CHAPTER 18

Policy Choices and the Prospects for Workers

For the past century rising inequality of incomes has been a dominant trend in the world economy. The most prosperous group of workers in the world—the skilled workers of the industrial countries—now earn on average some sixty times more than the poorest group—the farmers of Sub-Saharan Africa. The past fifteen to twenty years have seen rapid advancement for large numbers of Asian workers, but stagnation or decline for many in the Middle East, Latin America, Sub-Saharan Africa, and, most recently, the former centrally planned economies of Europe and Central Asia. Can the twenty-first century usher in an era of converging incomes? The stakes are high. There is the potential for great advances on all fronts: robust job creation, rising productivity, and improvements in job quality. But there is also the risk that progress will leave some out, from unemployed workers in the industrial countries to much of the population in Sub-Saharan Africa, and will fail to reduce severe inequalities in Latin America and elsewhere.

Conditions both in individual domestic economies and in the international economic environment matter to the outcome. The potential for deeper international integration expands opportunities for those countries and groups of workers with the capacity to respond. The actions of rich countries—in particular with respect to trade policy and fiscal deficits—will make a difference. Unless deficits fall, all will pay the price in the form of lower productivity and slower growth. International assistance is also vital in supporting the inclusion of all groups of workers in the global economy. But probably of greatest importance are the conditions prevailing within developing and transitional economies, in particular in the four areas discussed in the preceding parts of this Report:

- whether countries succeed in getting onto market-based growth paths that both generate rapid demand for labor and raise the productivity of the work force
- whether they succeed in taking advantage of changes at the international level, be it in reacting to new market opportunities or in attracting capital—or in managing the dislocations that changing trade patterns bring
- whether governments succeed in putting in place a framework for labor policy that complements informal and rural labor markets, supports an effective system of industrial relations in the formal sector, provides safeguards for the vulnerable, and avoids biases that favor relatively well-off insiders, and
- whether the countries struggling with the transition to more market-based and internationally integrated patterns of development succeed in this move without large or permanent costs for labor.

Two global scenarios

Two global scenarios, developed for this Report, illustrate the extent of what is possible and the magnitude of the dangers ahead for workers in each of the world’s principal regions. The first scenario is one of muddling through and is largely based on persistence of past trends. Because there is the distinct possibility that this path would lead to widening differences between some regions and widening inequality in labor income within some countries, we call this a scenario of slow growth and divergence—the “divergent” scenario. The second scenario explores the potential implications of strong policy action at the domestic level in all parts of the world, combined with deeper international integration. This we term a scenario of inclusion and convergence—the “convergent” scenario. Both scenarios are only illustrative—the numbers are projections based on many assumptions, and certainly not a forecast. But they are a plausible guide to the consequences of success and failure and take into account likely future trends in both economy-wide effects and international integration.

The principal determinant of the outlook for workers is domestic investment—in capital, education, infrastructure, and technology. The divergent scenario assumes that recent trends in investments continue or deteriorate, that a sizable share of those already enrolled in schools drop out prematurely, and that the overall productivity of labor does not rise rapidly (Table 18.1). The convergent scenario assumes that investment rates pick up, that enrollment rates stabilize at current levels and dropout rates decline, and that investments in infrastructure, technological transfers, and improvements in the quality of governance contribute to rising labor productivity. The convergent scenario must be supported by at least slight rises in saving rates, lower fiscal deficits in the rich countries, and reasonable amounts of international capital flows, including development assistance. The effort in Sub-Saharan Africa must be especially strong.

The international scene also matters greatly. In the divergent scenario, we assume that protectionism does not go
The convergent scenario will require high rates of investment in human and physical capital, as well as overall productivity gains.

Table 18.1 Assumptions underlying the projections

<table>
<thead>
<tr>
<th>Region</th>
<th>Investment share of GDP (percent)</th>
<th>Average years of schooling</th>
<th>Annual growth of total factor productivity (percentage per year)</th>
</tr>
</thead>
<tbody>
<tr>
<td>China*</td>
<td>30</td>
<td>22</td>
<td>26</td>
</tr>
<tr>
<td>East Asia</td>
<td>28</td>
<td>22</td>
<td>28</td>
</tr>
<tr>
<td>Former CMEA</td>
<td>19</td>
<td>18</td>
<td>22</td>
</tr>
<tr>
<td>Latin America</td>
<td>20</td>
<td>22</td>
<td>15</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>23</td>
<td>20</td>
<td>29</td>
</tr>
<tr>
<td>South Asia</td>
<td>23</td>
<td>23</td>
<td>26</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>17</td>
<td>16</td>
<td>25</td>
</tr>
<tr>
<td>OECDh</td>
<td>20</td>
<td>20</td>
<td>22</td>
</tr>
</tbody>
</table>

.. Not available.
a. Includes Hong Kong.
b. Includes Australia, Canada, European Union, Japan, New Zealand, and United States only.
Source: World Bank staff estimates.

