

Structural Adjustment, Labor Market, and Employment

AZIZUR RAHMAN KHAN*

Abstract

This paper explores the relationship between labor market and employment on one hand and macroeconomic imbalance and its adjustment on the other. It argues that distortions and rigidities in the labor market can aggravate macroeconomic imbalance and create impediments in the way of their adjustment. It also argues that the initial system of economic incentives and institutions and the composition of adjustment policies determine what kind of impact adjustment has on employment. A comparison of the experience of a group of South Asian countries with that of a group of East and Southeast Asian countries provides useful insights into the kind of labor market policies and institutions that are most conducive to the avoidance of macroeconomic imbalance and to the rapid adjustment of the imbalances that occur. This comparison also helps identify guidelines for the design of employment-friendly adjustment.

* Azizur Rahman Khan is Professor of Economics and Chairman of the Department of Economics, University of California, Riverside. This is the revised version of a paper presented at the Asian Development Bank Development Round Table on Employment Creation for Broad-Based Growth held 12-14 October 1994, Manila, Philippines. The author is grateful to three anonymous referees for very helpful comments.

During the 1980s the developing world experienced a fundamental shift in its preoccupation, away from growth and in the direction of adjustment of macroeconomic imbalances. In a large proportion of less developed countries (LDCs)—especially those in Latin America and Africa but also including some in Asia—the period of adjustment witnessed a reduction in growth, a rise in unemployment and an increase in the incidence of poverty. The question therefore naturally arises if the necessary task of adjusting unsustainable macroeconomic imbalances in the LDCs can be accomplished without allowing growth to fall and unemployment to rise.

Adjustment and its Components

Since the early 1980s the term structural adjustment has been used to denote the policies recommended by the multilateral donor agencies to overcome unsustainable macroeconomic imbalances faced by the less developed countries. In 1980 the World Bank introduced the Structural Adjustment Loan (SAL) as a new lending instrument. To become eligible for SALs the LDCs were required to adopt comprehensive programs for the adjustment of macroeconomic imbalances. There are three major elements of macroeconomic imbalance: deficit in the external trade account, deficit in government budget, and inflation. Often these imbalances coexist. Adjustment programs in the LDCs since the early 1980s have however been primarily focused on the first of the three imbalances simply because individual countries have less control in ensuring its sustainability than of the other two. In its first evaluation of the SALs, the World Bank clearly recognized that the introduction of the instrument was a response to the serious balance of payments problems affecting many LDCs in the aftermath of the second oil shock in 1979 (World Bank 1988).

In contemporary discussions a distinction is usually made between two qualitatively different kinds of policies—viz., *stabilization* policies and *structural adjustment* policies—for the adjustment of macroeconomic imbalance. Stabilization refers to an *orderly reduction in the level of aggregate demand* while structural adjustment consists of *supply side reforms in policies and institutions*. The term *adjustment* is often used to include both stabilization and structural adjustment policies.¹ Principal stabilization measures—adjustment in the exchange rate, reduction in fiscal deficit, and a contraction in money supply—reduce the level of aggregate domestic demand, reduce demand for imports, and increase exports. They have a powerful and quick contractionary effect on all three macroeconomic imbalances. They also have an adverse effect on the growth of output and employment.

Structural reform² instruments are far too numerous to be comprehensively enumerated. The important ones that feature in many adjustment programs include the liberalization of the trade regime; increasing the efficiency of public expenditure; restructuring of the tax system; financial deepening; improving the efficiency and the profitability of public enterprises; and improving the price system by removing distortions that damage incentives, encourage wasteful use of scarce resources, and discourage the use of abundant resources.³ Structural reforms contribute to economic growth by making resources more productive. They generate employment both by stimulating growth and making growth more labor-intensive. Their contribution to the reduction of macroeconomic imbalance is, however, indirect. Higher growth, greater exports, higher public revenue and a more streamlined public expenditure make it

¹ According to this vocabulary, the term “structural adjustment” in the title of the present paper should be replaced by “adjustment” which consists of both stabilization and structural adjustment.

² The terms “structural adjustment” and “structural reform” are used interchangeably in this paper as in much of the literature. The former term implicitly suggests that these policies should be invoked in the event of an unsustainable macroeconomic imbalance which needs adjustment. The latter term suggests the desirability of adopting these policies irrespective of the presence of macroeconomic imbalances. As discussed later, there is a case for preferring the second interpretation.

³ Certain policies answer the description of both stabilization and structural reform instruments. The exchange rate and the rate of interest are principal examples of this. They directly affect the level of aggregate demand. They also exert very powerful influence on the efficiency of resource use.

possible to reduce both external and domestic macroeconomic imbalances. But these improvements come more slowly than is often warranted by the crisis circumstances accompanying macroeconomic imbalances. This is due to the inevitable lag between structural reforms and the consequent improvement in efficiency and between greater efficiency and the reduction in macroeconomic imbalances.

Employment, Structural Imbalance, and Adjustment: The Asian Experience

Much of this paper is concerned with a comparison of the two groups of Asian countries which had distinctly different performance in terms of growth, employment, macroeconomic stability, and adjustment. The two groups are called East and Southeast Asia (ESEA) and South Asia (SA) although it should be made clear at the outset that the similarity of policies and outcomes, rather than geographical location, is the basis of the distinction. There are very important differences between the two groups with respect to initial circumstances and policy response to macroeconomic imbalance. The purpose of the comparison between the two groups is to relate these differences to their different performances in terms of macroeconomic adjustment, growth, and employment. The “ESEA experience” in the present context focuses on the cases of the Republic of Korea (hereinafter Korea), Indonesia, Malaysia, and Thailand.⁴ The “SA experience” is illustrated by the cases of Bangladesh, India, Pakistan, and Sri Lanka.⁵

The principal aspects of the comparative experience of ESEA and SA may be summarized as follows:

- (a) ESEA achieved a much higher rate of growth than SA did. During the 1980s, the decade of adjustment, they both performed far better than the non-Asian LDCs.
- (b) Growth in ESEA was far more employment-intensive than growth in SA;
- (c) ESEA was hit by external imbalance earlier and more severely than SA. The SA economies were initially less vulnerable to external shocks. Macroeconomic imbalance in these economies gradually became unsustainable due to the compounding of unfavorable external circumstances and domestic inefficiencies;
- (d) The ESEA economies achieved rapid and successful adjustment of macroeconomic imbalance after at most a very short period of decline in output and employment at the beginning of the adjustment process. Successful adjustment in this context is being defined as the simultaneous (i) elimination or a substantial reduction in macroeconomic imbalance, and (ii) achievement of significant growth in output and employment. The second condition by and large guarantees the avoidance of an increase in the incidence of absolute poverty. For the SA economies the process of adjustment has so far eluded these objectives of successful adjustment.

⁴ This list excludes the following countries located in East and Southeast Asia: People’s Republic of China; the former Indo-Chinese countries; the Philippines; Taipei,China; Hong Kong; and Singapore. The last three countries followed a development strategy that was similar to that of the four countries chosen to illustrate the ESEA experience. They have been excluded because Hong Kong and Singapore have for years have been classified as high income countries by agencies like the World Bank; also, these two countries and Taipei,China have avoided the problem of external imbalance, arguably due to their development policies. In this latter context their inclusion to illustrate the “ESEA strategy” would strengthen the conclusions of this paper. The Chinese experience, especially over the last 15 years, has been quite as remarkable as that in the most rapidly growing ESEA countries, though it has been based on very different policies, especially in the labor market. Former Indo-Chinese countries were politically and/or militarily still very unsettled during much of the 1980s. They appear to have started to grow rapidly in recent years. Development policies in the Philippines have fundamentally differed from the ESEA policies and have been closer to SA policies (see Khan 1996c).

⁵ The experiences of Nepal and Myanmar, the other major countries located in South Asia, have generally been worse than that of any of these countries.

