Macroeconomic policies for higher employment in the era of globalization

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Preface

Macroeconomic policy making over the past two decades has been overwhelmingly guided by the objective of attaining and maintaining macroeconomic stability, defined largely by strict adherence to rather conservative levels of inflation, budget and current account deficits. It was contended that such a stabilization programme, which was adopted by most developing countries under the aegis of the Bretton Woods institutions, would induce higher private sector participation, and enhance investment and growth. It is now fairly well established that these stabilization policies, which may have resulted in some static gains, have not necessarily yielded sustained levels of investment and growth.

It is crucially significant to note that the imposition of stabilization programmes coincided with further policy compulsions toward greater trade liberalization, market de-controls and privatization, and a roll-back of the role of the State. The present paper contrasts the changing historical circumstances to contend that the above developments, together with phenomenal growth in private trade in international capital, increased openness of trade, growing significance of intra-firm trade, and global “pressure on governments to conform in the conduct of economic policies”, have severely restrained the autonomy of an individual country to pursue national macroeconomic policy. The paper further contends that increasing globalization has led to significant “asymmetries” in global exchanges, e.g. the asymmetry between the freedom of capital movement and the restrictions on movements of unskilled labour. According to the author, while the process of globalization is eroding the macroeconomic policy space, its many asymmetries warrant the need for formulating “independent policies to guard against these” that may thwart national development goals.

In regard to the above, the paper traces the context in which the employment objective in policy planning has been relegated, and argues for re-instating that objective, especially from the vantage point of enhancing aggregate demand in the developing countries.

The paper argues that, at the international level, negotiations should pursue the logic of “affirmative action”, in order to take account of disadvantaged countries for example, through differential treatment according to varying stages of their economic development. At the national level, the paper posits the need for an “alternative set of macroeconomic policies”, in which an appropriately designed and executed employment strategy would constitute the core consideration. The author argues that such a policy regime would be guided by two broad principles: First, relatively higher emphasis needs to be given on internal/domestic market; and second, considerations of labour market flexibility and growth of labour productivity, need to be weighed alongside considerations of the level of employment. Higher employment would allow maintaining a relatively higher domestic demand, and reducing the need for government interventions in extending subsidies, income transfers and unemployment benefits. Within the above considerations, the paper provides a synoptic guideline and the basic ingredients of an employment-friendly macroeconomic policy framework.

The paper cautions that the constituent elements of such a framework would need to be country-specific, but based on the common recognition that higher employment and productivity can be complementary. These ingredients would include inter alia an appropriate choice on industries and sectors; bold public investment in social and economic infrastructures; construction-intensive activities; depending on country situation, employment guarantee schemes at a minimum wage; and in large agriculture-based economies, better
water management, minor irrigation and drainage systems; genuine decentralization; and a pragmatic balance between the role of the State and the market.

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1. The demise of high employment policies

The extent of autonomy with which a country can pursue national economic policies has been changing continuously during the process of globalization. Although the situation varies from country to country, almost by definition, globalization means an increase in the relative importance of the external vis-à-vis the internal sector of the economy. Broadly speaking, and in conformity with the standard practices of national income accounting, the internal sector consists of goods and services produced and used domestically; whereas, the external sector consists of goods and services produced domestically for export to foreigners minus import of goods and services produced abroad for domestic use. However, this traditional view of the internal and the external sector relating exclusively to trade in goods and services misses the most important aspect that distinguishes the contemporary process of globalization from comparable historical experiences (approximately 1880-1913, during the height of the Gold Standard). This does not involve trade in goods and services, but private trade in financial assets in the future and on-the-spot foreign exchange markets through an enormous range of credit instruments. In this trade in financial assets involving foreign exchange, governments used to be the dominant player. However, since the successive waves of deregulation of the financial markets, starting from around the mid-1970s in the OECD, the relative importance of private financial traders compared to governments increased so phenomenally that it has drastically narrowed the space left for macroeconomic policies by individual national governments.

The numbers in this respect are indeed staggering. Recent estimates suggest that in less than a decade, between 1992 and 2001, the total turnover in the foreign exchange market increased from a daily average of 776 billion to 1,173 billion US dollars. This daily average trade of some 1.2 trillion dollars is more than fifty times the daily trade in goods and services, and ten times more than the daily trade in securities (BIS, 2001). The combined official reserve of all the Central Banks is estimated to have declined from some 15 days of daily private turnover in the foreign exchange market in 1977 to about that of a day by 1995 (Felix, 1998; tables 1A and 1B). As the relative importance of the private traders vis-à-vis the Central Banks increased to overpowering proportions, both governments and Central Banks felt compelled to pursue policies that do not disturb the financial markets. Note in this context that the “independence” of the Central Banks from their national governments does not mean their independence from the international financial markets.

The increasing importance of the external sector brought about by more trade in goods and services, combined with the phenomenal growth of a deregulated global private foreign exchange market during the current phase of globalization, have impacted heavily on the way national economic policies are conducted. Although in many important respects, the OECD countries differ from the developing countries, the general impact almost everywhere has been to create a strong bias in favour of restricted monetary and fiscal policies.

