Reforming Labor Markets in the Near East

Implications for Structural Adjustment and Market Economies

Robinson Hollister, Jr.
Markus Goldstein

Sector Study Number 8
International Center for Economic Growth

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An International Center for Economic Growth Publication

ICS PRESS

Inquiries, book orders, and catalog requests should be addressed to ICS Press, 720 Market Street, San Francisco, California 94102, USA. Telephone: (415) 981-5353; fax: (415) 986-4878; book orders within the contiguous United States: **(800) 326-0263.**

Library of Congress Cataloging-in-Publication Data

Hollister, Robinson G.
Reforming labor markets in the Near East : implications for structural adjustment and market economies / Robinson G. Hollister, Jr. and Markus P. Goldstein.
p. cm. — (ICEG sector study series ; no. 8)
"An International Center for Economic Growth publication."
Includes bibliographical references and index.
ISBN 1-55815-318-7
1. Labor market—Middle East. 2. Manpower policy—Middle East. 3. Labor policy—Middle East. 4. Middle East—Economic policy. 5. Labor market—Arab countries. 6. Manpower policy—Arab countries. 7. Labor policy—Arab countries. 8. Arab countries—Economic policy. I. Goldstein, Markus P., 1970– . II. Title. III. Series.
HD5811.9.A6H65 1994
331.12'0956—dc20 94-13414
CIP

Preface

We are pleased to publish this paper on the labor markets in the Near East by Robinson Hollister, Jr., and Markus Goldstein, as the eighth in the Center's series of Sector Studies. These studies analyze one country's response to a specific policy problem or compare the policies of several countries.

Given the emphasis that economists place on improvements in human capital as an essential ingredient in economic growth, it is not surprising that properly functioning labor markets are a very important element in development. Labor markets are important for both economic and social development as they mediate the movement of labor to increasingly valuable uses. For this reason, a poorly functioning labor market, preventing labor mobility, can make economic development impossible. Given their importance, it is surprising that labor markets have been substantially neglected by development theorists and practitioners.

The authors of this paper focus their attention on Egypt, Jordan, Morocco, and Yemen, and argue that these countries' economic stabilization programs are being undermined by two forms of distortion in particular: by overinvestment in public employment and underinvestment in education and jobs for women. They argue that government regulation of the labor force for the sake of job security tends to inhibit the movement of labor into just those areas where it is needed for economic adjustment, namely, the manufacture of tradable goods for export. They conclude, therefore, that trade reforms are usually premature; it is the labor market that should be reformed first.

Structural adjustment is a long-term process that aims to wean developing countries away from dependence on government subsidies and toward reliance on trade and economic growth. Such a process inevitably causes disruption and even hardship. The authors are well aware that the hardship can be unfairly distributed. However, they note that in most of these countries data are lacking for close study of how adjustment has affected people and therefore of how its effects might be mitigated. Since an open economy is also a more uncertain economy, social safety nets will continue to be needed. In conclusion, the authors present a policy agenda that is both practical and compassionate, based as it is on investing in people.

Labor market problems are not confined to the Near East. We think this book will provide a valuable resource for policy makers, researchers, and administrators involved in economic development in most parts of the world.

Nicolás Ardito-Barletta
General Director
International Center for Economic Growth

February 1994

About the Authors

Robinson G. Hollister is Joseph Wharton Professor of Economics at Swarthmore College. While he primarily works on problems of poverty and social programs in the United States, he has had extensive experience in development economics. In the 1960s and 1970s he worked at the OECD and carried out several missions (along with pieces of analysis of education and labor markets) in Africa for UNESCO, the International Labour Office, and USAID. In 1979 and 1980 he lived in Malaysia and worked for the prime minister's Economic Planning Unit on issues of poverty and income distribution. He returned to Malaysia in 1989 as part of the ILO/UNDP/Government of Malaysia Human Resource Development Plan project on labor market developments. He has also done consulting work for the World Bank and the government of Indonesia.

Markus P. Goldstein is currently working as a consultant for the World Bank, where he is conducting a cross-country study on poverty and Bank policy. He has worked on international development issues for the Canadian government, USAID, and the Overseas Development Council. He is on leave from John F. Kennedy School of Government, where he is pursuing a master's degree in public policy.

Acknowledgments

This work on labor markets in the Near East was initiated at the request of USAID and supported by them. Draft revisions of the work were done while Professor Hollister was a visiting scholar at the Rockefeller Center in Bellagio, Italy, and a research scholar at the Russell Sage Foundation in New York. The authors wish to thank Terri Lucas of USAID who proposed the study and provided extensive sources and very valuable criticisms and suggestions throughout the study's development. Additionally, productive discussions with Depak Mazumdar and Peter Fallon of the World Bank were especially beneficial.

