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Aid, Growth, and Jobs

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ABSTRACT

Aid, Growth, and Jobs*

Various development objectives are worthy, but to my mind, one objective dominates all others: reducing the scourge of absolute economic misery in the world. In this paper, I focus on an important but relatively underemphasized approach to poverty reduction: helping the poor earn more in the labour market for the work they do, so that they can buy the goods and services they need to move up out of poverty.

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1 Introduction

How aid is spent may become more important than *how much* of it is spent.
Paul Collier (2012)

Collier was writing about how to make aid more effective for development, and he suggested several institutional innovations for making sure that whatever aid money is available is spent well. This paper too is about how aid money can be spent well; but rather than addressing the limitations of *institutional mechanisms* for delivering aid, I examine the *objectives* of aid and making decisions about how to *allocate* scarce aid resources among alternative uses. Various development objectives are worthy, but to my mind, one objective dominates all others: reducing the scourge of absolute economic misery in the world.[1]

I focus on an important but relatively underemphasized approach to poverty reduction: helping the poor earn more in the labour market for the work they do, so that they can buy the goods and services they need to move up out of poverty.[2] Why fighting poverty in the labour market is a central challenge for development is the subject of Section 2. Section 3 views five specific policy areas through the lens of raising poor people's earnings: growth, trade, private sector, wage employment, and self-employment earnings. Section 4 then presents an analytical framework aimed at guiding development organizations in planning development assistance and working with client countries to improve labour market outcomes. Section 5 offers some concluding observations on what constitutes a minimally acceptable foundation for a policy recommendation, how to think about targeting aid aimed at reducing poverty, where to seek applicable lessons, learning how labour market conditions change within countries in the course of economic growth, and the importance of research on the question of how developing country labour markets actually work.

2 Defining the development challenge

2.1 An update on global poverty

Nearly half of the world's people live on less than US$2.50 purchasing power parity dollars (PPP$) per day. (PPP$ convert local currencies to US dollars adjusted for what

1 When poverty is thought of in absolute terms, a poverty line is fixed in real dollars (or rupees or pesos) and is adjusted over time for inflation and only for inflation. The amount of poverty is then gauged by looking at those whose incomes or consumption and seeing how many of them there are, how far below the poverty line they are, and/or how unequal is the distribution of income among them. Absolute poverty is the focus of discourse in the United States and India, among others. Poverty conceived of in such absolute terms differs from the European notion of relative poverty, in which people are classified as poor by Eurostat if they live in households where the equivalized income is less than 60 per cent of the national equivalized median.

2 The 'labour market' is defined as the place where labour services are bought and sold. In the case of an employer-employee relationship, the employer buys the labour services of the employee. In the case of self-employment, an individual buys labour services from oneself. The poorer the country, the more important is self-employment vis-à-vis wage and salaried employment.

money will buy.) In 2008, of the world's 6.7 billion people, 1.3 billion lived on less than 1.25 PPP$ per person per day and another 1.7 billion lived on between 1.25 and 2.50 PPP$ per person per day.[3]

Of the world's poor, half live in just two countries, India and China. Another quarter live in sub-Saharan Africa (SSA). The remaining quarter are widely dispersed: in the rest of South Asia excluding India, the rest of East Asia excluding China, Latin America and the Caribbean, Eastern Europe and Central Asia, and the Middle East and North Africa.

Another feature about world poverty is that 72 per cent live in *middle-income countries*; twenty years earlier, 93 per cent were in *low-income* countries (Kanbur and Sumner 2011). This massive change is *not* because low-income countries were so successful in reducing poverty (although some were), while middle-income countries were not. Nor is it because the world's poor moved from low-income countries to middle-income countries. Rather, it is because a number of low-income countries became middle-income including the two most populous ones, China and India.

Certain characteristics of the poor are well-known: they are more likely to be rural, more likely to be poorly-educated, etc. Less well-known is how the poor work, to which we now turn.

2.2 Poverty and labour earnings

An oft-repeated truism is that the only asset of the poor is their labour. Lacking assets and income from other sources, what makes the poor poor is that they are compensated very little for the work they do or they are unemployed and therefore earn nothing. International Labour Organization (ILO) figures show that unemployment befalls about 200 million people in the world at the present time.[4] Two hundred million is a lot of people, but it is a much smaller number than the estimated 900 million people whom the ILO reckons are employed but earning so little that they and their families cannot achieve a standard of living of even US$2 per person per day (ILO 2012). Perhaps surprisingly, the unemployed are found disproportionately in *high-income countries* (ILO 2012) and in *non-poor households within those countries* (Sabia and Burkhauser 2010). Fighting unemployment is a legitimate policy challenge. However, the greater policy challenge is to generate higher earnings for those who are already working.

The people in the developing world are working hard and they are working poor. (*Working Hard, Working Poor* is the title of my new book, from which the following points are drawn.) Here are some of the main features of how people in the developing world are now working:

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3 The number living on less than US$1.25 PPP per day is reported in Chen and Ravallion (2012). I thank Shaohua Chen for providing me with a specialized POVCAL run estimating the number in the US$1.25-2.50 range.

4 The ILO defines a person as 'employed' if he or she worked one hour or more for pay or fifteen hours or more not for pay in the preceding week. A person who was not employed but who actively looked for work is counted as 'unemployed'. A third group is those who were not employed but who were not actively looking for work—say, because they were too old, too young, or too sick; these people are counted as 'not in the labour force' or, synonymously, 'economically inactive'.