...
Europe, and in both a growing underclass with few opportunities for employment. Despite persistent attention from governments, international agencies, and academics, deep questions remain about what can be done. There clearly has been a shift in the pattern of labor demand against unskilled and manual workers and in favor of college-educated and white-collar workers, and from full-time work, dominated by men, to more flexible or temporary work, with rising participation of women. As was discussed in Part Two, international trade, migration, and capital have had some influence, and their impact may be on the rise as much larger population blocs become integrated into world markets; but technological changes, in particular those associated with the information revolution, have probably been more important.

In the more flexible labor market of the United States a major question is whether the supply response to the shift in demand toward higher skills, already under way—as reflected in the recent rise in enrollments of adults in community colleges—will be sufficient to reverse the trend toward rising inequality and reach those left out in the 1980s. In Europe the issue is much more one of how to increase com-

### Table 18.2 Projections of growth in GDP per capita and exports by region (percent)

<table>
<thead>
<tr>
<th>Region</th>
<th>Annual average growth in GDP per capita</th>
<th>Annual average growth in exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>China*</td>
<td>4.6</td>
<td>2.3</td>
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<tr>
<td>East Asia</td>
<td>5.5</td>
<td>3.0</td>
</tr>
<tr>
<td>Former CMEA</td>
<td>-3.0</td>
<td>0.9</td>
</tr>
<tr>
<td>Latin America</td>
<td>1.7</td>
<td>1.4</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>0.8</td>
<td>1.4</td>
</tr>
<tr>
<td>South Asia</td>
<td>2.0</td>
<td>2.4</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>-0.3</td>
<td>-0.3</td>
</tr>
<tr>
<td>OECDb</td>
<td>1.9</td>
<td>1.6</td>
</tr>
</tbody>
</table>

* Includes Hong Kong.

** Includes Australia, Canada, European Union, Japan, New Zealand, and United States only.

** Source:** World Bank staff estimates.

### Table 18.3 Projections of wages of skilled and unskilled workers by region (percentage change from 1994 to 2010)

<table>
<thead>
<tr>
<th>Region</th>
<th>Divergent scenario</th>
<th>Convergent scenario</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Unskilled</td>
<td>Skilled</td>
</tr>
<tr>
<td>China*</td>
<td>19</td>
<td>35</td>
</tr>
<tr>
<td>East Asia</td>
<td>41</td>
<td>54</td>
</tr>
<tr>
<td>Former CMEA</td>
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<td>29</td>
</tr>
<tr>
<td>Latin America</td>
<td>-3</td>
<td>45</td>
</tr>
<tr>
<td>Middle East and North Africa</td>
<td>-2</td>
<td>27</td>
</tr>
<tr>
<td>South Asia</td>
<td>15</td>
<td>49</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>6</td>
<td>9</td>
</tr>
<tr>
<td>OECDb</td>
<td>15</td>
<td>47</td>
</tr>
</tbody>
</table>

* Includes Hong Kong.

** Includes Australia, Canada, European Union, Japan, New Zealand, and United States only.

** Source:** World Bank staff estimates.
petition in service industries to allow more labor demand
growth, and in some countries, notably Spain, how to shift
from patterns of collective bargaining that favor insiders at
the expense of outsiders. But increased flexibility in wage
structures will only significantly reduce unemployment in
the context of strong overall growth in labor demand.

The history of the past decade or so makes it difficult to
be optimistic that there will be a swift resolution of the em-
ployment problems in the industrial countries. A critical
question is what action in the industrial countries may
mean for the rest of the world. Under the divergent sce-
nario there is a significant probability that employment
concerns and fears of competition will lead to a stalling of
the potential gains from greater openness. As noted in
Chapter 8, the Uruguay Round agreement is too limited to
bring large gains by itself, and what gains it achieves are vul-
nerable to substitution with contingent protection—
whether through antidumping or through the capture of
labor and environmental standards by protectionists.
Under the convergent scenario, however, progress in do-
metric action helps support a faster pace of integration, al-
though with continued management of migration flows to
limit the pressure of migrants on the unskilled domestic labor market.

