Overview and main policy messages

Dismal chances for decent employment are as unsustainable as they are widespread in today's interdependent world economy and underscore the imperative of promoting decent work as the central aim of development. For the ILO, this implies the need for the world community to coalesce around two basic aims. The first of these, as articulated in the report of the World Commission on the Social Dimension of Globalization[1] is that of making employment a central objective of macroeconomic and social policies – rather than a hoped-for outcome of policies that, more often than not, do not directly address the employment challenge. The Commission report's conclusion is predicated on the observation that rising economic interdependence has neither been inclusive nor uniformly beneficial.

The second shared objective is that of poverty reduction, with a focus on the fundamental role that employment plays in attaining that objective. For a variety of reasons – a context of inadequate global economic growth among them – the 1990s largely saw a slowdown in the rate of poverty reduction. This, in turn, reinforces the need for policies to focus on "working out of poverty", a theme broadly explored at the International Labour Conference in 2003.

Employment creation and poverty reduction have long been mainstays of ILO research, policy advice and technical cooperation. Their need to remain so is again reinforced in an environment in which economic interdependence is coinciding with imbalances, asymmetries and inequality in the world. Less common is the association of employment and poverty reduction with the third theme of this Report, productivity.

Why a focus on productivity?

The fundamental reason for addressing the three issues together is based on the simple observation that a substantial share of poor people in the world is already at work: it is not the absence of economic activity that is the source of their poverty, but the less productive nature of that activity. In purely empirical terms, the link between work of low productivity and poverty is starkly clear. It is a straightforward proposition that if people – in particular, the 550 million people working in poverty – were able to earn more from their work, then poverty would decline. It is not just any work that can raise people out of poverty; what is needed is productive work. The ILO Employment Policy Convention, 1964 (No. 122), promotes freely chosen, "productive" employment. The Millennium Development Goals articulate the objective of decent, "productive" employment for young people.

[1] World Commission on the Social Dimension of Globalization: *A fair globalization: Creating opportunities for all* (Geneva, ILO, 2004).

The indications of a decent work deficit in the global labour market, from the absence of social protection to the absence of basic rights at work, are many. A key *economic* indicator of that deficit is whether men and women earn enough from their work to lift themselves and their families out of poverty. It is here where productivity matters most. It is through productivity that a material link exists between employment of any sort and decent work. This, by implication, suggests that a narrow focus on "unemployment" and "employment" as a means of describing labour market conditions is, in fact, a sorely inadequate gauge for most countries of the world.

The main policy messages of the *World Employment Report 2004-05* are laid out in this overview. It is useful to begin, however, with a brief discussion of the importance of productivity in the creation of decent jobs and poverty reduction.

The benefits of productivity gains

The pursuit of productivity gains is essential for increasing standards of living, for it is through this approach that rising levels of wealth are generated. The beneficial effects of productivity gains can be evaluated at the level of the individual worker or enterprise, as well as at the macroeconomic level at large. For workers, an increase in productivity ideally leads to higher wages, allowing them to take home higher pay or to reduce their working time, or both. For the enterprise, productivity gains result in lower unit costs of production and thus higher profits that can be reinvested and also distributed to workers in the form of higher wages or more jobs, as well as to shareholders in the form of increased dividends. Producing more with less also allows enterprises in competitive markets to lower their prices, and is thus a chief means by which enterprises shore up their competitiveness (and can, at the same time, make other firms relatively less competitive).

There are also important macroeconomic benefits arising from productivity gains. Aggregate demand both fuels productivity growth and is bolstered by it, both directly and indirectly. As to the latter, the direct stimulus comes from workers who are also consumers with higher disposable income to spend as a result of wage gains arising from improvements in their productivity. The indirect stimulus to consumption arises through the price channel: lower prices resulting from improved productivity are the equivalent of an increase in real incomes for people. Productivity contributes to a country's standard of living, as the most fundamental barometer of living standards is the earnings that people make, and the determinant of those earnings is the productivity with which people work.

Simple theories, but complex realities

The benefits of improving productivity seem straightforward, but a thorough understanding of productivity would fill (and has filled) volumes as, rather unhelpfully, just about "everything" matters. Indeed, a truly thorough excavation of the topic would entail an unpacking of all the determinants of growth and

development. For example, the prime source of productivity growth is technological change. Technological change, in turn, relies on innovation, which itself is influenced by an array of institutions, the quality of the supply of human capital, competitive market dynamics, spending on research and development (R&D), and investment in general. These in turn depend upon the strength and stability of aggregate demand, and thus on the macroeconomic framework. Investment is a catalyst for innovation, but the reverse is also true: innovation spurs investment. The determinants of productivity growth cannot be thoroughly fathomed without consideration, not only of the supply side, but also of the demand side components.

But sources of productivity growth also depend on macroeconomic institutional and regulatory factors. Changes in the organization of work and production have a profound influence on productivity, and one long acknowledged – from Adam Smith's depiction 250 years ago of the birth of the factory system with its ever more minute division of labour, to contemporary discussions of the "knowledge economy" and "high performance work systems", both of which underscore the salience of human capital and its organization as a source of productivity growth and competitive advantage.

Commercial regulations, for example the ease or difficulty with which new businesses can start up, can either facilitate or frustrate the entry into new, higher value-added activities. More fundamentally still, basic property rights and enforcement of contracts also play a role in productivity dynamics:

> Strengthening property rights over land appears to be an important element. For example, the 1978 rural reforms in China, which entailed a shift from collective to household farming, are credited with engendering increases in agricultural productivity and an explosion in town and village enterprises which have been the engine of growth in China up to the mid-1990s. In a similar vein a government program which increased tenurial security in West Bengal had a large positive effect on agricultural productivity. Issuance of property titles to urban households in Peru led to an increase in labor hours and a shift in labor supply from work at home to work in the outside market. Land reform acts passed in Indian states account for about ten per cent of the overall fall in poverty across the 1958-1992 period.[2]

Basic infrastructure also matters. An adequate transportation system lowers costs and improves market access, for example. So does a good communications infrastructure. Well-developed health-care and education systems are part of the social infrastructure which, among their other benefits, also improve productivity, since a healthy person is more productive, as is an educated one.

