguards against wrongful and unfair dismissals, while a significant majority required that termination be based on a valid reason. Furthermore, a majority of the countries reviewed required that notice be given prior to termination; however, the duration of the notice period varied from country to country.⁹⁷

Involuntary termination of employment, especially if it leads to a period of unemployment can, as shown in the IMF contribution to this background discussion document, be extremely damaging to individuals, their families and communities. Employment protection laws create an incentive for employers to regard workers as an asset to the business rather than simply as

⁹⁶ P. Cahuc and A. Zylberberg: *The natural survival of work*, op.cit.

⁹⁷ ILO: EPLex (Employment protection legislation database), <http://www.ilo.org/dyn/terminate/termmain.home> (accessed 22 Aug. 2010).

a running cost and therefore to reflect thoroughly on whether there are better alternatives to dismissal for the business and the worker. Statutory rights to notice and compensation also provide the worker with time and resources to search for a suitable position prior to eventual termination of the employment contract.

The extent to which protection for employment should be provided by the law is a much-debated issue.⁹⁸ One view is that excessive protection deters employers from hiring workers, because, if there is a need to terminate the relationship, the costs and procedures involved can damage the business or effectively rule out dismissal. Hiring and firing are both discouraged, thus reducing mobility in the economy as a whole and damaging productivity growth.

Another view is that employment protection legislation, by ensuring some measure of job stability, enhances aggregate productivity through enterprise adaptation, technological change, training, and fair and transparent rules, thus improving economic performance and the quality of work.⁹⁹

It is vital to find a balance between these different considerations. This means looking at policies that support worker mobility alongside those that encourage employment stability. The coverage and level of unemployment benefits, job-search support, training provisions, and housing and transport policies all make it easier for workers to move from one job to the next. Where such support is in place, workers have greater confidence that they will not be trapped in long-term unemployment, and fewer burdens are placed on employment protection laws.

Innovative reform avenues can instil greater labour market dynamism while also providing workers with adequate protection. These include more predictable legal procedures and a comprehensive approach that facilitates hiring and firing decisions while also providing efficient employment services and income support to job losers.¹⁰⁰ However, partial reforms, such as reducing protection on fixed-term contracts while leaving protection of permanent contracts unchanged, may aggravate duality, exacerbate social inequalities, and lower productivity growth.

Underlying the issue of the right balance between stability and mobility is the question of the employment relationship itself.¹⁰¹ In many countries, the scope of the employment relationship is undergoing reform as a result of court decisions and as a consequence of social dialogue.¹⁰² The Employment Relationship Recommendation, 2006 (No. 198), offers guidance on national policies for reviewing and adapting laws and regulations that give

⁹⁸ A. Muller: *Collective dismissals for economic reasons: legal rules tested by the economic crisis* (Geneva, ILO, forthcoming).

⁹⁹ For a summary of the literature, see ILO: *Note on Convention No. 158 and Recommendation No. 166 concerning termination of employment*, http://www.ilo.org/global/What_we_do/InternationalLabourStandards/lang--en/docName--WCMS_103555/index.htm (accessed 22 Aug. 2010).

¹⁰⁰ O. Blanchard: *Reforming labour market institutions: Unemployment insurance and employment protection*, Paper prepared for the Barcelona Conference on the Post-Washington Consensus, Sep. 2004 (Cambridge, MA, MIT and National Bureau of Economic Research, 2004).

¹⁰¹ S. Deakin: "The evolution of the employment relationship", Paper presented at the Second France/ILO Symposium on the Future of Work, Employment and Social Protection, Lyons, 17–18 Jan. 2002 (Geneva, ILO, 2002).

¹⁰² A. Supiot et al: *Beyond employment: Changes in work and the future of labour law in Europe* (Oxford, Oxford University Press, 2001). See also G. Casale et al: *Legal regulation of the employment relationship in the Asia-Pacific region* (Geneva, ILO, forthcoming).

effective protection for workers in an employment relationship, as well as listing criteria for determination of employment relationships.¹⁰³

Looking to the future, when examination of the terms of employment protection legislation is undertaken, this should be side-by-side with a review of the range of policy instruments needed to support worker mobility and enhance productivity performance through workplace change based on stable employment relationships.