In consequence, the focus of attention has shifted from the high employment objective of the “Keynesian” era (say, 1950-1973) to the price stability objective, especially favoured by the financial markets in the “Monetarist” era (say, 1973-1998). At least partly as a result of this, the world economy slowed down visibly almost in all regions in the latter period of 1973-98, compared to the period 1950-73. This happened despite rapid increases in the trade of goods and services, from a ratio of export to world GDP at 5.5 per cent in 1950 to 17.2 per cent in 1998. In the OECD countries, excluding Japan, the per capita GDP growth rate fell from an annual average of over 4 per cent during 1950-73 to slightly over 2 per cent during 1973-98, while in Japan it fell from a dramatic high of over 8 per cent to 2.34 per cent. In the
“other Asia”, which excludes the relatively fast growing countries of Korea, Taiwan, Singapore, Hong Kong, Thailand and Malaysia, as well as China and India (it also excludes six other less successful Asian countries due to comparable data problem), the average growth rate fell from 4.1 to 0.6 per cent over the same two periods. The picture was similar in most other parts of the world: the per capita GDP growth rate fell from 2.5 to 1.0 per cent in Latin America, from 3.5 to -1.1 per cent in Eastern Europe and the former Soviet Union. For 75 per cent of Africa’s population living in the poorest regions, per capita income had peaked by 1980, but fell by a quarter of it by 1998 (Maddison, 2001, chapter 3). However, the only notable exception to this bleak global picture were the so-called East Asian “tigers”; but even they lost their growth momentum soon afterwards as the financial crisis of 1997 set in. More interestingly, the large economies of China and India, both of which integrated with the global economy with greater circumspection for entirely different reasons under different political systems, continued to grow at a distinctly higher rate compared to most other economies.

Along with the slowing down of the growth rates in most countries, the rate of job creation has also slowed down in varying degrees. A summary statistic capturing this trend is the output elasticity of employment, particularly in manufacturing. In a comparison of the two decades of 1970s and 1980s, this elasticity for the manufacturing sector declined from 0.54 to 0.39 in East Asia, from -0.07 to -0.08 in OECD, from -0.07 to -0.43 in Latin America, and most remarkably from 4.72 to 0.86 in Sub-Saharan Africa (Mazumdar, 2003, based on UNIDO data).

The shift in the intellectual climate of economic policy-making from “Keynesianism” with its focus on employment, to “Monetarism”, with its focus on price stability, was shaped more by the changing historical circumstances than by the force of any logical argument. Several historical developments, some but not all connected with globalization, have been at work to bring about this change over time. They may be briefly summarized here (Bhaduri, 2002).

a. Most obvious is the greater openness in trade in commodities and services due to globalization. It makes the Keynesian closed economy model of demand management less easily applicable.

b. This is reinforced enormously by the very large volume of private trade in international capital with cross-border mobility at lightening speed. In turn, it has created a new type of “openness” due to the fear of sudden capital flight to which macroeconomic management began to pay overriding attention.

c. The increasing importance of intra-firm trade. It is conservatively estimated at 40 per cent of world trade in manufacturing, and is mostly accounted for by trade within multinational corporations among their respective subsidiaries. Consequently, international trade no longer reflects accurately trade among nations, but very often trade among the subsidiaries of the same corporation across national borders. While national governments remain politically accountable for their balance of payments performance, the actual control has shifted significantly to the corporations. This is aggravated further by the fact that multinational corporations can move location with relative ease from the higher to the lower tax regimes; they may also escape a high tax burden through various devices of “creative accounting” like transfer pricing, arrangements for out-sourcing for tax concessions offered by governments and so on. As a result, the national governments’ ability to tax multinational corporations is severely restricted. At the same time, governments, especially in developing countries, feel compelled to attract multinationals in a “race to the bottom”, for access to their intra-firm networks for promoting exports. It
also becomes a signalling device to the rest of the world on the favourable investment climate in the country, often encouraged by the Bretton Woods institutions.

d. On the *political front*, the collapse of the former Soviet Union signalled the ideological retreat of bureaucratic central planning, and the end of economic competition between the two alternative systems. It was well known at that time that the centrally planned economies had somehow maintained full employment, while the market economies were subject to serious fluctuations in economic activity and employment. This systemic competition reached its critical point after the Second World War. The Marshall Plan provided generously for the post-war reconstruction of Western Europe to face the economic challenge of socialism (Hobsbawn, 1994). The unprecedented high growth era of post-war capitalism (1950-73), which was largely propelled by mass consumption and wage-led growth under the welfare state, came to pose a successful counter challenge to socialism. (Marglin and Bhaduri, 1990). However, as the economic competition between the two systems receded into the background, the political compulsion in favour of the welfare state rooted in the Keynesian theory also lost much of its force as an insurance against socialism. In its place, *liberal policies favouring market forces instead of state action became the general macroeconomic policy mode*. Keynesianism, which had laid the intellectual foundations for economic intervention by the welfare state, also lost its wide political acceptability. As a result, demand management today exhibits a strong bias in favour of the market, particularly of the powerful financial market. Boosting consumers’ confidence through a rising stock market, and private wealth like housing, tax cuts in favour of the rich, instead of government sponsored welfare measures, have become almost the norm of demand management.

e. Perhaps least recognized is the role that the *global electronic media* plays in the conduct of economic policy. It has created a “*culture of reverence to the market*” in the conduct of macroeconomic policies. In developing countries, the media propagates an almost popular culture. It pronounces judgment on the correctness of economic policies, usually with little supporting economic reasoning. For instance, “*sound finance*” epitomized by the concern for a low fiscal deficit of the government, rapid privatization, restraint on wage claims and labour market flexibility are typically considered reforms and policies in the right direction, irrespective of the specific situation of a country. Considerable time is spent on expounding the virtues of liberalization and privatization, but little attention is given to cases or situations when these policies failed.

This climate of opinion, to which the media contributes significantly, puts considerable pressure on governments to conform in the conduct of economic policies. The tendency is reinforced further when governments are politically weak. They find it especially convenient to absolve themselves of economic responsibilities like maintaining high employment by embracing this market philosophy. While a democratic government can be held accountable for its performance at least at the time of the election, the performance of the market faces no such time constraint. Note that even in the world of pure “*general equilibrium*” theory, at best the existence of equilibrium with (Pareto) optimal properties can be proved under a string of unrealistic assumptions about perfect competition. However, in general neither the stability nor the speed of convergence to the equilibrium can be proved even in theory. This means that the market need not achieve its equilibrium within any given period of time; rather like a dictator, it can continue to promise without delivering! And, weak governments can conveniently buy time without taking the responsibilities for direct intervention, and argue that the market process is gradually working towards the desired equilibrium. However, while this may be
politically convenient for some governments, the poor and the unemployed with their problems of day-to-day survival in developing countries can hardly wait indefinitely for the market to do the job in the “future”. This indeed is the most compelling reason why governments must intervene in the market mechanism in an attempt to move speedily towards creating and sustaining a high level of employment.