For the obvious reason of the breadth of the topic, the present Report is not intended to be a historical review of growth and development with productivity as its cornerstone. Rather, its ambition is more circumscribed. The Report takes as its starting point the stark observation that, in today's world of widening inequality, differences in productivity performance emerge as an important policy

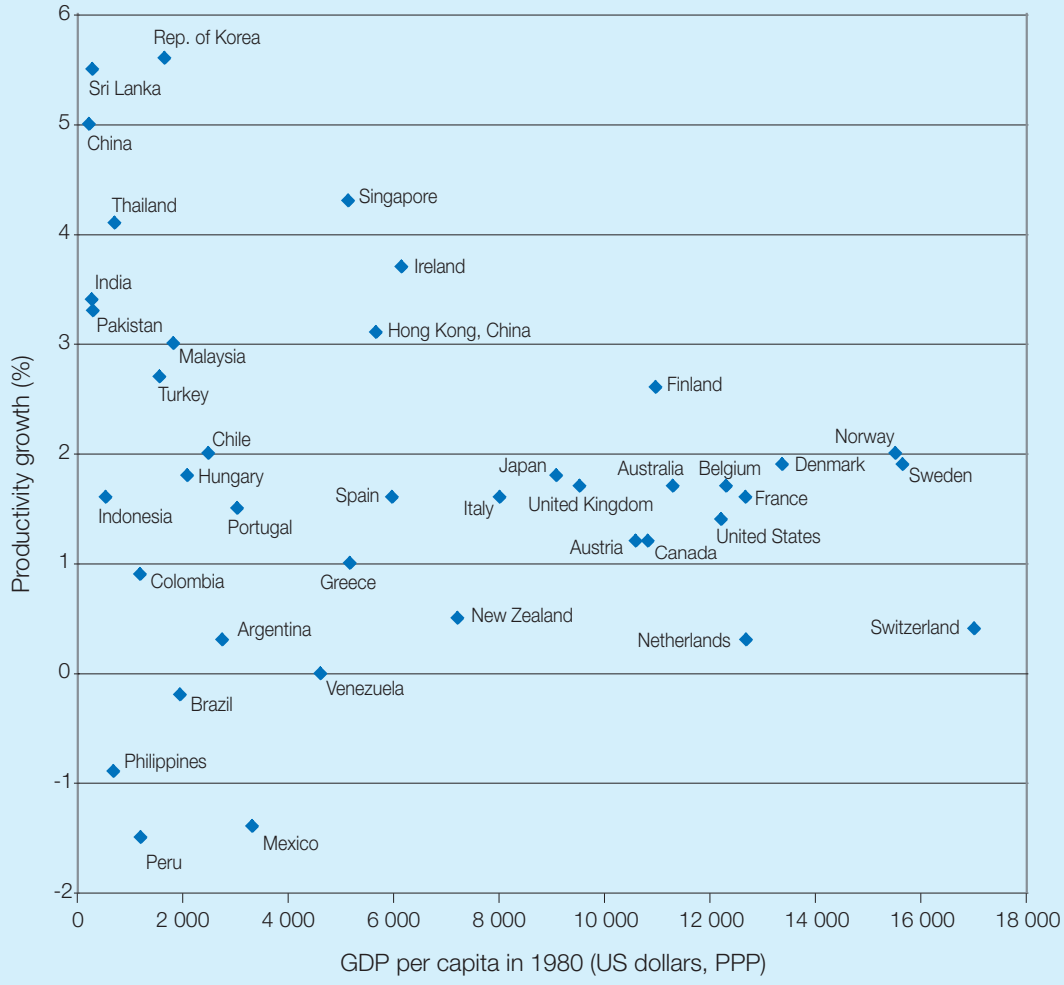
[2] Robin Burgess and Anthony Venables: *Towards a microeconomics of growth* (World Bank Policy Research Working Paper 3257, April 2004), p. 13.

factor to which attention needs to be devoted, particularly towards the goal of creating the conditions for decent work and poverty reduction.

The challenge can be visualized in figure 1 below, which shows the 20-year average annual growth of labour productivity, 1980-2000, in several countries, benchmarked against their per capita national income in 1980. The implication is that some countries that were relatively poor in 1980 became substantially wealthier because they were able to sustain strong growth in productivity, while others that were relatively poor in 1980 are, in relative terms, poorer still today, as productivity growth lagged.

In particular, many developing countries in the upper left of the figure (e.g. Singapore, the Republic of Korea) sustained substantial growth in labour productivity and were in consequence able to follow the path of income conver-

Figure 1. Annual growth in labour productivity between 1980 and 2000 vs. GDP per capita in 1980 (US dollars, PPP)



Source: World Bank (WDI), 2004; ILO (KILM, 3rd edition), 2003.

gence with the wealthier countries; that is, they would have moved substantially to the right of the figure if their per capita income were shown for the year 2000, rather than 1980. The fact that many highly developed economies, such as Switzerland, show low annual productivity growth rates does not indicate that later on in the development process productivity growth no longer matters. The relatively low growth rates only indicate that at later states of development the levels of productivity are so high that further productivity growth slows down compared to earlier stages.