Structural Adjustment, Labor Market, and Employment

Azizur Rahman Khan

Prior to the first oil shock the ESEA countries grew significantly faster and the SA countries grew much slower than the LDCs as a whole (Table 1). This pattern continued during the interregnum between the first and the second oil shocks although the gap between the SA growth rate and the growth rate of the LDCs as a whole became much narrower during this period. During the 1980s—the decade characterized by external imbalance, debt crisis, and adjustment in the LDCs—both the ESEA and the SA countries achieved an acceleration in the rate of their GDP growth while the growth rate in the rest of the LDCs fell sharply.⁶ This underlines the important point that the performance of the SA countries during this period, though inferior to the performance of the ESEA countries, was far superior to the performance of the LDCs in Latin America and sub-Saharan Africa. In the early 1990s most ESEA countries achieved a further acceleration in growth while all SA countries except Sri Lanka experienced a reduction in growth.

Not only did ESEA grow faster than SA throughout the period under review; ESEA growth was more employment-intensive (hence more egalitarian) than SA growth.⁷ Two types of evidence for employment intensity of growth are presented in Tables 2 and 3. The first of these is the rate of reduction in agriculture's share of employment. A rapid reduction in agriculture's share of employment indicates healthy growth of demand for labor in the rest of the economy. The ESEA countries have generally achieved better success in bringing down the proportion of labor force employed in agriculture. Among the ESEA countries, Korea and Malaysia have largely completed the “Lewis transition” of transferring “surplus” labor from agriculture to nonagricultural employment.⁸ The reduction has been substantial, though not dramatic, in Thailand and Indonesia. As will be discussed in the third section, the slower reduction in agriculture's share of employment in Indonesia was accompanied by a rapid increase in labor absorption in agriculture itself. In comparison with the ESEA countries, South Asia has experienced a slower reduction in agriculture's share of employment signifying the inability of industries and services in these countries to absorb labor as rapidly as in the ESEA countries.

The other set of evidence relates to the growth elasticity of employment in manufacturing industries. Measuring overall GDP elasticity of employment is not particularly meaningful because adjustment cannot be made in observed levels of employment for the underemployment in agriculture and informal activities that characterizes most LDCs. Making meaningful measurement of the growth elasticity of services is also not possible due to the difficulty in generating the necessary data. Table 3 shows the employment elasticities in manufacturing for the countries for which comparable data are available. These elasticities have been high and have evolved in a healthy manner in the ESEA countries; they declined in the 1980s for Korea and Malaysia—which began moving toward comparative labor scarcity—while still remaining substantially higher than the elasticities for the SA countries. For the SA countries the evidence is mixed for the 1970s: industrial growth was highly labor-intensive in India and extremely labor-averse in Pakistan. In Sri Lanka the evidence is hard to interpret in the absence of more detailed data: employment in manufacturing grew more than twice as fast as output indicating the possibility of an inefficient absorption of labor.⁹ During the 1980s the elasticity of employment became virtually zero in India and was very low in other SA countries. The Indian case dramatizes the trend that

⁶ It should be noted that while for all countries in East and Southeast Asia as a whole the growth rate accelerated during the 1980s, it actually fell for Indonesia and Malaysia. These two oil-exporting countries were hit by external imbalance much later than other countries. They took a good part of the 1980s to adjust. This brought their average growth rate during the 1980s decade down. Both these countries achieved an acceleration in their growth rates during the early 1990s.

⁷ Greater employment intensity of growth was only one of the several major factors contributing to the greater egalitarianism of growth in ESEA. The other factors are: a higher level of, and a greater equality of access to, human capital and a greater equality of access to productive resources (including land). See World Bank 1993b and Khan 1996a for a discussion of some of these issues.

⁸ This is also true for Taipei, China which is not included in the present illustration of the ESEA group.

⁹ An elasticity higher than 1 does not necessarily mean inefficiency or a decline in industry-specific productivity of labor. It may be caused by a shift in the composition of manufacturing in favor of industries with greater labor intensity. In the case of Sri Lanka, incomplete data indicate at best a stagnation in industry-specific productivity per worker.

Structural Adjustment, Labor Market, and Employment

Azizur Rahman Khan

may also have obtained elsewhere in SA: a fairly rapid rise in manufacturing output was translating itself into a growth in labor productivity with no growth in employment. This may indicate that industries were growing out of “disguised unemployment” with a concealed expansion in labor use which was not reflected in the headcount of employment. However, this may also indicate that industries were reluctant to absorb labor. In either case the circumstances indicate serious problems with the functioning of the labor market. The presence of disguised unemployment in industries indicates an inflexibility in the structure of employment. It should have been “possible for industries to layoff the surplus labor and gradually rehire them and expand employment as output grew. The perception that labor, once employed, is hard to relocate makes employers averse to the creation of employment, an issues whose implications are analyzed in the next section. A final point to note is that the very limited data show that wage repression—the gap between the increase in output per worker and the increase in earnings per worker—was generally greater in India than in the ESEA countries.

Table 1. Growth in GDP (percent per year)

	1965-73	1973-80	1980-90	1990-93
All LDCs	6.8	4.8	3.2	...
All Countries in East and Southeast Asia ¹	7.7	6.5	7.9	8.7
Indonesia	8.1	7.2	5.5	6.5
Korea, Rep. of	10.0	8.6	9.7	6.6
Malaysia	6.7	7.5	5.2	8.3
Thailand	7.8	6.9	7.6	8.0
All Countries in South Asia ¹	3.6	4.2	5.2	3.1
Bangladesh	0.5	2.4	4.3	4.0
India	3.9	3.8	5.3	2.5
Pakistan	5.4	5.2	6.3	3.4
Sri Lanka	4.2	4.0	4.0	5.6

¹All countries located in the region including the ones specifically cited.

... means data not available.

Source: Asian Development Bank (1991, 1992); World Bank (1986, 1990b, 1992a, 1993a, and 1995a); Khan (1994a).

Table 2. Sectoral Composition of Employment (percent of total)

	1971			1980			1991		
	A	M	S	A	M	S	A	M	S
Indonesia	...	...	...	61 ^a	9 ^a	30 ^a	53	11	35
Korea, Rep. of	48	15	37	34	23	43	17	27	56
Malaysia	52	10	36	37	17	46	27	21	53
Thailand	72	8	19	71	8	21	60	11	28
Bangladesh	74	7	19	69	8	23	65	14	21
India	...	...	...	71	13	16	65	15	21
Pakistan	58	...	...	53	15	33	47	17	36
Sri Lanka	50	...	...	45	12	44	48	16	37

Notes: ^aThis is for 1981. A = agriculture; M = manufacturing and mining in ESEA; and manufacturing, mining, and utilities in SA; S = all other (i.e., services, but including utilities for ESEA countries).

... means data not available.

Sources: Asian Development Bank (1985, 1993); Khan (1994a).

Table 3. Elasticity of Employment and Growth in Productivity and Earnings in Manufacturing

	Employment Elasticity		Productivity Growth (% per year)		Earnings Growth (% per year)	
	1970-80	1980-90	1970-80	1980-90	1970-80	1980-90
Indonesia	0.44	0.85	7.06	7.31	4.65	4.37
Korea, Rep. of	0.67	0.45	9.07	7.20	9.55	8.07
Malaysia	0.80	0.49	...	...	...	...
India	0.81	0.03	2.45	7.29	0.39	3.07
Pakistan	0.04	0.26	...	...	...	...
Sri Lanka	2.16	0.35	...	...	...	...

Notes: These estimates are based on comparable data sets in World Bank 1992a and 1995a. Elasticities are based on double-logarithmic regressions of employment on manufacturing value added, and growth rates are based on semilogarithmic regressions of variables on time. Elasticities for Pakistan 1970-1980 and India 1980-1990, including earnings growth rate for India 1970-1980, are not significant at any reasonable level. All other elasticities and growth rates are significant at 1 percent level. For data limitations, preadjustment estimates for Indonesia and Pakistan are for 1973-1980 and the Pakistan elasticity for the 1980s is based on data for 1980-1989. Blank entries and exclusion of Thailand and Bangladesh are due to the absence of comparable data.