2. Asymmetric aspects of globalization

The shrinking of space left for the nation state in pursuing macroeconomic policy would have mattered less, if the process of globalization could be relied upon to fill that space. However, significant asymmetries characterizing the current phase of globalization make this especially unlikely for developing countries.

First, and perhaps the most obvious is the asymmetry between the freedom of movement of capital, especially financial capital on one hand, and the restrictions placed on the other, on the movement of especially unskilled labour from developing countries. Despite vast improvements in travel and communications technology, available estimates suggest that labour migration as a proportion of the total world population has been lower in the current phase (1973-98) compared to the earlier phase of globalization (approximately, 1870-1913; see Nayyar, 2002; Maddison, 2001; OECD, 1998).

Standard economic theories try to get around this problem in two ways – either by taking recourse to Samuelson’s famous “factor-price equalization theorem” or, to the more recent “convergence hypothesis”. The former claims that free trade in commodities would tend to equalize the wage (and profit) rates across countries. In this sense, free trade in commodities is offered as a substitute for labour migration. The “convergence hypothesis” claims that countries empirically exhibit a tendency towards converge in terms of per capita income over time (e.g Barro and Sala-i-Martin, 1995). The string of unrealistic assumptions needed to justify either of these claims need not detain us any longer here. However, note that both the “factor price equalization theorem”, and the convergence hypothesis are based on the assumption of continuous full employment of labour, and access to the same technology in all countries.

It has been claimed recently (Fischer, 2003) that, although there is little statistical evidence of countries across the world converging in terms of per capita income, the two largest countries in terms of population, China and India, are showing this tendency towards convergence due to their above average growth rates sustained over two decades. This is offered as the basis of the comfortable thought that more people, if not more nations, are tending towards convergence in terms of per capita income.

However, for this argument to hold, the patterns of personal distribution of income inside the countries of China and India have to be reasonably stable, without being too adversely affected by the process of liberalization and globalization, particularly at the lower end of the spectrum. And yet, almost all evidence suggests that domestic liberalization policies, ushered in to take advantage of the global market forces, worsened the distribution of income in China. Perhaps a higher percentage of people now live in absolute poverty, with the relative poverty gap also widening. In India, the subject remains controversial. While statistically these would remain controversial issues, there is something else we know with greater certainty, if we know anything at all about the link between globalization, liberalization and poverty. It is that the poorest sections in depressed rural areas in both
countries are largely unreachable through the market process. Consequently, the “absolutely” poor are beyond the scope of either the factor price equalization theorem or the converge debate! Since these also tend to be the pockets of high unemployment, direct government intervention rather than reliance on either the global or the domestic market mechanism is clearly called for in this respect.

The second important asymmetry in the current phase of globalization arises, on the one hand, from the increasingly free flow of trade in goods and services, and on the other, the growing restriction on the transfer of knowledge and technology embodied in the production of those goods and services. In the emerging regime of trade-related intellectual property rights (TRIPS), developing countries find it increasingly difficult to learn or adopt the production technology involved in the goods and services they import. At the same time, in the more liberalized trade regime of the World Trade Organization, they come under increasing pressure to import those goods and services rather than produce them at home. It tends to be forgotten that international trade has often been about trade for learning the technology embodied in the traded goods. This learning process involved through international trade may well be the most important dynamic gain from trade (Pasinetti, 1981), far outweighing the static gains of existing comparative advantage. Thus, the asymmetry of the emerging trade regime has been to promote freer trade in goods and services, while denying the developing countries the dynamic gains from trade through faster diffusion of learning about the productive processes and products.

Third, in the current phase of globalization a curious asymmetry arises from the role assigned to the state in monitoring and regulating economic activities. The market-oriented economic philosophy intends rolling back the role of the state as an economic actor, but it typically results in an almost schizophrenic view of the state. It is usually claimed that the state cannot be trusted with expansionary fiscal and monetary policies because it is considered financially irresponsible. At the same time however, it is relied upon with far more complex financial tasks like extending the scope of the market though privatization, regulating the stock exchange etc. This schizophrenic view is rooted in the asymmetry of denying the state its developmental and welfare role, but using it to promote “marketization” and globalization.

Finally, an even deeper asymmetry is to be found in the relation usually presumed between democracy and the market. Although the two are treated as mutually reinforcing concepts in the economic philosophy of neo-liberalism, the relationship between the “freedom” of the market economy and the “freedom” of political democracy tends to be more complex, especially in developing countries. The democratic principle of “one-adult-one-vote” coexists rather uneasily with the free market philosophy that the rich, with their greater purchasing power, would have more “votes” than the poor in the market place. This asymmetry becomes more acute, the greater is the inequality in the distribution of income, and the larger is the proportion of the poor with political voting rights, but being economically marginalized. In these circumstances, familiar in many developing countries, the democratic form of government becomes difficult to sustain if too much freedom is granted to the market. And yet, the forces unleashed by the process of globalization tend to drive these developing countries towards a situation in which they have little control over the free play of the global market forces.

As a matter of fact, the history of the relation between economic development and democracy has been considerably more complex than current “political correctness” would have us believe. Historically, the per capita income of a country usually had to reach a relatively high level compared to that of many developing countries today, before steps towards political democracy could either be taken or sustained. In this sense, democracy seems to have either co-evolved or in some cases might have even been a consequence rather than a cause of economic development (Chang, 2002). The potency of this argument has
greater relevance, insofar as integration with the world economy through globalization has not resulted in higher growth performance in most regions of the world. And, because economic growth in most developing countries has not been stimulated during the current phase of globalization, it seems a misleading over-simplification to maintain that the democratization of the polity is necessarily promoted by globalization. Undoubtedly, democracy is a desirable system of government, and so is the system of a free market. But it is unhelpful rhetoric to confuse them in a cause and effect sequence, insofar as it hinders the designing of an appropriate macroeconomic policy regime in developing countries.