In contrast, developing countries in the lower left of the figure trailed behind in productivity growth over the 20-year period, the result being a greater gulf between them and the "high productivity performers" in per capita wealth. Again, decent work has many components; the fundamentally economic component is access to a level of income adequate to escape from poverty, which ultimately must come from growth – growth in output, growth in productivity, and growth in jobs.

A controversial topic? A simple understanding of productivity

If the beneficial outcomes of productivity improvements are so important in both theory and fact, why does the topic elicit such a broad spectrum of views: from those who single-mindedly view productivity gains as the panacea for economic growth, to those who are considerably warier? The answer is simply that productivity increases and jobs can be, and often are, inversely related – jobs can be lost as a result of improvements in productivity. The conditions under which this occurs beg the question of how productivity improvements themselves occur. And to understand that requires a simple definition of productivity.

Productivity is a relationship between outputs and inputs. It rises when an increase in output occurs with a less than proportionate increase in inputs, or when the same output is produced with fewer inputs. For example, a garment worker's productivity could be understood as how many shirts she is able to stitch in one hour. Let us assume that she can produce two. If new capital investment – a new sewing machine, say – allows her to complete three shirts in one hour rather than the two she had been producing, then this would be a 50 per cent increase in her productivity – perhaps attributable in part to new skills she has acquired, and in part to "new technology".

Yet productivity can be understood in terms of *value* as well as *volume*. For example, if for whatever reason the value of the final product increases (an increase in its price with no increase in the cost of inputs), this in money terms is an increase in productivity. It can even be imagined that productivity could increase in *volume* terms, (e.g. more coffee beans picked with the same number of workers), but decline in *value* terms through plummeting market prices, as has indeed happened in the case of coffee. Thus, higher physical productivity can result in lower earnings and incomes rather than higher ones.

When productivity growth is the outcome of the expansion of output with existing or even more "inputs", such as labour, then this can lead to a situation in

which everyone benefits. As a simple arithmetic proposition, however, if output growth trails the growth in productivity, then fewer inputs, such as labour, are required to produce a given level of output. This downside of productivity growth is historically commonplace. Labour-saving technological change often allows firms to produce the same or greater output with less labour input. Indeed, at least since the Luddite protest of two centuries ago in England,[3] the central concern of workers has been that gains in productivity brought about by new machines result in job losses. In an immediate sense, their concerns were indeed justified. In a longer term, aggregate sense, they were not; the Industrial Revolution was associated with substantial employment growth.[4]

The loss of a job is one matter. But potential adverse consequences of productivity gains are not limited to job loss alone. What if, for example, higher productivity is reflected solely in higher profits, rather than higher wages, perhaps because workers have little bargaining power? Or take, for example, the worker who is wary of productivity increases because, for him, it translates into working harder (more intensively) or longer hours for the same pay. Productivity has increased (through what amounts to a reduction in the cost of labour input) without any direct benefit to the worker whose effort was responsible for it. Indeed, the latter case has a contemporary resonance in Europe in recent months, as some companies on the grounds of remaining cost-competitive have sought to expand working time with no change in the level of remuneration.

In short, wariness over the impact of productivity growth is roundly justified, and the concern is even greater in today's world of growing economic interdependence. For example, the search for any one company's productivity improvements is less and less confined to national boundaries. The three-year recovery from the recent recession in the United States was characterized both by substantial gains in productivity and the longest period of "jobless growth" in post-war history. While their claims are overstated, as the Report's second chapter will discuss, critics of the relatively poor employment performance in the United States in that period attribute this to the outsourcing of jobs formerly in the United States to foreign locations – "jobless" in one location but "job-creating" in another in the broader geography of global competition.

The longer-term impacts of productivity growth

In the long term, there is no necessary trade-off between the growth of productivity and that of employment. And the evidence broadly corroborates this. Eco-

[3] In 1811, a group of workers in England formed a secret organization to fight against what was in their view the outcome of the Industrial Revolution. Their targets were the wide-frame stocking machines which were causing falling wages and unemployment in the Midlands. Letters were sent to factory owners, demanding the removal of the machines and workers broke into factories to destroy the new machines that the employers were using.

[4] At the time, however, employment growth had a further, defining characteristic: the master craftsman embodying all the skills needed to produce a product that was replaced by a greater number of workers with a lower level of skill.

nomic history shows that, in the long run, the growth of output, employment and productivity proceed in the same, positive direction. This is not, however, to say that the trends in each variable are either linear or homogeneous across countries. Indeed, a stagnation or decline in productivity characterizes some countries in the world well beyond the short term.