**South Asia, China, and Viet Nam**

Are China, Viet Nam, and the countries of South Asia poised for an East Asian-style takeoff and engagement in the international economy, or will their transitions stall? Their performance is key to the largest single groups of poor workers in the world—the rural farmers and laborers of the Indian subcontinent and China. At present, the countries of this region are weakly integrated into international trade; the unfolding export boom in labor-intensive products offers the best hope of raising the incomes of these workers. Their rising involvement will send positive ripple effects throughout the world in the form of higher demand from global markets, but also increased competitive pressures on unskilled workers elsewhere, with the attendant risks of protectionist backlash.

These countries have seen average incomes steadily rising, together with labor productivity. The accumulation of capital and skills has also been steady, but relatively slow outside China. There is good potential for rapid accumulation in the future. Agriculture has done well and explains a large part of past success. But in the subcontinent industrial labor absorption has been weak, and agriculture remains heavily protected. The liberalization of agriculture and the takeoff in manufacturing must go hand in hand in the future. In the absence of a strong pull of labor demand from manufacturing, there is a real risk of rising inequality and stalled reforms. In the convergent scenario there is steady growth in incomes and falling poverty. But reductions in inequality are likely to remain limited, especially in China and Viet Nam where rising agricultural wages could be offset by widening inequality elsewhere—some of it desirable because of decompression of earnings schedules in state enterprises, some less so where people are stuck in stagnating regions.

Labor policy remains in need of reform in both South Asia and China. Each has a small group of workers who are relatively well paid and enjoy high job security and, especially in China, generous nonwage benefits, but are stuck in activities that need to be restructured. Regulation is excessive, and workers have substantial political power—manifested in South Asia in independent and highly politicized unions, in China in the potential for industrial action. Resistance to change could threaten the transition to an open economy and the integration of the domestic labor market. The strong tradition of support for income stabilization in informal and rural labor needs to be maintained and supported, especially in terms of public works and basic safety nets.

Although the transition to new forms of governance is advancing fast, China and India, the two giants of the region, face internal difficulties. Managing the decline of public enterprises and the protected private sector is the key issue in the transition. In China social responsibilities must ultimately be shifted out of the state enterprise sector. In India the challenges are to raise rural incomes to reduce poverty, and to restructure inefficient enterprises with powerful unions. Under the divergent scenario, public sector retrenchment weakens and exacerbates the risk of slow growth, partial international integration, continued sharp dualism, and weak growth in unskilled labor demand; inequalities rise, especially in the subcontinent. Under the convergent scenario there is both rapid and equalizing growth prompted by rural-urban migration, skill accumulation, and rising rural productivity.

**Sub-Saharan Africa**

The plight of the African continent remains the most serious challenge for the emerging world order. International prospects are mixed. The Uruguay Round agreement will raise food prices, which will hurt the urban poor in the short term but create important opportunities for peasants down the road. The agreement will also erode the region's trade preferences in the markets of some European states, and greater global competition will reduce the returns to low-skill manufacturing activities. Even in primary commodities, an area of comparative advantage, Sub-Saharan Africa must raise productivity in order to compete with the resource-rich countries of Southeast Asia and Latin America.

The ingredients of any movement forward must include, first and foremost, greater accumulation of capital and improvements in efficiency. Investment rates have fallen to less than 16 percent of GDP. Given the high rate of population growth, standards of living cannot improve unless investment rises dramatically. Until this happens, the quantity of education is unlikely to present an important constraint, although raising its quality is vital; in the divergent scenario enrollment rates are actually assumed to continue to decline, as they did in many countries in the 1980s. Unless the strategic risks faced by investors, especially in terms of possible policy reversals, are reduced, investment is unlikely to rise sufficiently. To achieve the dramatic turnaround in overall efficiency that is required, there must be a great effort on many fronts, from an acceleration of the stillunfinished reform agenda to improvements in basic infrastructure and better governance. For the great majority of poor farmers, agricultural reforms are the most pressing concern. To take advantage of the potential gains offered by higher international food prices, this growth potential must be passed on to small farmers; this may require wellstructured land reforms in some countries, such as South Africa and Zimbabwe, and better access of farmers to financing.
Interventions in labor markets must mainly reduce the bias against small and informal businesses and agriculture. Public sector reforms are crucial for increasing the quality of the services offered. This should entail a simultaneous reduction in public employment and a more competitive wage structure.