3. Macroeconomic policies for employment generation: Interrelated national and international aspects

With its asymmetric characteristics, globalization poses a difficult challenge for national governments in developing countries. Their economic policies have to be conducted in a situation characterized by two contradictory tendencies. On the one hand, the macroeconomic policy space for national governments is becoming increasingly eroded by the process of globalization (section 1); on the other, the inherent asymmetries in this process (section 2) necessitate the formulation of independent policies to guard against these asymmetries working systematically against national developmental goals. The fact that globalization to date has turned out to be a flawed game, with asymmetrical rules fixed mostly by the more powerful richer nations, make this problem politically difficult for developing countries, and no developing country can avoid considering its interrelated international and national dimensions.

In negotiations about the global rules at the international level, the general thrust should be to press the need for differentiation according to the different stages in the economic development of different countries. Its logic is similar to that of “affirmative action” in the United States or of “reservation” in India. These have been generally accepted principles for protecting the rights of the relatively disadvantaged groups or “minorities”. As a matter of fact, not mere “majority” rule, but protection of “minority” rights is the essence of any democracy worth its name. Following the same principle, it is essential to devise and build into the process of globalization similar international rules. This is the only way globalization can become a more voluntary, participatory process for the economically weaker countries. The “rich-have-more-votes-than-the-poor” principle of the market system in negotiations for global rule making cannot achieve this.

Let only one recent example suffice here to illustrate how international negotiations deviate from this objective. The issue of fairer global trade in agricultural commodities, without subsidy to the farmers in richer countries is required, not merely for a freer trade regime; it affects also the poorest one billion people in the world, most of whom are connected directly or indirectly with agricultural activities in the rural areas of developing countries. There is hardly any other trade-related example with greater compatibility between a more efficient price mechanism operating through freer trade, and greater global equality. And yet, international negotiations governed by immediate and narrow national interests reduced global rule making to a “tit-for-tat” strategy of concessions and counter-concessions by all the countries concerned. In this process, the most essential principle lost sight of is that the protection of underprivileged or “minority” rights, through measures similar to affirmative action and reservation, is also needed on the international level. Without this, various aspects
of globalization, like environment, competition policies, international financial architecture etc. would have little chance of reaching a genuinely negotiated solution.

However, this situation would not change merely through negotiations until and unless developing countries are in a position to put their own houses in better order. Economically, this means less dependence on the richer countries in terms of aid, trade or foreign investment, and better economic performance at home. Only this way can they move towards a stronger position in international negotiations. This is also the unavoidable link for them between an effective macroeconomic policy regime at home and success in international negotiations.

From this point of view, an appropriately designed and executed employment strategy forms the very core of the macroeconomic policy regime. It can become the most effective way of combining equality with growth, while reducing political instability. It is in this context that the impact of increasing relative importance of the external vis-à-vis the internal or domestic market through globalization needs to be examined. It influences macroeconomic policy in a way which is seldom highlighted. It emphasizes the importance of reducing the costs of production through more efficient supply-side policies for increasing the international competitiveness of the national economy, while underplaying the problem of demand management for the domestic market.

The shift in focus from the demand to the cost or supply side has serious consequences, particularly in terms of level of employment. The most important examples relate to various cost-cutting policies in the labour market. For instance, the emphasis on increasing labour productivity is viewed not primarily as a source of greater availability of total output, but only as a tool for enhancing international or national competitiveness (Krugman, 1996). The result of this exclusive attention on the output per worker is to separate the productivity from the total output and the employment objective. For instance, the total output may decrease despite an increase in productivity, if the percentage decrease in the level of employment is greater than the increase in labour productivity. Thus the corporate strategy of “downsizing” the labour force to create a “lean and efficient corporation” for increasing market share, may turn out to be macroeconomically counter-productive, if both the total supply and the size of the domestic market shrink due to a lower level of aggregate employment.

An even more typical example of this line argument concerns labour market “flexibility”. Its central focus is some form of wage restraint, either by holding down the absolute level of wage, or its relative rate of growth compared to productivity growth. In both cases, such restraints on wage would tend to depress not only the unit cost of production, which is the objective of the policy, but also the consumption demand from wage income. Consequently, unless either higher investment or increased export demand makes up for that reduction in consumption demand in a regime of investment-or export-led growth (Bhaduri and Marglin, 1990), the problem of insufficient aggregate demand due to such policies of labour market flexibility would depress the level of economic activity and employment. Thus the policy of reducing unit cost through either downsizing the labour force or the flexibility of wages might turn out to be flawed from a macroeconomic perspective. It might be efficient on the microeconomic scale of a single corporation or enterprise, but such policies may also turn out to be counter-productive and inefficient on the macroeconomic scale at the same time, by precipitating a decline in demand, and higher unemployment.

This blurring of the distinction between micro- and macro- efficiency is indeed a general problem with many economic policies currently pursued in developing countries. It stems from “methodological individualism” in economics and from neo-liberalism in politics, with the two reinforcing one another. It gives rise to many “fallacies of composition” in macroeconomic policy, by assuming that the individual micro-economic “parts” have the
same properties as the “whole” macroeconomic system. As a matter of fact, the crucial difference between “business management” and macroeconomic policy lies precisely here. Therefore, while some of the corporate labour market management strategies may help individual corporations to gain a larger share of the national or international market by reducing unit cost, its overall macroeconomic effect may turn out to be counter-productive in terms of a shrinking size of the total market with lower employment level.