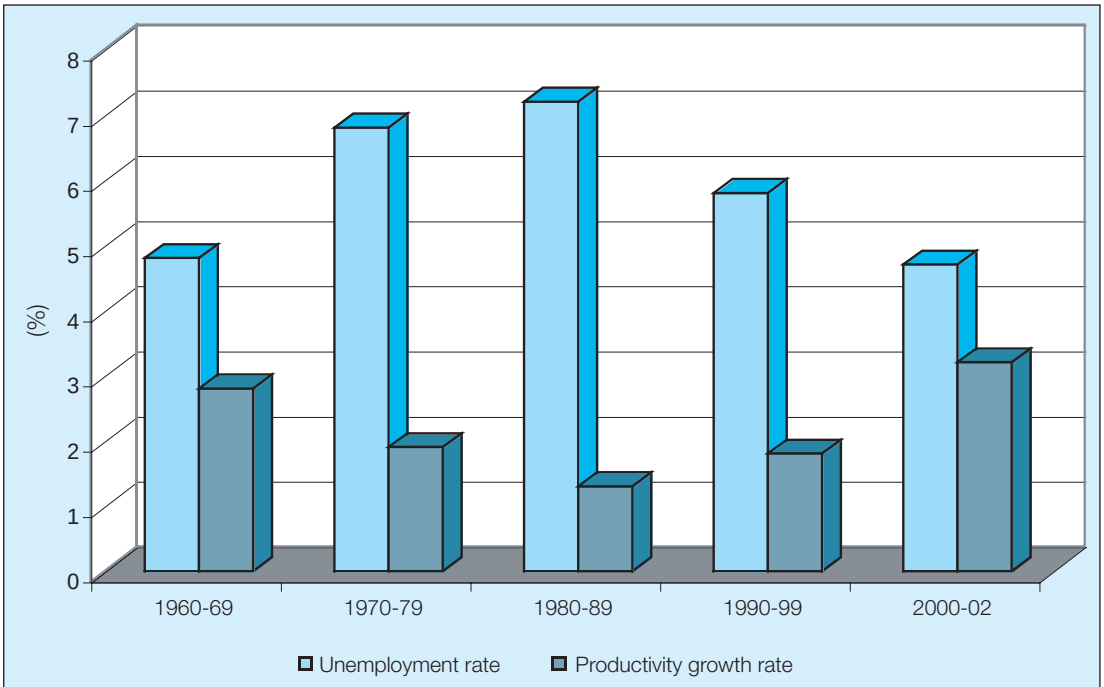
Of course, to the worker who loses his or her job as a result of productivity gains unmatched by an expansion in output, the notion that this is an "adjustment cost in the short term" is of little consolation. The fact that job losses will occur is an argument in favour of institutional and policy preparedness on both the supply side and the demand side of the labour market. The former, for example, would rely on efficient mechanisms for labour market intermediation through public and private employment services. It would also rely upon mechanisms for training and skill development in the event that a new job relies on a different set of skills from those needed for the old one it is replacing. Support to the demand side is also essential, which is why many countries engage in counter-cyclical spending or adjustments in monetary policy over the business cycle as a means of curbing the decline in aggregate demand and encouraging investment. Simply stated, costs in the short term can be mitigated by appropriate labour and macroeconomic policies and institutions.

The focus on job losses arising from the growth of productivity is typically a microeconomic perspective. As such, it is a partial view, trained on an individual company or sector, a particular location, and at a particular point in time. In consequence, it misses how economies adjust to productivity changes happening in any one sector.

Productivity gains work their way through the macroeconomy

People benefit from the reduction in costs that productivity gains elsewhere in the economy provide, even if those gains result in employment loss in the sector of their origin. The impact of productivity growth in any one sector of the economy depends upon the existence of "compensatory mechanisms" through which the economy adjusts. As such, productivity changes at the microeconomic level have important macroeconomic ramifications – two in particular. One is when technological innovation in any one sector finds cost-reducing and efficiency-enhancing applications in others; for example, the widespread application of information and communication technologies (ICT) has been a boon for productivity growth economy-wide, whether in traditional industries, such as garments, or in accelerating the growth of industries at the forefront, such as biotechnology. The other is through changes in relative prices. In competitive markets, an increase in productivity will result in a decline in the price of the product in which productivity gains have occurred. This might or might not result in a "net" increase in demand for that product. But this, too, does not tell the full story; a decline in relative prices is equivalent to an increase in real income for consumers, who, with their increased income, may then stimulate demand for other products or services in other sectors of the economy. In other

Figure 2. Productivity growth rate and unemployment rate in the United States, selected periods



Source: C. Walsh: "The productivity and jobs connection: The long and the short run of it", Federal Reserve Bank of San Francisco, *FRBSF Economic Letter*, No. 18, 16 July 2004, p. 3.

words, productivity increases in one sector could shift the composition of consumer demand economy-wide. One consequence is aggregate employment growth, although not necessarily in the sector in which the positive productivity dynamics have occurred. Evidence of this is suggested in figure 2, which shows the inverse relationship between productivity growth and unemployment in the United States in the aggregate.

The trade-off between productivity and employment growth as part of development

A single-minded focus on the inverse relationship between employment and productivity growth is too narrow. This is hardly surprising, and much wisdom, theory and evidence confirm this. In fact, the loss of jobs attendant upon productivity growth is just what is "supposed to happen" in the course of development. A long-standing assumption of development thinking is that of a country's gradual transformation out of relatively low value-adding agriculture and into higher value-adding manufacturing. Such structural transformation raises productivity overall, as productivity is higher in the newer sector, manufacturing, while the employment decline in agriculture is the result of achieving higher productivity in that sector as well.

At any level of development, productivity growth is pushing the structural transformation of economies. It is also a channel through which poverty reduc-

tion can occur. The Report presents evidence that when productivity and employment growth occur in the sectors in which poverty is heavily concentrated, the effect on poverty reduction is the strongest.

Main policy messages of the *World Employment Report 2004-05*

What, then, are the most important questions to address on the linkages between employment creation, productivity growth, and poverty reduction? The Report argues that there are four of particular relevance if the ultimate aim is not just employment but decent work and poverty reduction. The questions can be simply stated, as is done below. Their answers are more detailed, as the Report elaborates.

- What are the conditions under which employment and productivity growth can advance in tandem, creating an expanding "virtuous circle" of decent and productive employment opportunities?
- From the traditional standpoint of development economics, structural transformation out of agriculture and into industry and services has been the long-accepted path. But since most of the world's poorest people continue to depend on the land for their livelihoods, is it not the case that agricultural productivity is central to pro-poor growth? But is agriculture itself still relevant to development?
- A certain degree of labour and capital mobility is no doubt good for productivity growth – indeed, this is what structural transformation is all about – but is a certain degree of employment stability also important?
- If small firms and small-scale activities generally have lower levels of productivity than large firms, what can be done to overcome the potential of a "productivity divide" between large-scale and small-scale activities?