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Chapter 1

Labor Markets in the Development Process

Most studies of economic development and the policies that might facilitate or impede it have focused on a limited range of topics. The accumulation of capital, the pattern of investment in physical and human capital, the nature of international trade, how governmental policies may have influenced or can influence how these factors interact in the development process—such have been the major concerns. Relatively little attention has been paid to the processes in which the distribution of products of economic growth is largely determined, namely, the markets for labor services.

There are many reasons for paying more attention to the operations of labor markets in this context. Here, we list very briefly the most important ones.

For most individuals and families in most countries, the largest component of their income is the returns for their labor (earnings), either through self-employment or through payment for services. The determinants of the level and distribution of earnings are therefore the major determinants of the level and distribution of material well-being in the society. It follows that a careful look at the operations of labor markets is an important part of understanding how the development process unfolds and affects most of the population.

The interactions in labor markets result from the interplay of decisions by firms and individuals about the utilization of labor services. At the same time, however, they are the source of signals to firms and to individuals, signals that influence their decisions about the utilization of other resources. Poorly operating labor markets can generate poor signals with ramifications outside the immediate labor market that lead, in both the short and the long run, to an inefficient use of resources in other input markets and also in output markets. A price for low-skilled labor that is higher than its true opportunity cost, say because collective bargaining has set the wage too high, can lead to the substitution of more capital-intensive processes and, therefore, to lower employment than would be efficient. A price for skilled labor that is too low, perhaps because public sector wage rates have fallen too low, can lead to an underinvestment by individuals in developing productive skills, thereby slowing the development process.

It has become increasingly apparent, both in terms of the theory of economic growth and in terms of empirical findings, that growth in human capital plays a larger role in development than growth of physical capital. In addition, the lack of critical skills at particular points in the development of a given industry can create bottlenecks not only for that industry but also for the development process. There can be distortions in labor market processes that hamper the growth of human capital or lead to a failure to provide critical skills.

The interplay of the public and private sectors is particularly pronounced in the labor market. In many developing countries, the public sector, in the civil service, in the education sector, and in public enterprises, has been the major employer, particularly of the skilled labor force. It is clear that governmental decisions with respect to both wage setting and employment in the public sector will have a significant impact on what occurs in private sector labor markets. In addition, governmental policies can play a major role, improving or impeding development processes, in the operations of labor markets through legislated conditions of work, bargaining processes, specific limitations on hiring and firing processes, and even direct wage setting, as with minimum wages or relative occupational wages.

In developed countries, the economic issue that has always had the greatest prominence in political discourse is unemployment. In developing countries, as the size of the agricultural sector shrinks in the typical development process and urbanization increases, closer ties are forged between urban labor markets and political processes. "The educated unemployed" can become a concern disproportionate to their numbers because politicians fear their potential for generating political conflict. Unions can have a major influence on political strife particularly because they can be a mobilized force in otherwise weakly organized situations.

Perhaps most relevantly for this study, malfunctioning of the labor market can defeat attempts to adjust to external shocks or to achieve structural adjustments. This malfunctioning can take purely economic and purely political forms. Adjustment inevitably requires a change in the allocation of resources across sectors. Poorly functioning labor markets can stymie such reallocations either because of wage rigidities or because barriers to access, such as social constraints on the location or types of work permitted for various groups, limit the mobility of labor. Political support for economic reforms can be difficult to maintain if distortions in the labor market cause the gains and losses from reform to be highly unequally distributed. For the same reason, smoothly functioning labor markets can help minimize the exacerbation of political conflicts by reform efforts.

A better understanding of labor market operations, encouraged by international organizations, may help developing countries to develop stabilization and structural adjustment policies that have a better chance of succeeding. It can help them to formulate policies and projects for achieving a more equitable distribution of the benefits and burdens of stabilization and adjustment. It may, in particular cases, help them to identify strategic points of intervention that would smooth the adjustment process.

Structure of the Study

We briefly outline here the structure of the study that follows.

In Chapter 2 we provide a quick review of the rudimentary theory of how labor markets should operate in situations of stabilization or structural adjustment. We then present a series of experiences and theories about labor market operation drawn from recent developments in the developed countries. New theories developed in light of recent facts suggest different ways of evaluating labor markets in developing countries.

In Chapter 3 we present an ordered framework of perspectives on labor markets in developing countries. Under each topic we review relevant evidence from Egypt, Jordan, Morocco, Tunisia, and the Yemens—the Near Eastern countries that are the focus of this report.