...means data not available.

During the 1970s and the very early 1980s the redeeming feature of the South Asian employment scene was a relatively rapid expansion of employment in agriculture. Employment absorption in South Asian agriculture—after a spurt in the 1970s due to the impetus from substantial investment in agriculture and the replacement of food imports by domestic production—slowed down in more recent years. This is well documented by the Indian experience. Between the 32nd (1977/1978) and 38th (1983) rounds of the National Sample Survey (NSS), Indian agriculture created employment for 15 million persons, close to half the total increase in labor force. This represented a 1.9% annual growth in agricultural employment and an output elasticity of employment of 0.6. With the rapid growth of employment in unorganized industries and a moderate growth of services employment, India was able to have a growth in productive employment that enabled the economy to reduce the incidence of absolute poverty. Recent evidence for India shows a sharp decline in the output elasticity of employment in agriculture. The prospect for growth in agriculture has also declined due to the past success in replacing food imports (see World Bank 1989 for detailed evidence).

Structural imbalance hit the ESEA countries earlier and more severely than the SA countries (Table 4)¹⁰ Sri Lanka, the smallest of the SA countries shown, is the only case of an earlier and higher peak than in the ESEA countries. The peak ratio in Bangladesh was also higher than in most ESEA countries, but Bangladesh has always been heavily dependent on capital inflow. The peak ratios in ESEA, unlike the peaks in SA, represent sudden sharp increases from the levels prior to external shocks (Thailand being the only exception unless one goes further back in the past). With the exception of Sri Lanka, all SA countries registered a far slower rise in external deficit during the 1980s. The “outward orientation” of the ESEA economies made them vulnerable to external shocks from which the higher growth and the greater efficiency of these economies provided no immunity. The “inwardly oriented” economies of the SA countries were relatively better insulated from the immediate impact of external shocks although the insulation was essentially purchased at the cost of a highly inefficient system of resource use. The problem of macroeconomic imbalance gradually became serious once domestic inefficiencies exacerbated the effect of unfavorable external environment.

¹⁰ Indonesia and Malaysia, the oil-exporting ESEA countries, were hit by external imbalance somewhat later for the obvious reason that the second oil shock benefited their external account.

Table 4: Current Account Deficit before Official Transfer as Percent of GDP

	Peak Ratio and Year	Three-Year Average Ratio Prior to Peak Year	Three-Year Average Ratio at the end of the 1980s (1987-89)
Bangladesh	12.3 (1982)	9.5	6.0
India	2.8 (1985)	1.6	2.8
Pakistan	5.4 (1985)	3.3	3.8
Sri Lanka	19.7 (1980)	4.5	8.1
Indonesia	7.5 (1983)	1.0	2.1
Korea	8.4 (1980)	2.9	-5.8
Malaysia	13.5 (1982)	2.4	-4.4
Thailand	7.7 (1981)	6.4 (4.4) ¹	2.6

Notes: Negative sign represents surplus in current account. Three-year averages are unweighted averages of ratios for the three years.

¹Average for 1976-1978.

Source: World Bank (1995a).

The ESEA countries were able to adjust quickly and successfully. Indonesia, Korea, Malaysia, and Thailand are among the small group of countries around the world which can claim to have made successful adjustment of their macroeconomic imbalance according to the criteria outlined above. The rate of growth in GDP in Korea and Thailand during the adjustment decade was higher than the rate of growth during the pre-adjustment decade. Indonesia and Malaysia experienced a decline in growth rate which nevertheless was highly respectable by any standard. Moreover, their growth accelerated in the early 1990s. Korea and Malaysia achieved a positive current account balance by the late 1980s while Indonesia and Thailand were able to substantially reduce their external deficits. Evidence has already been cited for the rapid growth in employment in these economies. Available evidence suggests that Indonesia, Korea, and Malaysia achieved remarkable reduction in the incidence of poverty. Thailand's success in generating productive employment and reducing absolute poverty has been less remarkable than that of the others. (The details of these have been documented in Khan 1993.)

Economic reforms in the SA countries have so far not achieved successful adjustment according to the criteria outlined above although these countries have performed far better than the non-Asian LDCs. The growth performance of these countries during the first decade of adjustment was quite good. However, three of them—India, Pakistan and, to a lesser extent, Bangladesh—failed to sustain these growth rates in the early 1990s. Their success in bringing down their external imbalance was limited or negative (with the exception of Bangladesh where the deficit as a proportion of GDP remained high). As already discussed, their success in generating employment is at best highly ambiguous.

The present essay is focused on employment and labor market issues. Its objective is twofold: (i) to identify the kind of labor market policies and institutions that are conducive to the avoidance of macroeconomic imbalance and to the success of adjustment policies when imbalance occurs; and (ii) to outline the method of designing employment—preserving adjustment. The second section is concerned with the contribution of preexisting labor market policies and institutions to the emergence of macroeconomic imbalance and the effect of these policies and institutions on the process of adjustment. This section argues that the functioning of the domestic labor market contributed less toward the exacerbation of the imbalance caused by external shocks in ESEA than in SA.¹¹ It also argues that labor market policies and institutions constituted a far smaller obstacle to the success of adjustment in ESEA than in SA. The third section of the paper is concerned with the effect of adjustment on the level of employment. It argues that adjustment policies were more employment friendly in ESEA than in SA.

¹¹ Within ESEA this applies more strongly to Korea, which had a much more efficient domestic incentive system, than to the other three, which were initially characterized by numerous inefficiencies. There was much improvement in the incentive systems in the latter during adjustment.

The vastly different performances of the two groups of countries are of course due to differences in many other aspects of institutions and policies which cannot be discussed in this essay. It is however useful to enumerate them briefly (see World Bank 1993b and Khan 1996a for an elaboration of these points). Firstly, the ESEA societies had a greater commitment to a wide sharing of benefits of growth-demonstrated by an egalitarian access to land, productive resources and human capital-than was the case for the South Asian societies.¹² Secondly, the ESEA countries succeeded in achieving a much higher rate of domestic investment than the SA countries, mainly through higher domestic savings. Thirdly, the productivity of resources was generally higher in ESEA than in SA due to a system of incentives that promoted greater efficiency. An important aspect of the greater efficiency of the system of incentives in ESEA was its foreign trade regime which avoided the traditional ISI strategy and adopted what has come to be known as the “outward-looking” or the “export-led” industrialization strategy.¹³ The ESEA countries often deviated from the textbook rules of allocative efficiency in making widespread interventions for the promotion of worthwhile industries; but the method was fundamentally different from that of the ISI strategy pursued by SA which protected industries *arbitrarily*, without consideration of potential comparative advantage, and discriminated against exports. Another aspect of the more efficient system of incentives in ESEA was the avoidance of arbitrary and chaotic distortions in the pricing of resources, factors of production, goods, and services that result in an intensive use of scarce resources (e.g., capital and energy), an inadequate use of plentiful resources (e.g., labor), and a generally inefficient overall use of resources.

Labor Market, Structural Imbalance, and Adjustment

Inappropriate labor market policies and institutions can contribute to the emergence of external imbalance as well as other forms of macro- economic imbalance. Arbitrary public intervention in the labor market could result in raising the cost of labor so high as to affect international competitiveness and the overall productive efficiency of the economy, thereby creating or worsening the problem of macroeconomic imbalance. Public policy to stimulate rapid employment growth could lead to an unsustainable expansion of aggregate demand and an exacerbation of macroeconomic imbalance.

Similarly, labor market policies could become an obstacle to adjustment. For example, laws that make lay-offs inordinately expensive prevent an orderly reduction in public expenditure. These laws also make it hard to restructure industries by preventing a relocation of employment from the declining industries to the industries toward which comparative advantage might be moving.