The fallacy of composition extends to the international level in the present era of globalization, as each country attempts to improve its international competitiveness by cutting unit costs, but without paying sufficient attention to the problem of aggregate in the domestic market. However, since global trade has to be balanced by definition, the export surplus of some countries must be matched by a corresponding import surplus of some other countries. As a result, not all countries can achieve an export surplus in this strictly zero-sum game through competitive cost reductions. Unfortunately, an increase in only the absolute level of export would not solve the problem of raising aggregate domestic demand, because the reduction in domestic demand due to import must simultaneously be taken into account. Consequently, unless a country achieves a larger level of surplus of export relative to its import level, international trade would not help in stimulating aggregate demand at home.

It might be recalled here that the fallacy of composition that results from the lack of demand coordination at the international level is not a new problem. Advanced market economies had experienced similar problems after the breakdown of the Gold Standard during the inter-war period. It became acute due to “beggar-my-neighbour” policies of competitive devaluation of national currencies followed by countries, until a “Stand-Still” agreement could be reached in 1936. In the present phase of globalization a similar problem seems to be resurfacing, less acutely, but on a global scale. It arises from wrong policies accepted as conventional wisdom, and appears in various guises, such as competitive labour market flexibility, competitive tax cuts, usually in favour of the rich, or various concessions offered competitively by national governments in a “race to the bottom” to attract foreign investment.

Without adequate policy focus on domestic demand, it threatens to create policy-induced competitive depression.

At the same time most developing countries, with their weak technological and infrastructural base, cannot hope to solve the balance of payments problem through competitive labour productivity growth or wage restraint in the near future. Like competitive devaluation and “beggar my neighbour” policies, if it solves the problem for some developing countries, it necessarily creates the same problem for others in this zero sum game, as they tend to compete mostly for the same export markets, with the exception of a few natural monopolies. In these circumstances it becomes almost inevitable for them to take resort to other measures. While a more liberalized trade regime rules out increased import control through tariff or quota, the level of import is compressed through depressing aggregate demand in the domestic market. Many of the recommendations and “conditionalities” of the Bretton Woods institutions, having a distinct bias towards compressing domestic demand, especially by the public sector, encourage this through their stabilization and structural adjustment programmes.

The general outlines of these programmes of restrictive monetary and fiscal policies of the government are well documented, exhibiting clearly this bias. For instance, a close link is postulated between government budget deficit (but not private sector deficit) and current account deficit in the balance of payments to make expansionary fiscal policies unacceptable. Independence of the Central Bank, and insistence that the government borrow from the capital market at the market rate of interest, restrain the use of accommodative monetary policies. The result is often a high interest rate regime. It discourages borrowing at home to finance investment but encourages those firms which have access to the international money market
to borrow abroad. In developing countries, they typically tend to be the subsidiaries of some multinationals. As these domestic firms become more exposed internationally, their vulnerability increases due to growing external debt, which is often underwritten subsequently by the national government. With a rising servicing cost of the debt and the threat of a “run” on the increasing volume of foreign debt, governments, typically persuaded by the IMF and the World Bank, feel compelled to impose even more restrictive monetary and fiscal policies to compress import, resulting in shrinking growth and employment. At the same time, the compulsion also increases to attract short-term capital inflows through high interest rate and low taxes, to cover the growing debt service burden and the current account deficit. At the same time, the government attempts to keep up the domestic exchange rate in order to avoid speculative capital flight. The result is a vicious spiral of politically unsustainable forced austerity, and often a financial crash. With some variations, this story line applies to the recent experiences of several countries in Central and Latin America, as well as to some in Asia. Their details often differ in important respects and in the intensity of the depression or crisis. However, the basic lesson remains that in developing countries, market-oriented policies under the rules of the game fixed by globalization run a high risk of frequent financial crises, and of policy-induced contraction in the level of economic activity.

To sum up, by over-emphasizing the role of the external market and international competitiveness, macroeconomic policy in developing countries run into a dilemma. On one hand, by failing to emphasize the importance of demand in the domestic market through fiscal and monetary intervention by the national government, it strengthens the tendencies towards economic recession. On the other hand, by forcing all countries to strive towards achieving export-surplus, it tends to aggravate the conflict of economic interests among the trading nations. Since an export surplus attained by some countries to stimulate their domestic demand depresses simultaneously the level of demand in the import-surplus countries, the net outcome of these two counteracting forces would generally be uncertain in terms of employment and economic activity for the world economy as a whole. Its only assured outcome is a heightened sense of conflict of economic interests among the trading nations. In this respect, most developing countries with a weaker economic, political or technological structure are placed at a particular disadvantage. Not only are they unable to achieve the required export surplus due to their general economic weakness, they are also restrained from turning towards their internal markets due to restrictive fiscal and monetary policies of their governments.

4. A macroeconomic policy framework for high employment with growth

Even when it is recognized that in the present phase of globalization, neither unbridled market-oriented policies, nor mindless bureaucratic central planning would generally succeed in generating high employment and growth in most developing countries, one is left with the question: what is the alternative? This question is of paramount importance. It is perhaps the most important intellectual task facing economists concerned with development. It requires an alternative set of macroeconomic policies, which would be capable of generating high employment with growth in developing countries.

Two fundamental principles discussed in the last section provide some necessary guidelines. First, relatively greater emphasis has to be placed on the internal or domestic market compared to the external or foreign market, contrary to the opposite tendencies
generated by globalization. Secondly, this broad principle on the demand side needs to be complemented on the supply side by not separating the consideration of flexibility in the labour market and growth in labour productivity from that of the level of employment. This is important not only for an employment strategy, but also because productivity and employment together determine aggregate supply that needs to be matched by aggregate demand. These two basic principles can be largely complementary in order to make high employment and growth also complementary objectives.