The risks are high and are exacerbated by globalization. In the divergent scenario Africa continues to fall into poverty trap and becomes increasingly marginalized from the world economy. A credible strategy will require rising global demand for agricultural products and mining, as well as bold international actions that are commensurate with the challenge at hand. Measures such as greater and faster opening of agricultural markets in the industrial countries, debt reductions with strong conditionality, and a stronger anchor to the rest of the world—perhaps in the context of free trade agreements with Europe—must be considered seriously. The goal should be partly to secure markets with some degree of temporary preferences so as to offset the losses due to the Uruguay Round. Much more important, however, such agreements need to emphasize internal reforms and a clear time frame. This could help boost the credibility of the reform agenda and reduce its uncertainty by locking governments into a process they cannot afford to tamper with. If such a strategy is followed, South Africa, Francophone West Africa, and even Nigeria could emerge as important regional growth poles.

East Asia

The East Asian region, with a few exceptions, has been a paradigm of investment and international engagement bringing large gains, at least in wage incomes, to workers. Export-led growth is likely to continue with increasing insertion into the international economy at increased skill levels—and with deepening intra-regional links. There is, however, a risk of backlash from the industrial countries, possibly linked with concerns over labor standards, and a risk of rising competition—from China, Viet Nam, and the countries of South Asia for the poorer members of the group, and from Central and Eastern Europe for the richer ones. These risks are exacerbated by the expected opening up in agriculture, a highly protected sector: this is likely to hurt farm workers and lead to increased inequality.

There is a high probability of continued robust capital investment, but in the region's middle-income countries there is an emerging issue of skill shortages. In some countries, notably Thailand, education systems have lagged the development of democratic systems will increasingly come into play. Past development success has created a need to upgrade labor standards, and in particular to develop rational forms of formal job security. Korea has already started on this road, initiating in 1995 a major revision of its labor code and unemployment law.

Central and Eastern Europe and the former Soviet Union

The development path of the past has bequeathed to this region a rich stock of human capital and a developed but aging infrastructure. But the transition to the market has started with a collapse in production that has resulted in high unemployment. The key to renewed growth is a successful reorganization of labor out of the public sector and into higher productivity activities. This involves mass privatizations, falling trade protection, and a more workable financial system. The implied structural change will hurt some workers, either temporarily when reallocations are involved, or permanently when labor productivity is below the old wage. The main challenge is to allow the transformation to a private economy to proceed while minimizing social dislocations and transitional costs in unemployment.

Wages have exhibited a fair degree of downward flexibility; the challenge is to increase mobility across sectors. Nonwage labor costs are high and should be reduced in the context of a comprehensive reform of social insurance schemes. Unions are expected to continue playing a positive role at the firm level. However, they are likely to continue opposing rapid reforms unless the workers that stand to lose receive proper support and compensation.

External conditions appear favorable, especially for the countries of Central and Eastern Europe and the Baltic states, which have recently acquired preferential access to the markets of the European Union. This provides both new opportunities and a credible anchor for macroeconomic policies and reforms. The inflow of complementary capital will be important in generating growth, allowing the twin processes of job creation and job destruction to proceed smoothly, and retraining existing human capital.

There is, however, a serious risk of a stalled or incomplete transition if social tensions are not addressed. The main risks are of slow overall engagement in the international economy, led by difficulties in internal structural re-
forms; rising macroeconomic imbalances, prompted by high transfers and subsidies; and the creation of a new underclass of up to 10 to 20 percent of the population, hurt by passage through long-term unemployment and widening regional disparities. Managing the social dimension of the transition, keeping up the quality of social services, creating the conditions for rapid job creation, and avoiding the creation of new poverty are all key goals, but they must also be balanced with fiscal probity to ensure both social and macroeconomic stability. Success is likely to breed success by attracting foreign capital. But failure to jointly address these economic and social concerns risks prolonging the transition, at a high cost in human suffering and in lost opportunities.

Middle East and North Africa

Changing international conditions in this region make a shift from a state-led to a market-led and from a closed to an internationally oriented economy only more pressing. With the old sources of foreign exchange—aid and workers’ remittances—unlikely to grow, export growth is key for the future. Globalization offers opportunities but also exacerbates risks. More than ever before, a credible and realistic strategy is needed to link the region with the world economy. The possibility of reduced regional tensions and the potential for deeper links with the European Union offer important opportunities. But entry could be tough, given the region’s weak industrial history, and will require serious programs of internal liberalization.