Supporting micro-, small and medium-sized enterprises

All enterprises, large or small, need an enabling environment with laws and regulations that facilitate enterprise growth, foster decent work and safeguard the natural environment. Such an environment is characterized by, among other things, the rule of law and secure property rights and respect for universal human rights and international labour standards. It depends on the existence of open, rules-based, predictable and non-discriminatory markets and a non-corrupt and well-governed economy.¹⁰⁴ Good social dialogue between workers, employers and government to promote decent work with well-balanced policies that both protect workers and generate new jobs is also an important foundation for doing business.

Small businesses are big employers, and SMEs (including microenterprises) represent a very big slice of employment in most economies. In Japan, 94 per cent of business is micro, small and medium-sized and this represents 65.5 per cent of employment, including the business owners. In Turkey, micro- and small businesses alone account for over 99 per cent of concerns and 67.8 per cent of employment. Research on the United States shows predominantly young, small firms create, but also destroy, jobs, with about 60 per cent of initial jobs surviving after five years.¹⁰⁵ Although SMEs are often the source of dynamism and new product development and can be more agile than larger enterprises, they are also likely to be more vulnerable to economic downturns and changes in demand conditions.¹⁰⁶

Roughly three-quarters of all policy responses to the Great Recession have entailed measures to increase access to, and reduce costs of, credit to SMEs.¹⁰⁷ Tax incentives, including duty drawbacks, sector-specific tax incentives (spreading tax liabilities over a longer timeframe), and payroll tax rate reductions with incentives linked to employee retention, have also been common measures. Measures to ensure that micro-, small and medium-sized enterprises can take advantage of public works and procurement opportunities are also important. Business associations, including employers' organisations, play a vital role in ensuring that micro-, small and medium-sized enterprises are aware of support measures and how to access them.

Beyond crisis initiatives, other successful measures to encourage the formation and growth of SMEs and survival include support services to business start-ups, market development training and inclusive entrepreneurship development. The public policy mix depends greatly on factors such as sector, stage of business cycle and state of the economy. Policies to support job creation and job retention based on productivity improvement in SMEs can have macroeconomic benefits for the whole economy.

¹⁰³ ILO: *The employment relationship: An annotated guide to ILO Recommendation No. 198* (Geneva, 2007), <http://www.ilo.org/public/english/dialogue/ifpdial/downloads/guide-rec198.pdf> (accessed 22 Aug. 2010).

¹⁰⁴ G.Buckley, J.M. Salazar-Xirinachs and M. Henriques: *The promotion of sustainable enterprises* (Geneva, ILO, 2009).

¹⁰⁵ J.C. Haltiwanger, R.S. Jarmin and J. Miranda: *Who creates jobs? Small vs large vs young*, NBER Working Paper 16300 (Cambridge, MA, National Bureau of Economic Research, 2010), <http://www.nber.org/papers/w16300> (accessed 22 Aug. 2010).

¹⁰⁶ OECD: *The impact of the global crisis on SME and entrepreneurship financing and policy responses* (Paris, OECD, 2009).

¹⁰⁷ ILO: *Employment and social protection policies from crisis to recovery and beyond: A review of experience*, An ILO report to the G20 Labour and Employment Ministers' Meeting, Washington DC, 20–21 April 2010 (ILO, Geneva, 2010).

Boosting training and skills development

The globalization of markets is accelerating the diffusion of technology and the pace of innovation. New occupations are emerging and replacing others. Within each occupation, required skills and competences are evolving, as the knowledge content of production processes and services is rising. The cornerstones of the policy approach to expand the skills of women and men and broaden access to skills formation are quality education as a foundation for future training, closely matching skill supply to the needs of enterprises and labour markets, enabling workers and enterprises to adjust to changes in technology and markets, and anticipating and preparing for the skills of the future.