Like other markets, labor markets in LDCs suffer from imperfections which impede the most efficient and productive allocation of labor. Properly designed public interventions can improve the functioning of the labor market. Typical interventions made by the LDC governments, rather than improving the functioning of the labor market, further aggravate its imperfections and inefficiencies. Labor markets of many Asian LDCs are characterized by some of the following public interventions:

- (a) In the public sector the level of employment, the structure of labor remuneration and the degree of protection given the workers are determined administratively, without consideration for market forces. If public employment constitutes a large share of employment in the modern sector, these actions result in an arbitrary structure of wages and labor allocation.
- (b) Often wages in the private sector are directly controlled. Sometimes the entire structure of minimum wages and benefits, for specific categories of skills and occupations, are legislated.

¹² In the provision of human capital Sri Lanka was an exception among the SA countries; it performed better than the other SA countries and many ESEA countries.

¹³ This strategy was adopted by Korea; Taipei,China, Hong Kong; and Singapore in the 1960s. Indonesia, Malaysia, and Thailand gradually shifted from an ISI strategy to an export-led strategy during the process of reform beginning late in the 1970s.

- Government regulations often extend beyond wages and benefits and set standards concerning conditions of work and social security.
- (c) Government regulations provide employment protection by strictly limiting conditions under which employment can be terminated.
 - (d) Government regulations often restrict the mobility of labor by resorting to quotas for ethnic groups, castes, and gender.
 - (e) In regulating the conditions of workers' associations, governments rarely limit themselves to guaranteeing the workers the right of free association. There are tendencies to err on both sides. Numerous authoritarian LDC regimes have severely curtailed the right to free association; the consequent absence of a healthy trade union movement has proven detrimental to the development of efficiency and equity (see especially World Bank 1995b, 80-81). There are also plenty of examples of endowing influential unions, often associated with governments in power, with syndicalist control over conditions of work and employment far beyond what would be possible if free and competing trade unions operated in a well functioning labor market.

The justification for these interventions is based on the notion that the workers are a vulnerable group; providing them with secure employment, improved conditions of work, and higher earnings would improve the distribution of income and contribute to the creation of a just society. The argument is false both on analytical and empirical grounds. The effect of these interventions is to raise the real cost of labor both by driving wages above market wages and by making the restructuring of production very costly. These interventions are invariably limited to the modern sectors which employ a small proportion of LDC labor force. Even when they are purported to apply to the entire economy their actual implementation almost never extends beyond the modern sector. The artificially high cost of labor restricts the growth of employment in the modern sector. Rather than improving the distribution of income these interventions merely create an island of protected employment in a relatively highly paid, capital-intensive segment of the economy while relegating the rest of the labor force in less productive, less capital-intensive employment than would be the case without them. This technological segmentation of the labor market has adverse effects on both efficiency and equity.

To ensure efficiency, and equity, labor market interventions should instead aim at the most rapid expansion of employment and enhancement of labor productivity. There is a great deal of scope for positive public intervention to improve the distribution of access to productive assets and human capital and to help improve labor mobility. Policymakers can make growth employment-friendly by concentrating on these actions and avoiding distortions in the system of incentives in a way that the combination of labor with other factors, notably physical capital, is unfavorably affected. All interventions that make capital (labor) cheaper (dearer) than its market price should be avoided.

There are important differences between ESEA and SA in terms of benchmark labor market interventions. First, the public sector had more of a leadership role in the market by virtue of a larger share of aggregate employment in SA than in ESEA. Labor market practices in violation of market principles and their spread elsewhere in the economy were generally more widespread in SA than in ESEA.¹⁴ Public enterprises in SA are by and large not operated according to the principles of economic efficiency. In Bangladesh the loss sustained by public enterprises has been a major source of macroeconomic imbalance in government budget. In India a very high proportion of public enterprises has routinely incurred losses. The dismal performance of public enterprises has been partly due to their labor market practices. The Bangladesh case illustrates, perhaps in an exaggerated manner, this South Asian phenomenon. The expansion of employment in public enterprises in Bangladesh so consistently

¹⁴ Within ESEA there was considerable variation among countries in these regards, Korea (and also Taipei, China and the others not experiencing structural imbalance) being least prone to these distortions and Malaysia, Thailand, and Indonesia only gradually reducing these distortions during the adjustment process.

exceeded the rate dictated by efficiency that labor productivity declined sharply.¹⁵ The phenomenon can only be characterized as a kind of “soft budget constraint”¹⁶ facing the public enterprises and robbing them of all incentive to deploy labor efficiently, enforce labor discipline, and downsize employment by taking advantage of available legal means. The sheer magnitude of the public sector makes it inevitable for these inefficient practices to influence the entire modern sector. These inefficiencies have been far less a problem in ESEA partly due to the relatively smaller size of the public sector and partly due to a greater efficiency in the management of public enterprises.

Minimum wages in the ESEA countries do not have a significant influence on average wages, nor do they affect the structure of wages. In Korea there was no minimum wage legislation during its development phase; the first legislation, establishing minimum wages only for manufacturing industries, took place in 1988 when Korea had become a high ranking upper middle-income economy. In Malaysia there is no generally applicable minimum wage. Workers in individual industries can seek the protection of a minimum wage and by 1991 less than 2% of workers had done so. In Thailand and Indonesia minimum wages are relatively small proportions of average wages, have shown no upward trend in real terms, and have lacked serious implementation.

In South Asia minimum wages have often had a far greater influence on the level and structure of wages in the modern sector. An example is the Indian practice of setting minimum wages for a wide spectrum of occupations separately for each state. These have an enormous effect on the *structure* of occupational differentials which can no longer be determined by market forces. The lowest of the legislated minimum wages is often a higher proportion of average wage in SA than in ESEA (for details of facts on these aspects see Khan 1994b).

Legal provisions concerning the conditions of termination of employment have varied quite a bit among the ESEA countries, from extreme rigidity in the case of Korea to simple provisions for terminal payments, with plenty of loopholes, in Thailand. The point however is that the employers have found little difficulty in relocating labor away from declining industries. The Korean case provides a very interesting example. Korean labor code has been very rigid in requiring the evidence of imminent bankruptcy as the only just cause of dismissal, temporary retirement, suspension, transfer, reduction of wages, and other punitive measures. Severance payments were also quite generous. These strict conditions of termination should have been a serious obstacle to industrial restructuring. In reality Korea has not suffered from an immobility of labor. The attachment of the workers to their enterprises has been far weaker than the legal guarantees. Labor turnover rate has been extraordinarily high during both the preadjustment and adjustment periods. Declining industries—e.g., textiles, clothing and leather—had no difficulty in attaining drastic and quick reductions in employment during adjustment (see Khan 1994b for detailed documentation). The reasons behind this phenomenon can be traced to a well functioning labor market which ensured an elastic supply of labor to the rapidly growing secondary and tertiary sectors of the economy. Employers had little incentive to promote a permanent work force or to hoard labor. The structure of remuneration did not provide an incentive for long-term employment. The rapid growth of employment and real wages provided ample incentive and opportunity for the movement of labor between enterprises and industries.

Conditions of termination are very rigid in South Asia both in law and in practice. The issue received a great deal of attention in the debate in India on the urgency of devising an exit policy for “sick” industries which employ some 3 million workers. The problem is partly a matter of the existing labor laws which make layoff virtually impossible. But the reason that, quite unlike the Korean case, the rigidity of labor laws has been such a big problem in South Asia is that employment is growing too

¹⁵ Table 3 excludes Bangladesh because the data source for that table shows Bangladesh data with a clear break in comparability over time. The phenomenon of declining productivity has however been widely noted. See, for example, Khan and Hossain (1989, chapter 4).