The countries of the Middle East and North Africa have been on a roller coaster of boom and bust, driven by oil and a strong public sector. The combination of declining public sector revenues and rising urbanization and education have by now rendered the old social contract unaffordable, and the conditions must be put in place to allow the private sector to become the engine of growth. However, entrepreneurs are unlikely to take chances until strategic risk is reduced, and this will require progress toward regional peace and resolving internal conflicts, as well as resolute action on the economic policy front.

Public sector employment remains a major source of distortion, leading to macroeconomic fragility and reducing the credibility of other reforms. Together with an extensive web of regulations in the modern sector, this has resulted in a growing split between a regulated sector on the decline and an expanding low-productivity informal economy, with a small labor elite hanging on to its relative position at the expense of the majority. This may fuel social instability. There is an urgent need to revisit the social contract and redefine the role of the state, from an engine of growth to a regulator that allows markets to work and deliver socially acceptable outcomes. Labor policy also needs major reforms: unions are repressed and only weakly perform their role, or do so in a highly politicized fashion. There is a need to rationalize their function.

The divergent scenario could be gloomy. Lack of resolute reforms will lead to rising poverty and social polarization. The fickleness of private capital and the bumpy peace process heighten the risks, and rapid labor supply growth complicates the transition. However, the convergent scenario offers rosier prospects, with capital inflows allowing for a fuller use of existing skills. Credibility and domestic politics are the main issues. Mechanisms to facilitate the transfer of laid-off workers to new jobs, compensation for those hurt, and an overall policy framework supportive of reductions in poverty will be important ingredients of a successful transition.

Latin America and the Caribbean

The integration of this region with the global economy is proceeding apace, especially in trade and capital markets, and in Central America through international migration. The international environment is promising, because the natural resource base leaves the region less exposed to international competition in labor-intensive products. Rapid growth is possible. The hope is of diversifying exports away from natural resources and into medium-skill products. An important issue for the future is whether NAFTA will be extended to the rest of the hemisphere or get hamstrung by the standards debate.

Most Latin American countries have been taking off, with some recovery in wages. Although it would be wrong to overreact to Mexico’s recent financial trouble, there is a broader risk that the takeoff will fail to resolve the problems of inequality, and that countries will get caught in a vise of low-wage competition from Asia and fail to achieve the human capital accumulation appropriate for the region’s level of income. Accumulation is already rising fast in countries, such as Chile, that implemented robust reforms. The main problems that need to be addressed are the weakness of skill formation and the remaining biases against labor in countries where land distribution is unequal, such as Colombia and Brazil. Land reform and removal of policy biases against labor use in agriculture will be required.

Labor policy is a major piece of the unfinished agenda. Although some progress has been achieved in deregulating labor markets, distorted labor markets continue to lead to excessively large informal sectors in countries such as Ecuador and Peru. Unions have become weaker, except in the public sector, but independent unions have an important role to play and in some countries need to be strengthened, especially in their role in decentralized bargaining. There is also a need to reform hiring and firing rules, deal with public sector problems, and deepen the reform of systems of social security.

Transitional problems remain: issues of state enterprise
layoffs in Argentina, relative wage flexibility in Mexico, and special social safety nets. Under the divergent scenario there is a distinct possibility of only modest growth with widening inequality. This would ultimately threaten the social fabric. But concerted action could lead to recovery of labor demand in agriculture, easing the formal-informal divide and preventing inequality from rising further.

**Slow growth or inclusion?**

Governments have to work with the legacies of past policies and development structures. Workers have to live with the opportunities at hand. These are molded by the structure of the economies and societies in which they live and by the capabilities formed by their personal histories—what they have received from their parents and from their schooling. But for both governments and workers, that is just the starting point. Both are agents of change. Good choices by governments, in the domestic and the international realms, can lead to advances in the living standards of all groups of workers in the world and help bring back into the fold those who are unable to keep up or adjust on their own. If international conditions are favorable and governments do their part to create the right environment, workers will be able to make the job choices, negotiate the conditions of work, and make the schooling decisions for their children that will improve the welfare of all groups of workers. That could begin to reverse the long-run trend of widening international inequality between workers that has been so marked a feature of the past century, and bring new hope and opportunities to millions currently trapped in poverty. And that would set the stage for a truly global golden age in the twenty-first century.