When applied successfully, this approach nurtures a virtuous circle in which more and better education and training fuels innovation, investment, economic diversification and competitiveness, as well as social and occupational mobility – and thus the creation of more productive and rewarding jobs. Quality primary and secondary education, complemented by relevant vocational training and skills development opportunities, prepare future generations for their productive lives – endowing them with the core skills that enable them to continue learning.¹⁰⁸

Young women and men looking for their first jobs are better prepared for a smooth transition from school to work when they are given adequate vocational education and training opportunities, including in-work apprenticeships and on-the-job experience. Working women and men periodically need opportunities to update and adjust their skills: the guiding policy principle is lifelong learning for lifelong employability.¹⁰⁹

Robust training policies and systems are grounded in the characteristics and institutions of each country. Nevertheless, a number of common building blocks for skills development systems can be identified:

- Anticipating skill needs by engaging employers and workers in decisions about training provision, including in economic sectors; maintaining training quality and relevance; making training accessible to all sectors of society; ensuring that financing mechanisms are supportive of the above; and continually evaluating the economic and social outcomes of training.
- Keeping training relevant by building solid bridges through strong institutional and financial arrangements between the world of learning and the world of work. Bringing together business and labour, government and training providers, at the local, industry and national levels is an effective means of securing the relevance of training to the changing needs of enterprises and labour markets.
- Making training and skills opportunities broadly accessible to all women and men. Special measures can help overcome the difficulties that some groups (such as people with disabilities, minorities, those in need of a second chance) face in accessing skills.¹¹⁰
- Ensuring a close connection between training policies and employment policies as an effective means of bridging with the world of work. When combined with policies to

¹⁰⁸ R.J. Barro and J.-W. Lee: *A new data set of educational attainment in the world, 1950–2010*, NBER Working Paper No. 15902 (Cambridge, MA, National Bureau of Economic Research, 2010), <http://www.nber.org/papers/w15902> (accessed 22 Aug. 2010).

¹⁰⁹ OECD: *Learning for jobs: The OECD policy review of vocational education and training (VET)*, Initial report, Oct. (Paris, 2009), <http://www.oecd.org/edu/learningforjobs> (accessed 22 Aug. 2010).

¹¹⁰ S. Backup: *The price of exclusion: The economic consequences of excluding people with disabilities from the world of work*, Skills and Employability Department, Working Paper No. 43 (Geneva, ILO, 2009), R. Palmer: *Skills and productivity in the informal economy*, Skills and Employability Department, Working Paper No. 5 (Geneva, ILO, 2008), and D.H. Freedman: *Improving skills and productivity of disadvantaged youth*, Skills and Employability Department, Working Paper No. 7 (Geneva, ILO, 2008).

sustain growth and investment, facilitate job search and support entry and re-entry into the labour market, skills policies can lead to more and better jobs.

- Involving employers and workers and their representative organizations in training institutions in order to maintain the relevance of training and ensure that training costs and the gains of productivity improvement are shared equitably.
- Continuing and deepening exchanges of knowledge and experience among countries on training and skills development policies and systems.¹¹¹

Creating inclusive labour markets and extending social protection

Inclusive labour markets and social protection, as well as key ingredients for cohesive and equitable societies, are also investments in future productivity. By ensuring that working women and men have a degree of security about their future prospects for a job, or at least an income when they are unable to work, inclusive labour markets and social protection create a platform for better health and education for current and future generations. They empower the most vulnerable to gain control over the direction of their lives and become active and respected members of society.

Strengthening public and private employment services

An important labour market policy reform in many developed and some emerging countries has been the implementation of activation or mutual obligation strategies, which combine effective re-employment services with strong job-search incentives, backed by the possibility of moderate benefit sanctions.¹¹² However, in the current context of a large pool of jobseekers and weak labour demand, activation strategies are facing a difficult test.

To compensate for a sharp decline in vacancies, many countries have expanded short-term programmes for the unemployed, such as job-search training, short vocational training or general and remedial training, motivation and information seminars, work experience and internship programmes.

A particular focus of employment services is disadvantaged jobseekers facing multiple barriers in securing employment, including migrants, youth, older and low-skilled jobseekers. Helping these groups access employment more easily, particularly in a weak market, is not only an important contribution to greater equity, but also helps prevent the vulnerable from falling into long-term unemployment and inactivity.

Job subsidies can play a role in encouraging the hiring of workers at risk of detachment from the workforce and they may be particularly useful in stimulating an early pick-up in employment after a recession.