The Report's main messages address these questions.

1. Productivity and employment growth: Trade-offs and complementarities

That productivity and employment stand at times in inverse relation to one another is, as mentioned, a partial view based on enterprise-level considerations and specific time-frames. The latter is most apparent over the business cycle, although it is also true that this inverse relationship can be rather durable over time. For example, ever higher productivity and less employment describe the secular trend in agriculture and, in many countries, manufacturing as well.

It was noted above that adjustment at the macroeconomic level to gains in productivity wherever they originate can indeed be employment-enhancing. Two qualifications might potentially challenge this benign outcome, however. The first is whether, in view of rising economic interdependence and the technology-induced greater mobility of production factors, the positive link between employment and productivity growth – at least at any particular national level –

has undergone qualitative change. Much of the contemporary popular debate in the United States, for example, is on the ICT-induced surge in outsourcing attending the recent years of economic recovery. This was in turn reflected in substantial productivity gains and, until recently, anaemic employment growth in the country. A plausible claim can be made that ICT has been a catalyst in reshaping an international division of labour in which service-sector work that can be "digitalized", e.g. data processing, or software development, can be located in areas that enjoy comparative cost advantages.

It is also the case that, whereas the outsourcing of lower skilled, less well paid jobs is not a new phenomenon, increasing educational and skill levels in developing countries enjoying labour cost advantages, India and China predominant among them, may be attracting jobs once thought relatively immune to relocation. While the concept of such a "qualitative" change in the international division of labour has a certain logical appeal, the data to date are both incomplete and inconclusive. For example, in value terms, the United States, in fact, " insources" more jobs than it outsources. Nor, moreover, do most forecasts of the outsourcing of digitalized work from the United States suggest a substantial magnitude relative to the overall pattern of job creation and job destruction in the country.

It can also be argued that there are net benefits of outsourcing (or "offshoring") arising from the various compensatory mechanisms referred to earlier, such as reduced costs, repatriated profits, and new markets for home-country goods and services. According to one study, for every dollar spent on outsourcing, the United States domestic economy gains US$1.12-US$1.14, while the foreign host country receives US$0.33.[5]

It is institutions that make the difference in promoting the virtuous circle of productivity and employment growth.

To the worker who loses his or her job or fails to find one, however, these putative gains are rather abstract. Also, it would be premature to measure just how much developed country labour markets are in the throes of permanent, fundamental change.

In policy terms, it is safer to argue in favour of renovating labour market institutions so that they are equipped to keep pace with today's more rapid structural dynamics in the economy, characterized in some instances by an unusually high rate of permanent separations and a disproportionate loss of high-paying jobs. This underscores the need for a focus on "supply-side preparedness", with a particular emphasis on providing access to skills relevant to the future demand for labour.

A further qualification relates to whether differences in an economy's stage of development alter in any way the analysis of the macroeconomic advantages

[5] McKinsey Global Institute: *Offshoring: Is it a win-win game?*, August 2003 (www.mckinsey.com/knowledge/mgi/offshore).

of productivity growth. Here, two issues are noteworthy. The first arises from the observation that the mutually supportive, positive gains of productivity, employment, and output growth have eluded some regions in the world. Nor can the barriers to creation of a virtuous circle be described as "short-term". The reasons for the stalled trajectories are manifold and would involve a case-by-case review of markets, policies, governance, and institutions.

The central point is that the failure to reap the macroeconomic gains of employment and productivity growth is attributable to inadequacies in the markets, governance mechanisms, conditions and institutions through which such gains ought to occur.

Promoting productivity and employment growth together applies to countries at any level of economic development.

The second issue, a more general one, is whether an argument in favour of a strong policy focus on productivity can be made in the context of the widespread unemployment or underemployment that is characteristic of developing countries. In short, is there a policy choice between favouring employment and favouring productivity growth?

The answer must be that there is no such "either/or" choice: both employment and productivity growth must be jointly pursued – and this, for several reasons. As noted at the very outset, the problem often is not the absence of work, but of work that is sufficiently productive to yield a decent income. A focus on improving the productivity of the informal economy ought to be a priority policy concern.

It is also the case that, for companies that compete in global markets from any location in the world, a focus on productivity is essential, irrespective of its employment consequences, and a prescription to forego productivity improvements in favour of employment would not be sustainable.

The assumption that, in conditions of unused or under-used labour, employment of any type ought to take precedence over productivity improvements is unsound. In fact, it could carry with it the implication of widening inequality, since at higher levels of economic growth, it is productivity growth that contributes the major share.

In this context, it is useful to note that a labour-intensive development strategy is not necessarily a low-productivity strategy. Both theory and evidence – in particular, from the successful Asian economies – permit the conclusion that countries are well advised to emphasize the "factor" in which they have comparative advantage – and the availability of low-cost labour is a common such factor in the developing world.

Wage employment in the labour-intensive modern sector is more productive than the alternative it replaces. Focusing on the abundant factor, labour, can thus be an employment-rich, as well as a productivity-enhancing strategy.

Finally, and again a hallmark of the development model of several Asian countries, a focus on continuous productivity improvement as a catalyst for industrial upgrading is one that acknowledges the transitory nature of competitive advantage, and therefore allows enterprises to secure ever more stable niches in global markets.