Chapter 4 is a detailed review of the response of labor markets in developing countries to stabilization and adjustment. We present the limited available evidence regarding the Near Eastern countries' experience with stabilization and adjustment. We also draw heavily on empirical evidence compiled in several major cross-national studies.

In Chapter 5 the distribution of the effects of stabilization and adjustment is considered as are issues concerning the compensatory or "safety net" programs set up in response to these effects.

Chapter 6 reviews issues of labor supply and demand, as well as market interaction, and presents recommendations for future policy making.

A number of appendices follow: Appendix A provides the data and charts discussed in Chapter 3. Appendix B presents case studies of job creation programs, and Appendix C is devoted to recommendations about types of data that should receive highest priority for development analysis.

Chapter 2

Theoretical Issues: Labor Markets in Developing and Developed Nations

Many developing countries have been attempting to shift from the extensive state intervention that characterized policy during the 1970s. This chapter provides an overview of this process as well as a comparative picture of the labor markets in the more developed countries. In recent years a preponderance of discussion by those concerned with economic development has been devoted to topics related to economic stabilization and structural adjustment. Also, most of the recent writing about labor markets in developing countries has been in the context of issues related to the operation and impact of stabilization and structural adjustment. To facilitate a longer and more detailed review of these topics later in this study, we sketch out here how and why the operations of labor markets can, in some situations, affect the success of stabilization or structural adjustment and the distribution of its impact.

To begin with, a distinction needs to be made between the short-run policies of stabilization and the longer-run policies of structural adjustment. Stabilization aims to reduce a deficit in the current account of the balance of payments and bring the government deficit to manageable proportions, while reducing the rate of inflation. This type of policy is often effected through demand compression policies—a ''credit crunch'' and reduced government expenditures—that can cause a recession in the economy. Significant unemployment may emerge and threaten the sustainability of the effort. Theoretically, in the medium run (barring significant distortions in input and output markets) a return to full employment can be expected. The expenditure reduction used to bring the deficit into line may also have two side effects: (1) the market clearing wage may be depressed as government workers are released, and (2) lower levels of investment (both public and private) under these policies may reduce growth in the economy and real wages.

Structural adjustment, which is often undertaken in tandem with, or following, stabilization, has a broader and deeper set of goals. It aims to reform policies (micro and macro) and institutions so as to make them more efficient, to improve resource allocation, and to expand growth potential and resilience to future shocks, such as adverse shifts in the terms of trade. Typically, in recent years, a major adjustment goal—as embodied in, for example, the conditions for a World Bank structural adjustment loan—is increased export orientation, which requires the shift of resources from the nontradable goods to the tradable goods sector. In addition, if the adjustments are to be sustained, the goals of structural adjustment should, like those of stabilization, include the establishment and continuation of sound fiscal policies.

Major features of adjustment are external trade balance, internal fiscal balance, monetary control, adjustment of price structures (by such means as subsidies, tariffs, and taxes), and control structures (such as marketing boards, exchange controls, and investment controls).

A critical element in the implementation of adjustment is a shift in relative real wages. Usually, where there is agricultural export potential (or need for import reduction), urban real wages need to fall and rural ones to rise. More generally, reallocation must occur from protected activities to export-oriented activities, and changes in labor costs are a major determinant of the viability of such shifts.[1] Well-functioning labor markets will generate signals through relative wages to facilitate such a reallocation; poorly functioning labor markets may impede or even defeat the adjustment process. Exchange rate adjustments can fail if real wages do not decline and inflation is allowed to offset the adjustments.

Typically, in either the stabilization or the structural adjustment process, the size of the public sector's total wage bill must be reduced. How this reduction is accomplished can have big effects on efficiency in the use of skilled labor. If real wages in the public sector are cut (usually through a constant nominal wage and rising prices) but employment is not, the result can be the gradual development of dual job holding, corruption, and general inefficiency in the performance of the public sector work force, which will spend a disproportionate amount of its energies in other activities trying to maintain real income. Thus the skilled labor in the public sector neither performs its public functions well nor does it devote its full energies to new private sector activities.

Another series of major questions centers on whether government's intervention in the labor market, through "setting the rules of the game" (that is, through labor laws and their enforcement), as well as through its direct employment activities, makes adjustment in labor markets harder and perpetuates inequality and inefficiency or, on the contrary, makes adjustment smoother, more equitable, and more efficient.

Finally, there are issues concerning the sequence of the reforms that make up the adjustment process. Will adjustments work better if attempts are made to reform the labor market before exchange rate or capital control reforms are undertaken, or will they work better if the labor market reforms follow the others?