Gross hiring subsidies can reduce unemployment among the most disadvantaged jobseekers, although performance has been variable across countries. However, good programme design is important, including careful targeting of disadvantaged groups, and controls to prevent employers from firing and rehiring workers simply to gain access to the subsidy. Marginal employment subsidies, which are paid only for new hires associated with net employment gains, tend to be more cost-effective, because leakages through deadweight losses and churning can be reduced significantly. Well-targeted employment subsidies should be part of

¹¹¹ ILO: *Skills for improved productivity, employment growth and development*, Report V, International Labour Conference, 97th Session, Geneva, 2008, and ILO: *A skilled workforce for strong, sustainable and balanced growth: Proposals to G20 Leaders for a training strategy* (Geneva, ILO 2010), http://www.ilo.org/public/libdoc/jobcrisis/download/g20_skilledworkforce.pdf (accessed 22 Aug. 2010).

¹¹² OECD: "Policies targeted at specific workforce groups or labour market segments", in *OECD Employment outlook: Boosting jobs and incomes* (Paris, 2006), Chapter 4, <http://www.oecd.org/dataoecd/38/20/38569405.pdf> (accessed 22 Aug. 2010).

the policy tools that governments have to ensure that groups at risk of exclusion from the labour market are able to enter it and stay in productive work.

In addition to policies that help employers hire, income subsidies to low-paid workers make it more attractive for beneficiaries of income support to move into employment. “Make work pay” measures such as the United Kingdom Working Tax Credit and the United States Earned Income Tax Credit aim to increase the labour force participation of low-income households and to reduce poverty, and they are generally deemed to be effective.

Targeting employment programmes to disadvantaged communities

Where employment opportunities are scarce, public employment or public works programmes targeting depressed communities and vulnerable groups can be effective and socially and economically justified. They combine elements of basic income support with infrastructure investment. Such programmes, however, need to be well-planned and integrated with training and employment search support in order to help beneficiaries into long-term employment in the private or public sector.

There have been a number of significant innovations in public employment schemes in recent years. Beyond traditional construction work on infrastructure projects, countries have expanded the focus to work in the social sector, environmental services and multisectoral community-driven programmes. Such schemes are also helping to create employment opportunities for women, as in many countries construction work remains typically a male occupation.

India’s National Rural Employment Guarantee Scheme, launched in February 2006, and expanded to 619 rural districts in 2009, provides 100 days of employment at the minimum wage to 43 million low-income households. Women account for close to 50 per cent of beneficiaries. South Africa is implementing an Expanded Public Works Programme operating along similar principles, and an extensive community development programme. A new phase was launched in April 2009 with a target of 4.5 million jobs of 100 days. Mexico has recently expanded its temporary employment programme in response to the crisis. Over half a million jobs were created between January and July 2009.

Many schemes address rural underemployment in developing countries but are increasingly used in urban settings in both developed and developing countries. They help to develop community assets such as roads, canals or facilities for family care and can serve to encourage private investment, productivity and business activity in the local economy. Such programmes require adequate administrative capacity for implementation and monitoring and can be particularly successful where local community organizations are actively involved from the outset. When public employment programmes are framed within a long-term development approach, they have the potential to mitigate the impact of crises on employment as well as ensure more inclusive growth.¹¹³

The main challenge faced by public employment programmes is to reach the intended beneficiaries. Geographical targeting is frequently used: it allows resources to be channelled to the communities most affected and can be combined with targeting disadvantaged groups, such as youth. In Chile, when unemployment in a region exceeds 10 per cent, funding is triggered to finance contingency employment programmes. Many schemes aim to be “self-targeting” by applying the local minimum wage, thus making the jobs unattractive to people already working elsewhere, but paying enough to reduce household poverty. Many women participate in public employment programmes, especially when work can be combined with family responsibilities.

¹¹³ R. Lal et al: *Public works and employment programmes: Towards a long-term development approach*, International Policy Centre for Inclusive Growth, Working Paper No. 66 (Brasilia, UNDP, 2010).

Design of infrastructure programmes can, however, also serve direct employment creation. The quantity of employment generated by infrastructure investment varies significantly across countries and types of works, reflecting relative levels of productivity and wages, the choice of more labour- or capital-intensive techniques, and the extent of use of smaller enterprises. Tender specifications that encourage labour-intensive techniques are an important and widely used means of generating jobs. The employment impact is further enlarged where the indirect effects on supplying contractors and in the local economy are embraced in programme design. Decentralizing public investment, resulting in smaller tenders that boost smaller enterprises and local economies, shows benefits both in speeding up implementation and in raising the scale of job creation.