In the priority interest of providing income-generating work for their citizens, many developing countries opt for "employment-intensive" infrastructure building and maintenance projects over "equipment-intensive" methods of production. Here, too, it would seem that this reflects a conscious choice to maximize employment rather than productivity. Such a conclusion would be misleading, however. One reason is the same as that offered above; participants in "labour-based" production are likely to be employed at a higher level of productivity than their alternative work and earnings opportunities provided. There is also a second reason, as follows:

Evidence shows that the direct and indirect employment and economic effects of labour-based projects can often be superior to those of equipment-based projects. While this is self-evident in terms of employment outcomes, beneficial effects are further expanded indirectly, as income earners have more to spend in the local economy.

A focus on where people really work is as important as a focus on emerging, dynamic sectors.

There is widespread agreement that economic growth is the outcome of the shift of resources out of declining activities and into emerging, higher value-added ones. And much has been written on the historically unprecedented, "textbook" demonstration of rapid structural transformation in many East Asian countries. No doubt there is much still to learn from them. But emulation is difficult.

A sensible approach to addressing decent work deficits in the more immediate term is to focus on where labour actually works. In so doing, the focus shifts to the informal economy, on the one hand, and to the growing service sector, on the other.

A "stylized fact" of post-war development is the growth of the service sector in industrialized countries, as well as in the developing world. The term "service sector" disguises the considerable heterogeneity of employment in this sector. Service-sector jobs can be found at both ends of the decent work spectrum; the growth of the service economy is strongly correlated with wealth, as higher dis-

posable incomes allow for the purchase of services previously "unconsumed" or delivered through non-commercial means as household activity – cooking at home, rather than eating out, for example. At the other extreme, the often burgeoning growth of the urban informal service economy in cities in developing countries is a reflection of underemployment in the rural economy and an insufficient rate of employment creation elsewhere in the economy.

> *The service sector has been characterized as technologically non-progressive and unavailing of opportunities for productivity growth. This depiction, however, is incorrect. The sector in fact runs the gamut from low-productivity activities in the informal economy to some of the most productive occupations at the technological forefront of the modern economy.*

The transformation of the banking and financial services industries, wrought by the diffusion of information and communication technologies, is a case in point.

> For structural transformation to occur, a range of well-functioning institutions in the labour market, as well as other markets, is essential.

The evidence shows convincingly that the positive relation between productivity growth and employment growth in the service sector is not limited to the most advanced service activities of the wealthiest countries. The growth of India's software industry is a well-known case in point, but the evidence is more general still.

> *An analysis of 15 countries for which there are data shows convincingly that transportation and communication, a major share of service-sector employment, demonstrate higher than average productivity gains – that is, they contribute disproportionately to aggregate productivity growth – and, in most instances, to employment growth as well.*

A final point can be made on linking the dynamic sectors of the economy to those where most of the jobs currently are.

> *A strategy for increasing productivity and employment over the long run should have dual components: investing in the dynamically growing sectors of the economy, while building capacity in sectors where the majority of labour is employed. Establishing linkages in the supply chain between the two is one mechanism.*

2. Agriculture: What role in development?

Structural transformation is once again the implicit point of reference for the Report's third chapter. The observation was made earlier that the decline in agricultural employment arising from productivity increases has been the classic path to economic development. Indeed, the point at which countries experience

an absolute decline in agricultural employment has long been regarded as the "turning point" in development.

Agriculture should not be ignored if the focus is on poverty reduction.

A major part of the characteristics of the productivity/employment relationship in the agricultural sector arises from the nature of agricultural production itself; as standards of living rise, people tend to spend a proportionately lower share of their income on food. Known as "Engel's Law", the main implication is that an expansion in output made possible by improvements in agricultural productivity is often not met by an equal expansion in demand, and employment in the sector declines as a result.

But 75 per cent of the world's poor live in rural areas where agriculture is the mainstay of the economy. In fact, the agricultural sector employs 40 per cent of developing countries' workforces and contributes over 20 per cent of their GDP. The United Nations family has set itself the ambitious aim of halving the numbers of those in extreme poverty by 2015. Any serious effort to do so must acknowledge that there is both a geographical and sectoral component to address. In particular, the bulk of the world's extreme poor live in rural Asia and sub-Saharan Africa. And most of their economic activity is in agriculture.

There is extensive literature in economics on employment and poverty reduction. The literature on productivity and employment is equally extensive. However, considerably less attention has been paid to the direct linkage between productivity and poverty reduction. To the extent that it is low productivity, and thus low incomes, that underpin the phenomenon of rural poverty, a direct relationship between productivity increases in agriculture and poverty reduction ought to be apparent.

In a longer time frame, for economic development to occur, underpinned by the migration from low-productivity to high-productivity sectors, the policy framework – including investment, education, skills, and infrastructure policies – needs to play a strong, supportive role. While such a role is essential, a prescription for rapid structural transformation would seem, in purely empirical terms, easier said than done. Without a convergence of many factors, or "cumulative causation", sustained productivity growth in agriculture could merely result in employment displacement, rural-to-urban migration, and the replacement of rural poverty with the poverty of the urban informal economy.

Neglecting the agricultural sector during the process of industrialization can constrain the development process. While economic development needs industrialization, in many economies industrialization also requires the development of the agricultural sector. The policy challenge is to find the right balance in fostering the development process in all three sectors – agriculture, industry, and service – simultaneously.

It is in this context that two points are of particular interest. First, there are many developing countries in which both productivity *and* employment have increased in the agricultural sector.

> *Rather than considering agriculture as a mere way station on the road to economic development, it should be considered an essential part of that road – and one of continued relevance. This is especially true as the evidence shows convincingly that it is in those countries in which productivity and employment in agriculture have both grown where extreme poverty has declined the most. More specifically still, the growth of agricultural productivity is the strongest predictor of the reduction of extreme poverty.*

China is a good case in point: while rapidly becoming the "world's manufacturing base", it is also a country in which agricultural output and employment have both risen, and poverty has fallen substantially.