¹⁶ This term, coined by Janos Kornai to describe the environment in which state enterprises in socialist countries operated, means the assurance that public enterprises could never become bankrupt and would always have a claim on resources regardless of how inefficient they might be (see Kornai 1980).

slowly to provide adequate opportunity for voluntary turnover. The artificial overpricing of labor in the modern sector on the other hand creates a strong incentive in favor of hanging on to jobs.

Compared to ESEA South Asian labor markets are constrained by numerous quotas—e.g., provincial quotas for public employment in Pakistan and the ubiquitous quotas for castes in India—that inhibit labor mobility. Positive support—e.g., improved access to human capital and productive assets—is by far a better method of helping disadvantaged groups than setting arbitrary targets.

Compared to ESEA South Asia also has the propensity to institute social security in the organized sector ahead of the ability of the society to provide security to the broad masses of the labor force. Thus, for example, the 1976 Employees Old Age Benefits Act in Pakistan provides for a pension to all workers after retirement and in case of invalidity. Korea adopted a system of pensions only in 1988, years after it reached the top echelon of upper middle-income countries.

The greatest difference between ESEA and SA has been in the superior performance of the former in all areas of “positive” interventions to promote productivity and mobility of labor: improved access to human capital and productive resources, rapid expansion of employment, provision of employment services, and creation of institutions that transferred the benefits of increased productivity to the workers in the forms of higher earnings. Limitation of space compels us to avoid documentation and to refer to available alternative sources (see UNDP 1994 and Khan 1994b for an analysis).

We can now consider the following two issues: (i) Were structural imbalances in ESEA and SA exacerbated by their labor market policies and institutions and did the difference in the labor market policies and institutions in the two country groups make a difference to the effect that they had on structural imbalance? and (ii) Did different labor market policies and institutions in the two groups affect their adjustment processes differently?

The origin of macroeconomic imbalances in the ESEA countries was principally due to external circumstances. This was particularly the case for the Korean economy which was not characterized by serious domestic distortions that hindered growth and efficiency. This was true of the labor market as well. The public sector exercised no wage leadership role and its own wage structure was free of serious distortions. There was no minimum wage legislation. Labor market regulations were innocuous. The social security system was rudimentary. There was the rigid law regulating the conditions of termination; but in practice this did not constitute a problem. No part of Korea’s macroeconomic imbalance in the early 1980s can be attributed to its inability to relocate labor away from declining or unprofitable industries.

The other ESEA economies under review had significant inefficiencies in their domestic economies, including the labor markets. In Thailand, Indonesia and Malaysia public employment increased too rapidly and became a source of unsustainable expansion in aggregate demand in the preadjustment period. Low remuneration of public employees in Thailand and Indonesia during this period and the ethnic quotas in Malaysia were sources of additional inefficiency in the allocation of labor. But beyond these blemishes the macroeconomic imbalance in these ESEA countries were not due to labor market distortions and inefficiencies.

Labor market interventions were not a significant obstacle to adjustment in the ESEA countries. Indeed Korea’s successful adjustment owed a great deal to the labor market flexibility that kept wage increases within the limits of productivity increases and permitted a short-term decline in real wages (by 4.6% in 1980 and 1% in 1981) in response to a decline in aggregate output due to massive stabilization. Wage flexibility permitted by the labor market relieved the pressure for employers to reduce employment and the downturn in real wage brought about a demand side response by the employers. The rest of the adjustment period witnessed a steady rise in employment and real wages. During the adjustment period—between 1982 and 1987—real wages increased at an annual rate of 7.2% while labor productivity increased at an annual rate of 7.5%, allowing a decline in unit labor cost and an improvement in international competitiveness (which was further bolstered by the adjustment in the real exchange rate).

In Indonesia, Malaysia, and Thailand adjustment consisted of both stabilization (fiscal retrenchment, control of money supply and exchange rate adjustment) and widely ranging structural

reform to overcome the domestic inefficiencies that were substantial in these economies. An important element of reform was in the labor market policies pursued by the public sector. As parts of their programs of stabilizing the level of demand, all three countries brought down the rate of growth of public employment. Labor markets in these countries were flexible enough not to obstruct the implementation of the adjustment programs.

The outcome in South Asia was very different. Inefficiency in the labor market, as a part of the inefficiency of the domestic economic institutions and incentive systems, was a significant contributor to structural imbalance. Unrealistic wages and employment policies in the public sector and the absence of positive action to promote labor productivity were among the reasons for the inefficiency of industries. The inflexibility of the SA labor markets has been an impediment to their adjustment and the employment hostility of their adjustment. The problem is dramatically highlighted by the debate on the exit policy of the sick industries in India. The issue is viewed as one of preserving a basic principle of egalitarianism: protecting the livelihood of the workers. The point is that these workers would have been better protected if sick industries were closed and the savings diverted to expand productive employment elsewhere, and/or workers were trained for alternative productive employment. As discussed in the previous section, it is possible to interpret the employment hostility of India's industrial growth during the 1980s as a method of concealed employment creation by bringing down the rate of underemployment. The labor market should have been flexible enough to permit a straightforward reduction in underemployment. Otherwise industries will continue to be averse to job creation after they succeed in "growing out of underemployment" because of the fear that they would not be able to relocate labor when necessary.

Adjustment and Employment

This section is concerned with the design of employment-friendly adjustment. It argues that the initial conditions of most Asian LDCs should make it possible for them to combine adjustment with employment—friendly growth. The experience of Indonesian adjustment is used as an illustration of the possibility that countries with an inefficient initial economic structure can institute reforms under adjustment that are likely to produce this outcome.

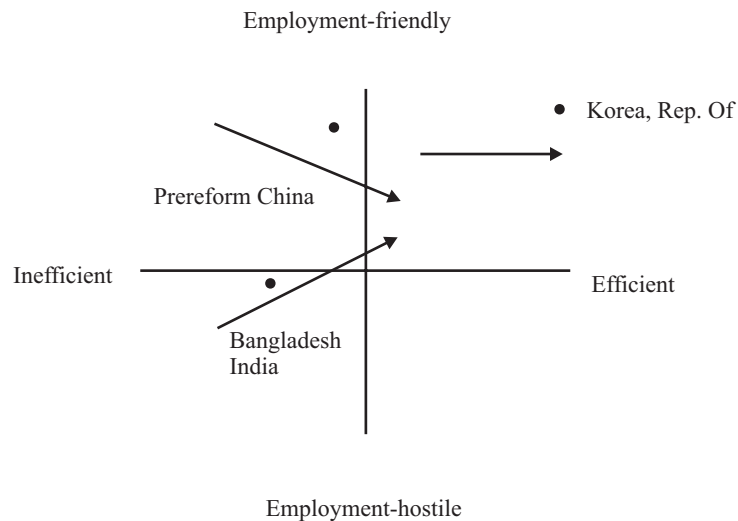
Adjustment Policies and Initial Conditions

What adjustment policies are feasible and desirable and how they affect the level of employment are substantially dictated by the initial economic environment and incentive system. Figure 1 is a simple device to determine the location of countries in terms of the efficiency of resource use, shown along the horizontal axis, and the degree of employment friendliness, shown along the vertical axis. The point of intersection of the two axes indicates an economic environment that represents the average degree of efficiency of resource use in LDCs and the average employment friendliness of growth. The further right (left) along the horizontal axis a country is the greater is its efficiency (inefficiency) of resource use. The higher up (lower down) the vertical axis a country is, the more employment-friendly (employment-hostile) the economic system. For the present, mainly illustrative, purpose one might use the rate of growth in GDP (with an adjustment for the resource cost of growth in obvious cases) as the index of efficiency and the output elasticity of employment as the index of employment friendliness.¹⁷ Countries