The role of social protection policies

Social protection policies play a major role in cushioning economic shocks, in preventing families from falling into poverty and in improving social cohesion. At the same time, they can help to reduce precautionary savings and boost aggregate demand. In the long term, evidence shows that social protection helps to build human capital and labour productivity, contributing to the sustainability of economic growth.¹¹⁴ Nevertheless, the ILO estimates that 80 per cent of the world population does not have effective access to comprehensive social protection systems.¹¹⁵

Extending social protection coverage through the implementation of a basic social protection floor is attracting increasing attention as a key growth and development policy that focuses on people living in poverty and vulnerable situations, according to their needs and means. Such a floor, in both developed and developing countries, would consist of a set of essential transfers, services and facilities that all citizens everywhere should enjoy to ensure the realization of their fundamental rights. It comprises measures to ensure access to essential services, such as water and sanitation, food and adequate nutrition, health, education and housing, as well as social security transfers paid to the poor and vulnerable aimed at providing a minimum income and an affordable access to health services when needed. The notion is that every country, including the least developed, can set the goal according to its needs and means. Least developed countries should benefit from development cooperation to establish such a floor while they build up mechanisms for its sustainable financing. This concept is being elaborated jointly by the ILO and WHO.¹¹⁶

The positive correlations between the level of social security expenditure per capita and productivity and reduction of poverty rates are established for developed countries.¹¹⁷ Recent studies have shown that the effects can be even higher in developing countries.¹¹⁸ Social transfers, in the form of pensions, family benefits and other cash transfers, can contribute to protect household consumption against shocks or crises, thus preventing asset depletion or the adoption of short-term strategies with long-term adverse consequences, such as taking

¹¹⁴ van de Meerendonk, A. et al: *Economic impacts of selected social security policies covered by the international labour standards: A review of recent research* (Geneva, ILO, forthcoming).

¹¹⁵ ILO: *World social security report 2010: Providing coverage in the time of crisis and beyond* (Geneva, forthcoming).

¹¹⁶ ILO and WHO: *The social protection floor: A joint crisis initiative of the UN Chief Executives Board for co-ordination on the social protection floor* (Geneva, 2009), <http://www.un.org/ga/second/64/socialprotection.pdf> (accessed 22 Aug. 2010).

¹¹⁷ M. Cichon and W. Scholz: "Social security, social impact and economic performance: A farewell to three famous myths", in P. Townsend (ed.): *Building decent societies*, op.cit., and van de Meerendonk, A. et al: *Economic impacts of selected social security policies covered by the international labour standards*, op.cit.

¹¹⁸ ILO: *Extending social security to all: A guide through challenges and options*, Social Security Department (Geneva, 2010).

children out of school. Costing studies in Asia and Africa have demonstrated that the implementation of basic social security packages is affordable even in poor countries.¹¹⁹

The Unemployed Heads of Household programme (*Plan Jefes y Jefas*) in Argentina attenuated the sharp fall in income as a consequence of the financial crisis in 2001. The programme was particularly effective in protecting the extremely poor.¹²⁰ Brazil's *Bolsa Familia* is reported to have contributed, together with other social assistance programmes, to a 16-per-cent fall in extreme income poverty.¹²¹ In Mexico, the conditional cash transfer programme *Progresa* (later renamed *Oportunidades*) led to a reduction of 10 per cent in the poverty headcount ratio two years after its start.¹²² The improvement in the level and quality of nutrition is predicted to have long-term effects on the lifetime productivity and potential earning capacity of recipient children.¹²³

A comparative study of social pensions in Brazil and South Africa has found that, in the absence of non-contributory pensions, the poverty gap would be one-third larger in Brazil, and two-thirds larger in South Africa. Having a non-contributory pension recipient in the household reduces the probability of poverty among household members by 21 per cent and 11 per cent in Brazil and South Africa, respectively.¹²⁴ South Africa's social pension appears to be especially important for 35 per cent of blacks who survive on less than \$1 a day, as that proportion would increase to 40 per cent in the absence of the pension.¹²⁵

Social transfers can also facilitate productive investments by poor households, especially where the regularity of transfers enables them to take the risk of more profitable or more productive economic activity.¹²⁶ They can play an important complementary role to facilitate access to credit by encouraging small-scale savings and thus investment decisions, and by enabling access to credit. Studies of social transfer programmes in Mexico and Brazil have shown that beneficiaries are able to begin to save and invest, and also that access to credit is facilitated following the receipt of transfers.¹²⁷