Needless to add, these general principles have to be country-specific. For instance, relying more on domestic demand is generally easier for the larger than for the smaller countries. The smaller countries have a more immediate interest in this respect. However the larger countries also have to realize that the same principle guiding voluntary participation in a democratic order at the international level applies with even greater force in the case of forming regional blocks, because the global economic climate otherwise is not particularly favourable to forming such blocks by developing countries. For no country, large or small, can a regional block be viable for long unless it satisfies the game-theoretic principle of a “stable coalition”. In the present context, this broadly means that, not only the regional block should be mutually advantageous to its members, but each member of the block must also recognize that they would be worse off by leaving the block, or by trying to make alternative blocks. This requires adhering to the principle of voluntary participation within the regional block in the enlightened self-interest irrespective of the size of the country. Just as the continuing stability of a democracy requires majority rule, recognizing the rights of the minority, similarly larger countries also need to recognize that, even without strict reciprocity, some special rights have to be conferred on the smaller countries in their own longer-term self-interest. In this respect it is analogous to affirmative action and reservation in the interest of a stable, democratic polity (see section 3).

The emphasis on the internal market also provides the perspective necessary to deal simultaneously with employment and labour productivity growth, getting away from the usual rhetoric that productivity growth and labour market flexibility are required as instruments for greater international competitiveness. The macroeconomic policy framework has to reinforce instead the link between rising productivity and an expanding domestic market to achieve and sustain a high employment rate. Since high employment also has a built-in mechanism for maintaining high domestic demand with more equal distribution of income, it actually reduces the need for government interventions in several other directions, e.g. unemployment benefits, extensive subsidies, income transfers etc. Thus a high employment policy becomes desirable, not only in its own right, it is also a way of reducing many other administratively costly, wasteful and cumbersome forms of government interventions.

Once it is recognized that productivity and employment can be complementary objectives, it becomes necessary to treat with skepticism theories which argue in favour of relatively capital-intensive techniques of production for increasing productivity and surplus per worker at the cost of the current level of employment. It is claimed that this is needed for stepping up the longer-run growth rate of output and employment (e.g. Dobb, 1960; Sen, 1960). The argument is unacceptable for several reasons. It has adverse distributional implications, insofar as a higher surplus per worker through a more capital-intensive method of production implies a higher share of profit in national income. It is likely to reduce consumption out of wages, posing the problem of maintaining adequate aggregate demand in the domestic market of a developing economy. It can be escaped under bureaucratic central planning by taxing and investing the entire surplus, but this solution is neither desirable nor viable in a market economy.

From the supply side, the crux of this strategy of raising productivity and employment simultaneously lies not in focusing mostly on the debate between labour- or capital-intensive
techniques, but in choosing a suitable mix of industries and sectors. Let an important example illustrate this. Investments in social and economic infrastructure, e.g. health, education, simple housing, energy and communication are almost universally recognized to be the important and basic ingredients for raising labour productivity. Developing countries, especially as regional blocks, may even have the capability in terms of their existing industrial structures and capacities to provide for many of the physical inputs required, for at least in some of these investments, with minimal foreign components. However, guided by the crippling doctrine of “sound” public finance, which puts a strict ceiling on the government’s fiscal deficit in all circumstances, they do not undertake such bold public investment programmes by expanding demand through government orders. They are deterred further by the fact that such projects carried out through available domestic capabilities would not have sufficiently high productivity. These views are counter-productive in terms of both employment and growth through capital formation.

The essence of the Keynesian argument is relevant in the present context. Investment in many of these circumstances would be capable of generating much of the needed savings through an expansion of output. In the present example, it would be attainable by the expansion in output made possible through relaxing the constraints on infrastructure with some time lag. And, the weaker the constraint of the supply of wage-goods, the less would be the fear of inflation in the short run. In undertaking these investment programmes, a well-run public distribution system covering the poorer sections of the working population – rather than a low fiscal deficit of the government – should be the focus in dealing with the problem of inflation. Insofar as public finance is concerned, the higher level of supply that would come forth in response to the higher level of demand over time would expand tax revenue. In addition, economic infrastructural investments, which increase private property values, also provide a legitimate basis for expanding the tax base by taxing capital gains on those properties at a higher rate. While devising the exact contours of the tax regime must be left to the individual governments concerned, this indicates the direction for formulating an employment-oriented alternative set of macroeconomic policies.

A well functioning public distribution system for the poorer sections is an essential component of such an employment strategy. Nevertheless, the expansion of domestic supply especially of wage goods to match the additional demand created by higher investments, would be easier to achieve, if the speed of adjustment of supply is relatively fast. In choosing specific projects the investment programmes, their short- versus long- yielding aspect needs to be carefully examined. This is generally a more important consideration than capital intensity in the choice of both the method and the composition of industries and output. Insofar as smaller decentralized projects have this advantage over larger projects, they are to be favoured.

The identification of the sectors and industries would naturally tend to vary from country to country. In developing economies with a predominant agricultural sector, growth in agricultural yield and employment, especially by reducing drastically seasonal unemployment, seems relatively speedily attainable through better water management by means of short-yielding, minor irrigation and drainage schemes. This is also a precondition for raising agricultural yield and greater labour absorption in agriculture through greater crop diversification and increased cropping intensity.

However, without better communication and storage facilities, commercialization of agriculture will not proceed far, which in turn is essential for crop diversification and greater labour absorption in agriculture. Fortunately, these are construction-intensive activities, where rural unemployment can be absorbed in an economically useful manner. An employment guarantee scheme at a minimum wage can provide the framework for this in many developing countries.
Perhaps the most obvious starting point for breaking the inertia of low employment, is to finance the employment guarantee scheme through an expansionary budgetary policy of the government. As emphasized earlier, current orthodoxy in economic theory, encouraged by the Bretton Woods institutions, takes the view that budget deficit is undesirable in almost all circumstances. However, this is not merely or even primarily a technocratic issue. Any government accountable to its people must ask the question: do we leave the unemployed and the desperately poor to the mercy of the market forces? Particularly when no one knows even in theory, let alone in practice, how long the market mechanism might take to do this job even, if it does it at all; or do we try dealing urgently with the problem of survival for the poor even at the risk of partial failure? Governments in poor countries can remain legitimate in the eyes of the majority only by acting urgently.