¹⁷ In Figure 1 only relative locations of countries matter. To take absolute locations literally one would require better measures of these indices than are available. Thus high growth can be achieved at a very high resource cost; hence a proper index of efficiency should be the weighted average of growth and (say) total factor productivity. Output elasticity of employment should similarly be normalized for relative resource endowment to measure the degree of employment friendliness of growth. In the diagram, People's Republic of China, by the standard of its prereform growth rate, should have been located to the right of the vertical axis. It has been put to the left because its high growth is believed to have been achieved at very high resource cost (low total factor productivity), although reliable and internationally comparable estimates do not exist.

that combine a greater than average efficiency of resource use and a higher than average employment friendliness—*efficiently employment-friendly countries*, e.g., Korea—would be in the northeastern (NE) quadrant. Countries that combine a less than average efficiency of resource use with greater than average employment friendliness—as was the case in prereform China and the former centrally planned economies with their system of guaranteed lifetime employment—are *inefficiently employment-friendly* and located in the northwestern (NW) quadrant. Countries with less than average efficiency of resource use and less than average employment friendliness—the *inefficiently employment-hostile* countries like many in South Asia—are in the southwestern (SW) quadrant. Countries with greater than average efficiency of resource use and less than average employment friendliness—the *efficiently employment-hostile* countries—would be located in the southeastern (SE) quadrant. It is unlikely that LDCs would normally qualify for classification into this last category. An employment-hostile environment indicates an inefficient use of the most plentiful resource in an LDC and hence is inconsistent with efficient resource use. This essay will ignore this category.

Figure 1: A Classification of Countries according to Efficiency and Employment Friendliness



Note: Arrows indicate likely paths representing combinations of changes in efficiency and employment as adjustment of structural imbalance takes place. See Khan (1993) for an alternative interpretation of this figure.

In the efficiently employment-friendly countries structural imbalances are mainly due to external factors, not domestic policies and institutions. The efficiency of the policy regime rules out a significant role for structural adjustment measures in the adjustment programs.¹⁸ Stabilization is the main option for adjustment in these countries. This means that adjustment is in conflict with growth and employment during the transition period. The redeeming feature is that the efficiency of the economic system permits a quick resumption of growth once stabilization succeeds. Given the employment-friendly structure of incentives, growth, once restored after successful stabilization, is employment-intensive. This expected growth path under adjustment is indicated by a horizontal arrow in the eastern direction in Figure 1. The Korean experience of overcoming structural imbalance in the early 1980s followed these predictions very closely.

¹⁸ There may however be a role for the restructuring of the system of incentives to adjust to changes in external conditions.

In the *inefficiently employment-friendly* countries structural imbalance is due substantially to domestic policies although it may be precipitated or aggravated by external circumstances. Structural reforms of domestic distortions must dominate any program of adjustment. This means that stabilization need not bear the principal burden of adjustment.¹⁹ In this case the conflict between adjustment and growth during transition can be limited. Adjustment, focusing on economic efficiency, is however often incompatible with the protection and/or expansion of employment. Economic efficiency requires the dismantling of inefficient policies, e.g., guaranteed employment. Adjustment is likely to combine growth with increased unemployment.²⁰ The growth path under adjustment is indicated by an arrow in the southeastern direction. For adjustment not to reduce employment it is essential for growth in these economies to be very rapid and for reform programs in these societies to assign priority to measures that are most (productive) employment-friendly. Most of the former centrally planned economies have followed a path that is vastly inferior to these predictions. Adjustment process in these economies has led to reduction in output, sharp fall in real wages and increased unemployment. People's Republic of China appears to be an exception because of the success of its reform program in achieving a sharp acceleration in growth. Even so People's Republic of China experienced apparently employment—hostile growth during the post-reform period. The elasticities of employment with respect to output have been 0.26 for the economy as a whole and 0.27 for industries for the decade 1984-94. Comparable elasticity for ESEA countries have been far higher.²¹

In the *inefficiently employment-hostile* countries structural imbalances are due substantially to the countries' own policies although external circumstances may be responsible for their aggravation to a state of unsustainability. Thus structural reform of domestic distortions can be the major focus of the adjustment program, with a limited role for stabilization. This means that the conflict between adjustment and growth during the transition period is likely to be far less than in the economies with an efficient structure of production and incentives. The notable feature of this case is that there is also a strong likelihood of complementarity between adjustment and employment expansion. This is because of the employment hostility of the inefficient benchmark policies and incentives. As structural adjustment dismantles these policies (e.g., labor market policies that make labor artificially expensive; underpricing of imported capital due to an overvalued exchange rate and direct licensing of capital goods to the investors; artificial cheapening of investment funds; and discrimination against labor-intensive agricultural and small-scale production), higher growth and a rapid expansion of employment occur simultaneously. The growth path under adjustment is indicated by an arrow in the northeastern direction as shown in Figure 1.

Most contemporary LDCs, including many in Asia, belong to the inefficiently employment-hostile category. This means that properly conceived adjustment programs in a large majority of contemporary LDCs can simultaneously satisfy the objectives of growth and employment expansion (and hence equity and poverty reduction).

The Mix of Stabilization and Structural Reform

Just because initial inefficiency of a country provides ample opportunity for its adjustment-program to be based on structural reform measures does not mean that in reality it is possible to avoid

¹⁹ Conditions under which the stabilization component can *actually* be small are discussed later.

²⁰ It is possible to argue that much of the benchmark employment is unproductive so that its reduction should not be considered to be a reduction in *productive* employment. The fact nevertheless remains that the income distribution effect of the process is same as that of an increase in unemployment.

²¹ The elasticities for People's Republic of China are based on the same method as the ones reported in Table 3 (see China SSB 1995). This paper considers the employment hostility of Chinese growth as apparent rather than real because the low headcount rate of employment growth appears to have been accompanied by a rapid reduction of underemployment especially in industries, a phenomenon that may also have obtained in India. See Khan 1996b for the Chinese estimates.

dependence on stabilization instruments. Structural reforms often take a long time to work their way to an improvement in macroeconomic imbalance. For this reason, stabilization instruments need to feature prominently if there is an urgency to bring down the external imbalance to a sustainable level sooner than would be done by structural reform measures alone.

The weight of the stabilization instruments in an adjustment package depends on the availability of external resources and on external circumstances generally. This is why the role of the donor community is of critical importance for an orderly adjustment in the LDCs. If donor policies lead to a reduction in external resource flows and an exacerbation of external imbalance, a large dose of stabilization is forced on the LDCs, with the consequent aggravation of stagnation and unemployment.

There may also be important domestic obstacles to the predominance of structural reform measures in an adjustment program. An understanding of these obstacles must be sought in an examination of the reasons behind the structural distortions that cause inefficiency. These distortions—e.g., a foreign trade regime of overvalued exchange rate and licensing of imports that redistributes income in favor of the domestic commercial and industrial classes, against the poor peasant producers of exports and the consumers of protected domestic manufactures; and the regulation of conditions of work and wages in the tiny modern sector which benefits a minority of politically powerful, organized workers at the cost of restricting the growth of employment—are not inherent in the economic structure but outcomes of government policies: The typical defense that governments offer for these policies is that they believe that they benefit the society. Thus, for example, they argue that an adjustment of the exchange rate is unlikely to be of benefit because the demand for exports is inelastic and that protection is beneficial for industrial development. Similarly they defend the labor motions as beneficial to the living standard of the working population as a whole. In reality policymakers in LDCs know better. Too often these policies are adopted not because of the reasons cited in their rhetorical defense but to ensure the outcome that they actually produce, in other words, to make an income transfer in favor of certain powerful groups. The lack of political will for reform can be traced to the power of the beneficiaries of these distortions. Their power may continue to guarantee the exclusion of structural distortions from an adjustment program unless a coalition successfully confronts them.