Unemployment benefits provide income security, protect against poverty and cushion the social impact of loss of earnings. Throughout the duration of the benefit payment, unemployed workers can search for jobs that better match their abilities, increasing the efficiency of the job-matching process. Complementary skills-upgrading programmes contribute to empowering job losers, helping to reintegrate them at similar or even higher productivity levels when the economy recovers. Thus, from a macroeconomic perspective, unemployment benefits maintain income and smooth consumption among job losers, thereby limiting reduction in consumption and contributing to maintaining aggregate demand, especially in economic downturns when mass unemployment threatens to create a vicious spiral of deflation.

¹¹⁹ C. Behrendt and K. Hagemeyer: "Can low-income countries afford social security?", in P. Townsend (ed.): *Building decent societies*, op.cit.

¹²⁰ E. Galasso and M. Ravallion: *Social protection in a crisis: Argentina's Plan Jefes y Jefas*, Policy Research Working Paper No. 3165 (Washington, DC, World Bank, 2004) and ILO: *Extending social security to all*, op.cit.

¹²¹ K. Lindert et al: *The nuts and bolts of Brazil's Bolsa Familia Programme: Implementing conditional cash transfers in a decentralized context*, Social Protection Discussion Paper No. 0709, May (Washington, DC, World Bank, 2007).

¹²² E. Skoufias: *Progresa and its impacts on the welfare of rural households in Mexico*, Research Report 139 (Washington, DC, International Food Policy Research Institute, 2005), <http://www.ifpri.org/sites/default/files/publications/rr139.pdf> (accessed 22 Aug. 2010).

¹²³ ILO: *Extending social security to all*, op.cit.

¹²⁴ A. Barrientos: *What is the impact of non-contributory pensions on poverty? Estimates from Brazil and South Africa*, Institute for Development Policy and Management (Manchester, University of Manchester, 2003).

¹²⁵ ILO: *Extending social security to all*, op.cit.

¹²⁶ A. Sajeda, A. Rai and G. Topa: "Does microcredit reach the poor and vulnerable? Evidence from northern Bangladesh", in *Journal of Development Economics* (Amsterdam, Elsevier, 2003), Vol. 70(1), pp. 59–82.

¹²⁷ ILO: *Extending social security to all*, op.cit.

In Brazil, evidence shows that unemployment benefits empower workers to overcome liquidity barriers to becoming self-employed.¹²⁸ Turning unemployment into self-employment has also become a major focus of German active labour market policies.¹²⁹ In Spain, a recent stimulus package allowed the unemployed to withdraw 60–80 per cent of the accumulated amount of the entitlement over the benefit duration, as a start-up allowance to become self-employed.

Well-designed unemployment support schemes can also contribute to avoiding a transition to inactivity and, in the long term, to an increase in expenditures on disability and retirement benefits.¹³⁰ A study on the European transition economies showed that unemployment insurance schemes contributed significantly to poverty reduction during the 1990s. In Hungary and Poland, for instance, poverty among the unemployed was reduced by 50 and 45 per cent, respectively, as a result of the cash transfers made in the form of unemployment benefits.¹³¹

Nevertheless some analysts have warned of the possible impact of generous unemployment insurance schemes in inducing moral hazard among workers, discouraging work and reducing efficiency of the labour markets.¹³² Some authors have found a positive elasticity of unemployment with respect to benefit duration and have identified a high probability of unemployment exit just before the benefit is exhausted.¹³³

Other authors argue that generous unemployment benefits can increase productivity by helping the unemployed find jobs that match their skills.¹³⁴ By empowering workers and increasing their bargaining position, unemployment insurance contributes to raising wages and to facilitating job matches (see “Promoting productivity through support for mobility, skills and small businesses”). Complementary skills-upgrading programmes further contribute to empowering job losers, helping them to reintegrate at similar or even higher productivity levels when new jobs open up. Even if there is some negative effect on unemployment duration, evidence shows that there is a positive indirect effect of unemployment insurance on subsequent employment stability.¹³⁵

From a macroeconomic perspective, by maintaining income and consumption among job losers and reducing the risk of permanent detachment from the labour force, unemployment benefits contribute to economy-wide productivity and maintaining aggregate demand in economic downturns.¹³⁶ Furthermore, strong unemployment insurance schemes within wider

¹²⁸ W. Cunningham: *Unemployment insurance in Brazil: Unemployment duration, wages and sectoral choice*, 16 Mar. (Washington, DC, World Bank, 2000).