In financing an ambitious employment generation programme in a developing country, the most serious fiscal problem that the government has to guard against is the external public debt to be serviced in foreign currency. A high level of external debt squeezes the import capacity. In addition, it carries the danger of precipitating a sudden financial crisis, if for some reason foreign private lenders try to withdraw their credits in a panic. With internal debt these problems tend to be less serious without capital account convertibility. This is because the government usually has the option of recycling this debt to a large extent with new issues and new credit instruments. By and large, when an economy is growing with reasonable price stability, the equality in the distribution of income and low unemployment, the government remains credible in the eyes of its people without difficulty, even with high fiscal deficits. It is also able to finance its debt without difficulty; and there is no obvious limit to the extent to which a credible government can borrow further to service its internal debt. It is indeed rather one-sided of the so-called “sound finance” doctrine to suggest that the level of fiscal deficit, more than any other indicator like growth or employment level, affects the credibility of the government. Thus, in the face of serious unemployment, the central issue should not be whether the government should run a large deficit to finance its employment generating policies, but whether such a strategy would be effective. Three conclusions regarding the government’s budgetary policy follow: (a) greater caution should be applied in contracting foreign debt, and premature capital account convertibility; (b) a bureaucratic limit on the extent of a permitted budget deficit is not justified in leaving serious unemployment problem unattended; (c) a closer examination is needed not of the extent of deficit, but whether the deficit can be effective in fighting unemployment, and sustaining high employment with growth over time.

A more general objection about the budget deficit of the government follows from a general mistrust of the government, which is often but not always justified. The government, like the market, often fails, and fails miserably. The way to approach this issue is to consider whether some correction mechanism can be put in place in case of serious and continuous failures. This applies both to the government and the market. While we must remember how disastrously things can go wrong with no self-correcting mechanism under bureaucratic central planning, we must also not forget that the market has not solved the serious unemployment problem over the years in most developing countries.

Drawing lessons from both these experiences, a more pragmatic balance between these two equally essential institutions, the state and the market, seems unavoidable. A more balanced and fruitful approach towards this problem would be to let both these essential institutions develop in a historical “double movement” (Polyani, 1944). In this process, each institution would play the role of restraining the other from over-reaching itself. By and large, this seems to have happened historically in most cases of successful development of the market economies. Thus, when the market fails visibly and marginalizes too many citizens, as in the case of serious unemployment, the state has to take corrective actions. Conversely,
when the state over-reaches itself in an unsustainable manner by continuously expanding socially unproductive employment, the market has to reassert itself for restoring the balance. There is clearly no once-for-all ideological answer in this complex game of balancing, which is valid under all circumstances. It is more akin to a process of “challenge and response” between these two equally essential institutions. The employment-promoting programme has to be devised with this broader historical perspective in mind. From this point of view, genuine decentralization, giving powers to the local bodies in devising and executing such a programme, would dilute the power of the centralized government. This would maintain a better institutional balance, and therefore, should be encouraged as far as possible.

Schemes for employment generation chosen by a remote, non-accountable centralized bureaucracy often turn out to be useless, because they fail to be sensitive to local needs. Very often, they also suffer from “gigantism”, by being unnecessarily big and technologically complicated. A centralized bureaucracy can handle them more easily, but the relatively unskilled and unemployed labour cannot contribute effectively to such schemes. In addition, a large fraction of the funds usually leaks out in administering these large, centralized public works, with the result that the programme becomes less effective in reaching the unemployed poor. A common dilemma is that a relatively large machinery for supervision would raise the administrative costs; but without it, there is the danger of non-performance, inefficiencies and corruption.

The way out of this dilemma is to take recourse to decentralization with three essential provisions. First, while the decentralized local bodies should have control over the use of the funds in executing the local projects, they must be accountable through transparency in their budgets. This can be attained through legally recognized rights to information regarding the functioning of both the central bureaucracy and the decentralized local bodies. Second, the public distribution system for essential wage goods should also be decentralized simultaneously. This requires creating local storage facilities which will provide an avenue for useful decentralized public works. Finally, to sustain such programmes over time in a market economy, attempts have to be made to rely increasingly on the market. This requires moving gradually towards the principle of “(s)he who benefits should (partially) pay”. This can be attained in two mutually supportive ways.

The first way would be to aim at extending the schemes to specific types of capital formation on local private property, although they are chosen for their social benefits or positive externalities, e.g. small irrigation, land improvement, linked pathways through private lands etc. While they would benefit the community, they might also benefit directly one or more private owners of land or other property. The application principle would mean that those private beneficiaries should partly bear the cost of those projects, The second way reinforcing the first, would be to ensure that the private owner(s) belonging to the local community participate(s) voluntarily, because they benefit and bear part of the cost through transparent time bound negotiations at the local level. The payments to the local bodies have to be based on transparent rules. If achieved, this decentralized system involving also the owners of private property would reduce both the cost of the public works to the local bodies and the need for supervision, because the private beneficiary would be interested in the quality of the public work done.

The above argument might even be extendable within limits to the use of some socio-economic capital formations at the local level, like secondary schools and vocational training centres, insofar as the private beneficiaries acquire skills through training for improving their earning. If they actually improve their earning, they might bear part of the cost according to their ability to pay as decided by the local bodies.

However, it has often been suggested that better training schemes like micro-credit, would raise the aggregate level of employment. This view is not entirely correct, and training
facilities by themselves usually cannot generate more employment on the macro scale. Being pure supply side policies, there must either be latent demand in the market for those skills or conscious demand side policies must complement them simultaneously. As a matter of fact, by itself and in the absence of untapped latent demand in the market, training usually raises the bar on entry to the labour market. It becomes like shuffling the long queue of job seekers, where the better-trained are placed in the front of the queue without the length of the queue itself getting shortened. The increased level of say, graduate unemployed in many developing countries points precisely to this phenomenon. Both micro-credit and training schemes are useful supply side programmes in isolation, provided there is untapped latent demand for those skills and products in the market. However, it would be misleading to consider them as substitutes for the policies focusing on domestic demand-led expansion in favour of which we have argued.