Labor Markets in Developed Countries

Discussions of labor market reform in developing countries often need to be carried out with reference to some conception of what the markets might look like if they "operated properly," yet that conception is seldom clearly spelled out. Instead, vague reference is usually made to the way a labor market might operate in the idealized world of neoclassical theory in which both output and labor markets are perfectly competitive. Alternatively, reference is sometimes made to getting the developing country's markets to work "the way markets work in developed countries." In the following section we describe how recent events have given rise to various theories about how labor markets may operate. These theories suggest that even when there is a high degree of competition in labor markets, with firms acting to maximize profits, there may tend to be downward rigidity in wages, appearances of discrimination across groups, limits to mobility of labor among sectors, and a persistence of involuntary unemployment.

New Models of Labor Market Functions We start here with a compact summary indicating how the theory and experience from the developed countries might be salient to the issue in the developing countries that are the primary subject of this study. The summary, for those who may find it too compact, is followed by a more detailed, albeit highly simplified, explanation of the theories and how they seem to have been stimulated by the recent experience of developed countries.

The "insider-outsider" models developed for the industrialized economies seem to fit well with the situation of the government sector in developing countries, and of their organized formal sector, where "insiders" freeze out those working in the informal sector.

The new views of the unions, views that emphasize their role in helping to mobilize the internal structure of organizations, suggest that they may have a constructive role to play if they can be shaped to give voice to the outsiders rather than simply protecting the privileges of the insider. The government may have an important tripartite role to play in representing outsider interests so as to balance both those of the employers and of the insider unions—or even of unorganized insider employees.

The "efficiency wage" models that have been developed suggest that even in a well-operating labor market we should expect to continue to observe wide dispersions in wages that persist over time. No matter how much distortions from minimum wages, government job security regulations, or union strength are mitigated, high wages may persist even in the face of excess supply because it is "efficient" for employers to pay such wages.

Segmentation of the labor market is another possibility that needs to be taken seriously. The varieties of barriers that give rise to such segmentation, such as a strong role of government as an employer or gender divisions within both industry and agriculture, should be looked for carefully.

"Share contracts," which relate worker compensation to the firm's performance, may provide a type of labor market organization that will create more flexibility in markets. At the same time, they may give workers the feeling that fluctuations in their compensation are fair because they arise from their shared responsibility for performance, or from the need to spread the impact of externally generated deteriorations in market conditions. But effective share contracts require a level of openness and accountability on the part of management—government or private—that will engender workers' trust in the fairness with which their share is determined.

We turn now to the specifics that gave rise to these various theories.

Sustained High Unemployment in Europe and the United States In the last decade or so there has been considerable turmoil in the labor markets of developed countries, and this has been accompanied by revisions in theories of labor economics.

The 1970s and 1980s were in general characterized by much higher levels of unemployment in the United States and Europe than were the 1950s and 1960s. Of course, the two worst worldwide recessions since the

Great Depression played a large role in creating these high levels of unemployment but, in general, the levels tended to stay higher than in the previous decades even when the economies emerged from the recessions. This development was sometimes referred to as an upward drift in the "natural rate of unemployment."[2]

Partly as a result of these trends, macroeconomists focused more of their attention on how the operation of the labor market might explain sustained high unemployment. In the 1970s the "rational expectations" school of macroeconomists had suggested that such unemployment as existed must be "voluntary" in character, that is, largely related to job search behavior and an unwillingness to take available jobs at the going wage rate. In reaction, neo-Keynesians began to develop more complex theories of how labor markets might generate sustained "involuntary unemployment," including "overlapping contracts," "menu costs," and other explanations for failure of labor markets to clear.[3]

New Theories of Labor Market Processes In the later 1970s and early 1980s a sharp and puzzling contrast began to develop between the United States and Europe. For most countries in Europe, sustained high rates of unemployment were accompanied by a continued rise in real wage rates. For the United States, in contrast, particularly after 1982, the overall rate of unemployment declined slowly and employment-to-population rates rose to new highs, indicating a tightening of labor markets, but real wages stagnated and in some cases declined, which is usually a sign of looser labor markets.

These contrasts generated considerable debate about differences in the way labor markets operated in Europe and the United States.[4] Some stressed the role of small enterprises as a source of new employment growth in the United States and "the greater flexibility of United States labor markets," which together would tend to generate a combination of less unemployment but lower real wages. Others stressed the higher degree of collective bargaining in such European economies as Germany and France and their stronger social safety net systems. The European unions pushed hard for higher wages, obtained at the price of sustained higher unemployment, and the social safety nets tended better to mitigate the pains of the unemployment, thus creating a higher tolerance for the tilt toward a tradeoff between high wages and high unemployment.

European economists, in particular, developed a class of "insider-outsider" models that seemed to fit the experience in Europe. The basic idea in these models was that those workers already employed—the insiders—