¹²⁹ H. Baumgartner and M. Caliendo: *Turning unemployment into self-employment: Effectiveness and efficiency of two start-up programmes*, Discussion Papers of DIW Berlin, Paper No. 671 (Berlin, DIW German Institute for Economic Research, 2007).

¹³⁰ S. Carcilio and D. Grubb: *From inactivity to work: The role of active labour market policies*, OECD Social, Employment and Migration Working Paper No. 36 (Paris, OECD, 2009).

¹³¹ M. Vodopivec, A. Wörgötter and R. Dhushyanth: “Unemployment benefit systems in Central and Eastern Europe: A review of the 1990s”, in *Comparative Economic Studies* (Basingstoke, Palgrave MacMillan, 2005), No. 47, 1 Dec., pp. 615–651.

¹³² L. Kratz and B. Meyer: “The impact of potential duration of unemployment benefits on the duration of unemployment”, in *Journal of Public Economics* (Amsterdam, Elsevier, 1990), Vol. 41, No. 1.

¹³³ J.C. van Ours and M. Vodopivec: *How changes in benefits entitlement affect the duration of unemployment*, Center for Economic Research, Discussion Paper No. 2005-30 (Tilburg, Tilburg University, 2005).

¹³⁴ J. Berg and D. Kucera (eds): *In defence of labour market institutions* (Basingstoke, Palgrave Macmillan, 2008).

¹³⁵ K. Tatsiramos: *Unemployment insurance in Europe: Unemployment duration and subsequent employment stability*, IZA Discussion Paper No. 2280 (Bonn, Institute for the Study of Labour (IZA), 2006).

¹³⁶ A. Auerbach: *The significance of federal taxes as automatic stabilizers* (Cambridge, MA, National Bureau of Economic Research, 2000).

social protection systems are likely to stimulate households to reduce private savings intended to cover contingencies such as ill health or job loss, thus raising consumption and aggregate demand.¹³⁷

Reasonable social protection policies are essential building blocks for productive economies and social cohesion. They can, furthermore, be built block by block. For countries expanding their systems, a key issue is the enlargement of the tax or contribution base in line with benefit commitments to ensure the fiscal sustainability of social protection systems. For countries with mature systems, long-term fiscal sustainability is also a vital issue, requiring broad consideration of benefit levels and coverage, as well as financing mechanisms. Short-term emergency cuts can have damaging long-term consequences.

More and better jobs generating sustainable growth and development

To sum up, the strength and quality of labour market institutions can make a substantial contribution to international efforts to generate sustainable growth and development. Although each country's labour market institutions have a particular history and character, countries face many common challenges in shaping policies that create decent work opportunities for all. A consensus is building for the coordination of efforts to prioritize employment growth, because strong growth in jobs and incomes in many countries at the same time will buttress global demand, creating still more jobs.¹³⁸

The crisis and recovery will accelerate the structural changes already underway. By anticipating these changes, policies help people prepare for the opportunities that arise in the transition to a more balanced global economy based on sustainable growth. An increased focus on employment and social policies in national and international macroeconomic policy-making can help realize strong, sustainable and balanced growth. Wider debate on these issues can only help to enrich and improve policy

coherence.

¹³⁷ E. Engen and J. Gruber: “Unemployment insurance and precautionary saving”, in *Journal of Monetary Economics* (Amsterdam, Elsevier, 2001), Vol. 47, No. 3, pp 545–579.

¹³⁸ See *G20 Labour and Employment Ministers' Recommendations to G20 Leaders*, Washington, 21 April, 2010, http://www.dol.gov/ilab/media/events/G20_ministersmeeting/results.htm (accessed 22 Aug. 2010), and United Nations: *Recovering from the world financial and economic crisis: A global jobs pact*, United Nations Economic and Social Council resolution (New York, NY, 2010), http://www.un.org/ga/search/view_doc.asp?symbol=E/2010/L.9/Rev.1&Lang=E (accessed 22 Aug. 2010).

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