The Choice of Stabilization Instruments

The argument above should not be interpreted as a blanket prescription against all forms of stabilization. Of the three principal instruments of stabilization, the adjustment of the exchange rate to an “appropriate” level is desirable in any case. As noted earlier, the exchange rate should be regarded as both a stabilization measure and a structural reform measure. Besides affecting the level of demand, it also affects the efficiency of resource allocation. In many inefficiently employment-hostile countries (e.g., where exports consist of labor-intensive products) an adjustment of the exchange rate, complemented by measures to enhance supply elasticity, should help expand employment and promote equity.

For the other two broad categories of stabilization measures—reduction in public expenditure and control of money supply—one must look at detailed subcategories for which employment effects can be traced. As the Indonesian case, reported below, shows, the prime candidates behind in public expenditure include: untargeted subsidies; nonessential recurring expenditure include; untargeted subsidies that do not enhance the human capital endowment of the poor (e.g., subsidized modern hospitals and institutions of higher learning in liberal arts); and capital-intensive investment in large scale projects with long gestation lags. Similarly, a contraction of money supply and credit should be sought by means other than sacrificing the flow of credit for the acquisition of assets and the continuation of production by the poor, e.g., lending for low-income housing, peasant agriculture and small enterprise.

The Prioritization of Structural Reform Instruments

A basic asymmetry between stabilization instruments and structural adjustment instruments is that the former need not be invoked unless there is a structural imbalance²² while the latter need not, indeed should not, wait to be implemented until the emergence of a structural imbalance. These reforms are essential in any case, not because the economy is faced with an unsustainable imbalance.

While the reform of structural distortions should not await the advent of a structural imbalance, a program of adjustment should, and is usually forced to, address these distortions. Empirical studies have shown that in a large majority of LDCs these distortions often represent a coherent system of incentives that simultaneously reduce the efficiency of resource use and the expansion of employment. The most widely observed system of distorted incentives in the LDCs is the one associated with import substituting industrialization (ISI). By now the adverse effects of this system of incentives is well documented: it discriminates against exports; creates insurmountable obstacles to efficient resource use by making relative prices and profits completely unrepresentative of social scarcities and benefits; restricts employment by encouraging capital-intensive technology and discouraging labor-intensive production; and redistributes income in favor of the rich and powerful.²³ The reform of these structural distortions is therefore likely to contribute simultaneously to higher growth, greater employment and more equity.

How should one go about sequencing these reforms in terms of priority? First, the distortions that are the primary obstacles to efficiency must be removed. These relate to disincentives to exports, wild variations in effective protection among activities, rigid quantitative control of import and distribution, overt distortions in relative prices of goods and factors of production (including those due to inappropriate labor market interventions).

The experience of the ESEA countries shows that the pursuit of overall efficiency is quite consistent with widespread public intervention to promote equitable growth. A lot of *limited* deviations from the standard prescriptions for allocative efficiency were made by the ESEA countries in the interest of promoting growth. Thus a degree of financial repression was the cornerstone of the Korean strategy of promoting labor-intensive exports, by providing the latter with relatively inexpensive credit. Financial repression must however not be taken so far as to render the reward for saving negative or too low. Again, as is amply demonstrated by the experience of some of the best performing ESEA countries, it is not necessary to abandon the promotion of “infants”. These must however be carefully designed. They must not discriminate against exports by shifting incentives in favor of sale in the limited domestic market, but provide support for the expansion of infants in both domestic and export markets without discrimination.

While reforms for allocative efficiency, implemented within the framework of a strategy for growth, are likely to lead to a rapid expansion in employment, it is not necessary that the structural reform measures that promote the greatest gain in efficiency would be the one to promote the most, or any, expansion in employment. In the event that they do not simultaneously promote employment growth—especially in the rare case that they actually hamper the growth of productive employment—the objective of employment expansion must be pursued by adopting separate or compensatory policies, not by allowing the inefficiency—causing distortions to survive.²⁴

²² This applies only to “pure” stabilization instruments, not, for example, to the exchange rate which is both a stabilization and a structural adjustment instrument.

²³ The most extensive set of studies documenting these effects were carried out under the auspices of the NBER and are summarized in Krueger (1983).

²⁴ The writer cannot readily think of an Asian example. In Mexico, the reform of the trade regime, once completed, is likely to reduce the domestic output of corn. Allegedly this would reduce employment and increase poverty, other things remaining the same. Clearly, the reform of the trade regime will bring in benefits so great that abandoning it because of the reduction of employment and output of corn would not make sense. One solution would be to consider the possibility of keeping corn out of the ambit of trade reform by protecting it (the classic Asian example is the rendering of rice, the principal wage good, “nontradable” in certain ESEA countries, thereby establishing a great deal of control over real labor cost) if it can be shown that the resulting inefficiency

An Example of Adjustment with Employment Expansion: The Case of Indonesia

A good example of the implementation of much of the above guide-lines for the design of employment-friendly adjustment is the case of Indonesia. At the time Indonesia was hit by external imbalance in the 1980s its economic structure and incentives arguably resembled the *inefficiently employment-hostile* case outlined above. The rate of growth of the economy was high—over 7% per year during the 1970s—thanks to a high rate of investment made possible by large oil revenues supplemented by generous inflows of external capital. The economy was however characterized by inefficiencies—artificial depression of terms of trade for agriculture, large urban subsidies, arbitrary protection, capital-intensive public investment, and urban-intensive public expenditure to mention some—which led to widespread misallocation of resources. Productive employment was far less than what it would be under an efficient system of incentives. Since crop production was restricted due to price disincentive and low agricultural investment, much of employment in agriculture was in residual activities with low productivity. Elsewhere in the economy the composition of public investment and the system of incentives promoted a production technology that was relatively capital-intensive. The society was characterized by substantial inequality in the distribution of income. This was reflected in a rural Gini ratio of income distribution of 0.4, which was high in comparison with that in other Asian LDCs (see Khan et al. 1992, Table 10), and an estimated half of the country's population in absolute poverty in the mid-1970s (see World Bank 1990a).

By the early 1980s the end of the oil boom led to an unsustainably large external imbalance for Indonesia. The current account deficit during 1983 was 7.5% of GDP. It was in this context that Indonesia embarked on a program of adjustment.

Given Indonesia's inefficiently employment-hostile initial conditions, there was an opportunity to combine efficiency, employment expansion, and equity through structural adjustment. The adjustment process in Indonesia appears to have made good use of this opportunity. The distribution of income improved and the incidence of absolute poverty declined over the adjustment period (between 1984 and 1987). The World Bank estimates that the proportion of population in poverty declined between 1984 and 1987 from 39.4% to 26.8% in rural areas and from 12.8% to 7.3% in urban areas. The Gini ratios of *income* distribution for the same time period are not available. For the distribution of *expenditure*, the Gini ratio declined over the same period from 0.293 to 0.277 in rural areas and from 0.333 to 0.329 in urban areas.²⁵ The achievement of greater equity and reduced poverty was principally due to a rapid expansion in productive employment, a good part of which was in agriculture. But, as Table 3 shows, the elasticity of employment in industries nearly doubled during the adjustment decade as compared to the decade before. The employment friendliness and equity of adjustment derived from the choice of specific instruments of stabilization and structural reform. There were reductions in the levels of public investment and expenditure. In public investment, labor-intensive projects under the regional development program were encouraged while large public investment programs, usually more capital-intensive than the average investment projects, were canceled. Public expenditure was reduced overall, while components that provide service to the poor, especially the production activities of the poor, were preserved. The adjustment of the exchange rate shifted relative prices in favor of agriculture. Combined with large public investment in agriculture, this increased the growth of crop production which led to a sharp rise in the absorption of labor. Earnings per rural household increased rapidly. Structural reforms

is outweighed by the benefit of protecting employment and avoiding the increase in poverty. Should this not be feasible in the globalized environment of NAFTA, Mexico should consider compensatory measures for the expansion of employment, including public works program in the corn area during the transition period.