5. A set of specific proposals

In the light of our above discussion, a set of specific macroeconomic policies that can initiate and sustain a high level of employment may be summarized briefly.

Domestic demand-led expansion is the cornerstone of this employment strategy. This means placing due emphasis on the domestic market, instead of being too preoccupied with competitiveness in the external market. In this sense, it is not an export-led growth strategy, because most developing countries cannot achieve continuously an export surplus in an international zero-sum game to stimulate sufficiently their home demand. Nor is it an import substitution policy, because that too is motivated largely by considerations of dealing with the external market and the foreign exchange constraint. Our emphasis instead is on the domestic market to promote and sustain higher employment by changing the sectoral composition of investment.

An employment guarantee scheme at the minimum wage rate, financed to the extent necessary by an expansionary budgetary policy of the government, might be required to break the inertia of continuing serious unemployment. This would kick-start the programme in the face of serious unemployment, especially in depressed rural areas.

The need for decentralization of activities and administration through local bodies with increasing reliance on the market. This might be attained by gradually extending to private properties some of the public works, based on the principle of “(s)he who benefits should (partially) pay”.

The decentralization has to cover both public works and the public distribution system for essential wage goods. This indeed is the appropriate way to ensure higher employment with price stability, without a crippling obsession with the budget or fiscal deficit of the government.

The decentralization would function satisfactorily only if transparency regarding the allocation and use of funds can be ensured. In turn, this requires recognizing the right to information at all levels of administration concerning the receipts and disbursement of funds, and the rules according to which this is done.

A crucial component of this strategy is not to separate the objectives of growth in productivity, and in employment. This separation typically happens, because productivity growth is considered only as an instrument for enhancing competitiveness, while it is forgotten that higher productivity together with higher employment makes more goods and services available for the domestic market. It is important to recognize that, especially in poor
countries with various types of technological backwardness and handicaps regarding international marketing, productivity increase along with higher employment is needed, more for augmenting the availability of total output than international competitiveness.

The higher availability on the supply side is to be matched by the increased level of demand resulting from the expansionary government budget to finance the programme for higher employment. Consequently, the speed of adjustment of supply has to broadly keep pace with the expansion in demand. This requires paying greater attention to short-yielding projects, especially for wage goods, where decentralized schemes like minor irrigation, drainage and storage facilities usually have some natural advantages in this respect.

Since only a sufficiently expanding market can accommodate high growth in both employment and labour productivity, fiscal and monetary policies at the macro level should primarily be directed at influencing the rate of expansion of the domestic market. It is important not to follow fiscal and monetary policies exclusively either in search of productivity growth, or for improving the balance of payments.

The extent to which decentralized public works leads to more economic and social overheads and infrastructural facilities, it implies an indirect increase in the social content of wage. The local bodies should try to ensure that this indeed becomes a reality. It can go some way in reducing the pressure for increases in private wage rates, and make such employment-generating schemes more self-sustaining.

Many developing countries are facing an increasingly unmanageable problem of rapidly expanding cities and mega-cities with deteriorating infrastructure due to the massive influx of job seekers in the urban sector. This has meant, on the one hand, more and more resources going into the cities in a desperate attempt to cope with the problems of urban infrastructure, and on the other it meant lack of resources to improve rural infrastructure. The result has often been a steadily growing urban-rural divide, and a phenomenal growth of the so-called urban informal sector. Thus, it is not only the direct pull of higher expected earnings from urban employment that leads to in-migration into cities (Harris and Todaro, 1970), but also the indirect pull that operates because the urban centres are generally far better equipped with economic and social overheads. In effect, this becomes the “social” component of urban living, raising indirectly the urban wage or earnings. An important objective of decentralized public works in rural areas would be to reduce gradually this urban-rural gap in the social infrastructure. In turn, this would reduce also the gap between the social component of living and earning in urban and rural areas.

Employment in the informal service sector has grown at a disproportionately rapid rate in many developing countries. A high percentage of this employment is not wage employment but self-employment. The self-employed category consists of a relatively small percentage of high professionals, and often a very large percentage of the poor who are forced to take refuge in this sector without any other possibility of a livelihood. In particular, they are attracted to urban areas due to the urban-rural discrepancy in the availability of socio-economic infrastructural facilities. In any employment policy, it is essential to consider this segment characterized by massive disguised underemployed. By and large, their productivity, at least in the short run depends not so much either on the little capital or skill they possess, but on the level and composition of demand generated for their products, and on the infrastructural facilities they can use (Reddaway, 1962; ILO, 1972). One of the advantages of the macroeconomic policies outlined above for improving local infra-structural facilities in non-urban areas would be to help many of the self-employed to find a better livelihood in the rural service sector, by providing them with better infrastructural facilities. At the same time, it would also reduce the pressure for in-migration to the urban areas.

Finally, for generating and sustaining employment in the informal, less skilled services at a higher level of earning, several possible sources of demand need to be
considered. This is especially relevant for those small countries, which are not predominantly agricultural, or have other natural limitations. A main thrust in their macroeconomic policy should be to develop a symbiotic relation between the organized and the unorganized sector even within the domestic economy through sub-contracting, complementary skill and training development etc. Fiscal and monetary policies should be designed towards this objective. One way to visualize the strategic link to be forged between informal services and other sectors of the economy is to develop “nodal points”. They would mostly link backwards from the level and pattern of final as well as inter-industrial demand generated in other sectors and converging to the node of informal services as the supplier. In this respect, policies often failed in the past in many countries, because emphasis was laid almost exclusively on improving and modernizing the supply side, without forging the necessary demand links to the local markets either in the rural areas or, to the organized industries and urban centres. In contrast, the concept of a “node” might be a helpful starting point, insofar as various types of demand from these different sources would have to converge to some extent in the informal service sector to make it absorb labour in a socially useful way. This might also be the way ahead for transforming gradually the informal service sector from mostly a “refuse sector” of the desperate jobseekers into a genuinely dynamic sector of the economy.
6. References