> Return the focus to agriculture for promoting decent work: if agriculture has lagged behind, this is a symptom of a coordination failure involving the retreat of public policies.

The second point is that it is widely acknowledged that since the "green revolution" of the 1970s and 1980s, rural development and the agricultural sector in many developing countries fell victim to an era of policy neglect in the 1990s. The neglect, moreover, has occurred both at the national policy level as well as within the multilateral system. While the point cannot be unequivocally made, it is perhaps no mere coincidence that the decade of rural policy neglect of the 1990s also witnessed a pronounced slowdown in the rate of poverty reduction in the developing world.

For many although not all developing countries, it makes sense to promote the growth of productivity and employment in the agricultural sector. To do so requires:

- A focus on food price development. It is important that food prices in the poorest parts of the world do not rise to levels that could harm the poor and thereby undermine poverty reduction. At the same time, prices have to be high enough to ensure that food-exporting countries can foster an attractive investment environment and earn enough foreign exchange to meet domestic development objectives.
- A focus on income distribution, particularly a better distribution of land ownership in agriculture, both to facilitate output growth and accelerate poverty reduction.
- Investment in water supply, infrastructure, health, education, agricultural research and development, and other institutional reforms, even though the impacts of these kinds of investments have a relatively long gestation period.

- That non-farm activities should be fostered as an additional source of employment creation, adding further to the poverty reduction potential of the agricultural sector.

> Agricultural productivity growth depends on social rather than private investment alone, e.g. in water management, communications, skill development, land reform, etc.

It ought finally to be noted that whether a focus on agricultural productivity and employment growth makes sense for a country depends on that country's stage in the development process, and the potential of its agricultural sector in terms of natural resources and human resources. Nor is national action alone adequate.

> *The vitality of the agricultural sector depends upon international commodity prices, product niches, and market access. As such, success at any national level depends critically on the behaviour of the world community and the achievement of the Doha round of trade negotiations within the World Trade Organization, without which steps towards fairer globalization – one of greater inclusion and less poverty – cannot be made.*

3. Workforce mobility, workplace stability: How does each relate to productivity?

If economic development is enabled by structural transformation out of lower to higher valued-added activities, it stands to reason that a certain amount of capital and labour mobility is necessary for this inter-sectoral transition to occur. Capital mobility is present when adequate savings, whether domestic or foreign, are available for investment in new growth sectors in a context of macroeconomic stability and sufficient demand. Labour mobility relies in turn on the availability of workers with appropriate skills or the ability to acquire them with relative ease.

> Employment "stability" is not "labour immobility": jobs and skill requirements can change for the same person working for the same firm.

But the evidence shows that, however important the mobility of capital and labour might be for higher productivity, a certain amount of stability is just as important. The measure of stability used is average employment tenure, or the amount of time a worker stays with his or her present enterprise. A useful distinction to make at the outset is that "stability" is not a synonym for "immobility", since employment tenure is not the same thing as job tenure; an employee can remain in long-term employment with an individual enterprise but undertake new jobs and assignments over the course of his or her tenure with the firm.

Why, then, is such employment stability important for high levels of productivity? The most convincing answer lies in human capital theory.

Much of how workers learn to do their jobs better comes from formal training and the training they receive on the job from more experienced workers, as well as from simply learning by doing. Employers have no incentive to invest in their employees' training if they believe that their employees will leave the enterprise before the gains of that investment can be realized. Employees, on the other hand, have no incentive for acquiring new, more productive ways of doing things if, in the absence of some employment security, they fear they will "work themselves out of a job".

There are, moreover, significant feedback mechanisms: for example, the high level of productivity that employment stability brings shores up the competitiveness of the enterprise and thus its ability to provide employment security to its workforce.

Employment stability promotes productivity growth, but the reverse is also true: productivity growth promotes employment stability.

There are considerable differences in the length of average aggregate tenure across countries, sectors, and occupations. Many factors account for these differences. In purely arithmetic terms, for example, a country in which output is growing faster than in another will have lower average tenure as more new jobs are being created, bringing down the average tenure duration. Countries that have younger workforces, such as those in the developing world, will also have lower average tenure than those in which the workforce is older, and consequently has been on the job longer and is likely to be less mobile. Countries or industries characterized by a high share of small firms are also likely to be ones in which average tenure is lower, as small firms enter and exit the market more frequently than do large firms. Despite these and other factors explaining differences in tenure, however, evidence suggests that these differences are quite stable over time: for example, average aggregate tenure is substantially lower in the United States than in many European countries, but this has been the case for two decades and in a proportion that is roughly the same now as it was then.

Economies change. Labour laws and institutions often need to change, too. But they are often more consistent with, rather than counter to, economic incentives and market forces – that is, employment stability laws exist, but there are powerful economic incentives for stability to occur.

Apart from the raw economics of an industry or demographics of a country, institutional differences have an important role to play in explaining differences in average tenure. For example, a labour market institution such as employment protection legislation can make an enterprise's ability to engage in economic dismissals either more or less difficult. There is, in fact, a strong and convincing correlation between average tenure and the "stringency" of employment protection

legislation in regulating economic dismissals. On the one hand, many have argued that employment protection legislation needs to be reformed with a view to providing greater "flexibility" at the micro level. There may well be instances in which this is called for. On the other hand, however, it is noteworthy that the *legislated* promotion of an appropriate level of employment stability is consistent with, rather than counter to, the purely *economic* incentives for employment stability on both the supply and demand sides of the labour market. In short, it makes economic sense for employers to seek to retain their workforce.