²⁵ The World Bank's poverty estimate is based on an absolute poverty income threshold that ensures a per capita daily intake of food energy of 2,100 kcalories and an allowance for protein intake. The trends in poverty and inequality, based on data from household expenditure surveys (SUSENAS), are reported in World Bank (1990a). An account of adjustment in Indonesia is given in Ahmed and Chhibber (1992).

elsewhere in the economy reduced the relative underpricing of capital and improved the incentive for labor absorption. Progressivity of the tax system was increased to contribute to the equity of the adjustment process.

Another feature of Indonesia's adjustment that deserves emphasis is that it included a considerable dose of stabilization (two substantial devaluations, massive fiscal retrenchment, and strict monetary policy). Although the scope for structural adjustment reforms was very large, the urgency of bringing down the imbalance dictated a big dose of orthodox stabilization. While the dose of stabilization was large, it was not as large as in some Latin American countries. Indonesia's current account balance before official transfer continued to be significant—averaging -2.1% of GDP during 1987-1989, for example—and outstanding external debt as a proportion of GDP rose steadily through the 1980s. Had the donor community treated Indonesia the way it treated Latin America, the chances are that Indonesia would have been forced to adopt even more severe stabilization with a reduction of growth in output and employment.²⁶

Conclusion

There is a two-way relationship between structural imbalance and adjustment on the one hand and employment and labor market policies on the other. Employment and labor market policies influence the emergence of structural imbalance as well as the process of adjustment. The nature and composition of adjustment policies exert strong influence on the level of employment.

Appropriate interventions in LDC labor markets should aim at promoting productivity and mobility of labor by improving the access of the labor force to human capital, productive resources, labor market information, and services. Relatively few LDCs specialize in these interventions. Typical labor market interventions in LDCs tend to raise the cost of labor in the modern sector, create a duality in the labor market, prevent the relocation of labor that is warranted by structural adjustment, and reduce the overall labor intensity of growth. These labor market policies reduce the efficiency of resource use and exacerbate macroeconomic imbalance. They also constitute an obstacle to structural reforms that are necessary for the adjustment of imbalance.

The initial conditions of an economy strongly influence the effect that adjustment has on the growth of its output and employment. In a large majority of LDCs the initial structure of incentives and institutions simultaneously produce inefficiency and employment hostility. As structural reforms remove inappropriate policies and institutions, the result is a convergence of productive efficiency and employment expansion.

Given the initial structure of the economy, the effect of adjustment on growth and employment depends on the specific instruments of stabilization and structural reform chosen. In the total adjustment package the weight of stabilization measures should be limited as far as possible given the need to reduce macroeconomic imbalance at an acceptable rate. This is feasible only if external resources are available to permit a gradual process of adjustment. Components of stabilization should be carefully chosen to reduce their impact on employment as far as possible. In deciding the sequencing of structural reform measures, priority should be assigned to the reform of those distortions that impede productive efficiency most. Accumulated experience suggests that in most cases these measures combine efficiency with employment expansion. Should this not be the case, the reform of distortions causing the greatest inefficiency in resource use should receive priority. Adjustment programs should include compensatory measures for the expansion of employment to offset the lack of employment friendliness of the efficiency measures. The degree of employment friendliness of specific structural reform measures differs from one country environment to another. A selection of instruments cannot be made on a priori basis. This must be based on a careful analysis of the effect of each policy instrument in the context of the given country.

²⁶ As noted above, Indonesia's growth did decline somewhat during the adjustment period (1984-1990) before rising again in the early 1990s.

By juxtaposing the experience of a group of East and Southeast Asian countries against the experience of a group of South Asian countries, one can learn valuable lessons about the relationship between adjustment policies and employment. The ESEA group, especially the most advanced ones, was characterized by relatively few of the inappropriate labor market interventions that are common in LDCs. These economies also had a relatively efficient domestic system of resource use. The macroeconomic imbalances that hit these countries in the early 1980s were primarily due to external shocks. Domestic policies, including the labor market policies, were not significant contributors to the imbalance. The adjustment process in these countries was facilitated by the flexible working of the labor market. Adjustment in these countries succeeded in quickly restoring growth that was employment-friendly. These countries found broad complementarity between efficiency and employment expansion by being able to limit the magnitude of stabilization (except in Korea where the relative efficiency of the initial economic structure required the focus of adjustment to be principally on stabilization) and to incorporate numerous instruments of structural reform that simultaneously promoted efficiency, employment and equity.

The South Asian economies were characterized by inappropriate labor market interventions of substantial proportions and widespread inefficiencies in the use of resources. In these countries macroeconomic imbalance was as much the outcome of these domestic inefficiencies as of external circumstances. The process of adjustment was hampered by the rigid labor market institutions and the resistance to the removal of structural distortions. So far the adjustment process in these countries has not succeeded in combining a critical minimum program to signal a decisive break with the modest growth in output and employment that obtained in the past.

References

- Asian Development Bank, various years. *Key Indicators of Developing Asian and Pacific Countries*. Hong Kong: Oxford University Press for the Asian Development Bank.
- _____, various years. *Asian Development Outlook*. Hong Kong: Oxford University Press for the Asian Development Bank.
- Ahmed, S., and A. Chhiber, 1992. "Successful Adjustment to Oil Shocks: The Rare Case of Indonesia." *The Bangladesh Development Studies* June-September:185-213.
- China State Statistical Bureau (China SSB), 1995. *China Statistical Yearbook 1995*. Beijing: China Statistical Publishing House.
- Khan, A. R., 1993. *Structural Adjustment and Income Distribution: Issues and Experience*. Geneva: International Labor Office.
- _____, 1994a. *Overcoming Unemployment*. Geneva: International Labor Office and the United Nations Development Programme.
- _____, 1994b. "Stabilization, Structural Adjustment and Income Distribution: Issues and Evidence from Asia." In R. Islam, ed., *Social Dimensions of Economic Reforms in Asia*. New Delhi: International Labor Office (SAAT).
- _____, 1996a. "Why Has South Asia Grown so Slowly?" In A. Abdullah and A. R. Khan, eds., *State, Market and Development*. Dhaka: The University Press Limited.
- _____, 1996b. *Employment, Growth and Liberalization: China's Growth in a Globalizing World Economy*. Bangkok: ILO East Asian Multidisciplinary Advisory Team.
- _____, 1996c. *Employment in a Globalizing and Liberalizing World: The Case of the Philippines*. Manila: ILO South-East Asia and Pacific Multidisciplinary Advisory Team.
- Khan, A.R., and M. Hossain, 1989. *The Strategy of Development in Bangladesh*. London: Macmillan.
- Khan, A. R., K. Griffin, C. Riskin, and R.W. Zhao, 1992. "Household Income and its Distribution in China." *China Quarterly* December:1029-61.
- Kornai, J., 1980. *Economics of Shortage*. New York: North-Holland.

- Krueger, A. O., 1983. *Trade and Employment in Developing Countries: Vol. 3, Synthesis and Conclusions*. Chicago: The University of Chicago Press.
- United Nations Development Programme (UNDP), 1994. *Human Development Report*. New York: Oxford University Press.
- World Bank, 1986. *World Development Report 1986*. New York: Oxford University Press.
- _____, 1988. *Adjustment Lending: An Evaluation of Ten Years of Experience*. Washington, D.C.
- _____, 1989. *India: Poverty, Employment and Social Services*. Washington, D.C.
- _____, 1990a. *Indonesia, Strategy for a Sustained Reduction in Poverty*. Washington, D.C.
- _____, 1990b. *World Development Report 1990*. New York: Oxford University Press.
- _____, 1992a. *World Development Report 1992*. New York: Oxford University Press.
- _____, 1993a. *World Tables 1993*. Baltimore and London: Johns Hopkins University Press.
- _____, 1993b. *The East Asian Miracle*. New York: Oxford University Press.
- _____, 1995a. *World Tables 1995*. Baltimore and London: Johns Hopkins University Press.
- _____, 1995b. *World Development Report 1995*. New York: Oxford University Press.