For all policy environments, the question is how best to obtain the greatest benefits from the mobility of capital and labour, and the productivity-enhancing inter-sectoral transformation that they support, while at the same time providing adequate employment stability at the micro-level in the interests of promoting high levels of productivity.

There are no easy answers to obtaining this policy and institutional balance. In view of the intensification of product market competition arising from globalization and rapid technological change, it is indeed possible that product market regulation will need to be made more compatible with more rapid adjustments to change.

A prescription for the full-scale reform of product market regulation would be difficult to identify. This, however, does not preclude the identification of some common areas of change. For example, reducing the regulatory and/or cost burdens often facing new business start-ups makes good sense.

The regulatory/institutional challenge for most countries is to define a concept of "protected mobility" for ensuring economic as well as social efficiency, allowing flexibility for the firm and protection for the worker.

It may be that labour market institutions and regulations are in need of adjustment. The evidence now weighs in favour of new regulations or re-regulation, rather than a focus on deregulation that has dogged the debate on labour market flexibility for a quarter of a century. And two pieces of that evidence are particularly convincing.

There is a strong and positive correlation between a country's openness to trade, a measure of its globalization, and how much that country spends on active labour market policies as a percentage of GDP.

There is a strong and positive correlation between spending on active labour market policies and workers' perceptions of their employment security.

Some countries appear to have a workable balance between the amount of micro-level flexibility the regulatory system affords, and workers' perceptions of their own employment security.

> *What appears to matter is whether workers feel that, if they lose their current job, they will be able to make the transition smoothly into one of equal or better quality. This in turn implies an effective (and productive) means of dealing with the changes wrought by globalization in an institutional environment that promotes an appropriate level of micro-level flexibility, backed up by a strong guarantee at the macro level of labour market security.*

Different countries will approach the challenge of adjustment in different ways. A concept of "protected mobility", or the promotion of both flexibility and security, would appear to make sense. An appropriate level of employment stability is important to this. Finally, employment stability is also important at the macroeconomic level; working men and women who feel secure in their jobs or in their ability to find acceptable alternative employment provide a stimulus to aggregate demand, whereas employment insecurity can weaken aggregate demand.

4. The small-scale/large-scale productivity difference

An empirical regularity of most countries' economic structures is the predominance of small relative to large enterprises as a share of total enterprises, and as a significant share of total employment as well. In definitional terms, the small and medium-sized enterprise (SME) sector typically refers to enterprises in the formal economy. But, relative to industrialized countries, developing countries are characterized by a higher share of a range of small-scale activities of many types, such as self-employment, and small enterprises and micro-enterprises, operating in both the formal and informal economies. These latter small-scale activities usually operate at lower levels of productivity than do large firms.

> *A key challenge for improving standards of living in developing countries is therefore to improve productivity in small firms and in small-scale activities generally. The challenge is all the more important in view of the productivity differential between small and large firms and, thus, the implication that inequality in the form of a "productivity divide" can have structural roots.*

Small firms have their own survival strategies based on the segmentation of markets.

In view of their productivity disadvantage, one question is why small firms are not driven out of competitive markets. Evidence does suggest a higher degree of volatility in the small-firm environment, with a higher rate of start-ups and failures. This notwithstanding, the question is how, with a lower level of productivity, small firms manage to survive in competitive markets.

Small firm survival appears to hinge on the fact that small firms compete in different markets from the markets in which large firms compete, even when small firms are ostensibly producing the same product as large firms.

On the one hand, the shelter of non-competitive markets (markets that may not be fully exposed to trade liberalization or markets that are in fact multiple for ostensibly the same product) is useful, as it provides at least some security for the jobs that small firms create. In some instances, of course, the route to productivity improvement could be at the expense of employment creation. On the other hand, however, the jobs are often of lower quality and less well remunerated than those in the more competitive, modern sector of the economy; that is, there are substantial decent work deficits in the range of small-scale, informal activities.

While the growth of large firms is not to be discouraged, there are ways of overcoming the disadvantage of small firms; collective action by small firms themselves, assisted by local authorities and other actors can boost productivity and market access.

Experiences in some countries have shown that the productivity disadvantage of small firms is not necessarily an intractable problem. Despite relatively high wages, for example, small firms in northern Italy have been able to overcome their size disadvantage by being part of a dense network that blends competition with cooperation. The productivity advantages can once again be expressed in simple terms.

Through cooperation, such as the collective purchase of raw materials or the joint sponsorship of industry training, input costs can be lowered. Similarly, through the collective sharing of orders too large for any one small firm to fulfil, market share can be expanded.

As such, some models of small-firm cooperation can promote both improved productivity and employment growth, as input costs are lowered and output is expanded. Such models are not an enclave, but fully integrated into the global economy. They can also be successful in the perpetuation of local "social capital", or trust. Indeed, a considerable advantage of building cooperative links among small firms is that, in so doing, greater social cohesion can be generated as well as a shared commitment to local development.

Developing countries can promote the integration of their small firms into the broader economy and thereby overcome the inequality inherent in their "dualistic" economic structures characterized by unintegrated markets, a small modern economy and a much larger informal economy. The upgrading of existing clusters of small firms, the development of efficient cooperatives, access to commercial credit, and the collective provision of missing business services are ways in which developing countries such as Brazil, India and Indonesia are attempting

to address the challenge of integrating their small firms in wider markets. By implication, this too is a strategy for improving productivity in the informal economy, and for building bridges between the formal and informal economies.

The main messages of the Report can, of course, neither be prescriptive nor lend themselves to identical policy changes in a diverse world. The search for answers to all of the four main questions elaborated in the chapters of the Report can nevertheless make a fundamental contribution to the promotion of decent work, the economic underpinning of which is productive employment.