A low rate of unemployment

Using standard ILO definitions of employment and unemployment, unemployment rates are *low* in low- and middle-income countries—lower than in high-income countries. The reason usually given is:

The need to work

The generally accepted explanation for below-average unemployment rates in developing countries is the so-called luxury unemployment hypothesis: few people in developing countries can afford to be unemployed for very long, so in order to earn something, they take up whatever employment is available or, failing that, create their own.

Insufficient good jobs

Jobs that are secure, pay well, and offer social protections are few in number relative to the number of workers who want such jobs and able to perform them.

Low earnings despite long work hours

Average work weeks are long—at least 48 hours in Peru, Korea, Thailand, and Pakistan, among others. And yet weekly earnings are low, because hourly earnings are so low. An Indian woman with whom I lived hand-rolls cigarettes for a living. Each day, she rolls a thousand of them, working very fast for eleven hours. This earns her fifty Indian rupees per thousand—about US$1.10.

Uncertain incomes

The great majority of the working poor have the problem of low daily earnings when they work. They also have the problem of uncertainty about whether they will have work. Casual employment is much more prevalent than continuous, ongoing employment. Seasonality is endemic.

Where and how they work

Most commonly, developing country workers work on farms and in their own micro-enterprises, not in factories and offices. Self-employment is the norm, wage and salaried employment the exception. Those in low-income countries work predominantly in rural areas; middle-income countries tend to be more urbanized. The workers are overwhelmingly informal, which is often defined as meaning that the enterprise is not registered with the government, the workers and the firm do not pay taxes, and therefore the workers do not receive government-mandated or—provided job-related social protections. Unemployment benefits exist only for the best-off workers in developing countries.

The special problem of indecent work

A seventeen-year-old sex worker in Kenya named Alice says, ‘I try to use condoms every time, but sometimes they reuse or offer much more money if we don’t. If I am offered 200 [shillings] for sex with a condom or 1,000 [shillings] without, then I don’t use condoms. I have to feed my baby’. Despite efforts to eliminate them, jobs that are outright indecent—modern-day slavery, indentured servitude, child prostitution, and the like—are far too common.

The particular disadvantages faced by women

Women in developing countries face all the labour market problems that men do, and then some. Women are less likely to be working in the paid labour force, more likely to be in low-paying occupations, more likely to be in precarious work, more likely to be victims of labour market discrimination, more likely to be low earners in self-employment, less likely to own land, and less likely to have secure land tenure rights.

Developing countries' employment problem

The preceding profile tells us that what most developing countries have is primarily a problem of working poverty, not a problem of unemployment. 'Absorbing the unemployed' is precisely the *wrong* way of looking at the problem. 'Creating higher-paying employment opportunities' in wage employment or self-employment is a much more appropriate characterization.

2.3 In summary

Three billion people in the world are poor. For every worker in the world who is unemployed, four-and-a-half workers are working poor. This means that most of the poor are poor because, despite working, they do not earn enough to enable their households to escape from poverty; they are not poor primarily because of unemployment. Not enough 'good jobs' are available for all who want and can do them. Labour market policies aimed just at lowering unemployment focus on a small part of developing countries' labour market problems and ignore the much larger problem of low earnings among the employed. Raising the earnings of employed workers, be they in wage employment or self-employment, deserves more policy attention and development resources than are often given to it.

Let us now look at the principal policy options which developing countries and those that aid them face.

3 Policy options for improving employment outcomes[5]

Given the preceding facts about world poverty and the importance of labour incomes for determining poor households' standards of living, how can aid be focused on *helping the poorer half of the world's workers earn their way out of poverty?* Let us assume that development assistance organizations have decided to devote at least some of their policy efforts and budgets to raising poor people's labour market earnings. For some of the poor, this will mean creating new wage and salaried employment into which they can move. For others of the poor, it will mean raising their self-employment earnings in the activities where they are now working. For others, still it will mean education,

5 This section is based on Fields (2012, Part Two), to which interested readers are referred for additional details.

training, and skills development. And all the poor are likely to be affected, for better or for worse, by policies with respect to economic growth, international trade, and the private sector.

The balance of this section presents some of the main policy options in each of these areas, indicating where possible some of the lessons from international experience which may prove informative in helping aid agencies and client countries design better policies. We start with policies that are outside the labour market but have an important bearing on labour market outcomes for the poor, then turn our attention to labour market policies per se.

3.1 Economic growth

International evidence reveals two general patterns about the relationship between economic growth and poverty change in the developing world (Fields 2001; Asian Development Bank 2007; United Nations Economic Commission for Latin America and the Caribbean 2011). First, when economic growth has taken place, poverty has fallen in the great majority of cases, though not all. Second, when poverty has not fallen, typically it is because economic growth has not taken place.

Why has economic growth not been shown to bring about poverty reduction everywhere? Part of the answer may be measurement problems. On the one hand, although economic growth may have been reported, it may not indeed have taken place. On the other hand, poverty may not have been recorded as falling, even though it may have been. These 'anomalous' data points need to be examined one by one to ascertain their validity.

For those country observations that are valid and in which poverty did not fall despite economic growth having occurred, we may then ask, 'why'? Two cases are illustrative.

Long ago, research I conducted on the Philippines during the presidency of Ferdinand Marcos (Fields 1980) revealed that despite substantial economic growth, the real incomes of the poorest had *fallen* considerably. When I reported these results to the United States Agency for International Development, which had funded the research, they contacted the aid mission in the Philippines to inquire whether what the data showed was indeed true, and if it was, to redirect the United States' aid programme accordingly. Consequently, I met with officials from the Philippine national planning commission, who told me: 'What you reported is indeed true, but you left out one important thing: the increase in poverty took place under the previous planners, not us'. What happened in the Philippines at that time was a blatant instance of 'crony capitalism': Marcos and his cronies (including his infamous wife, Imelda) had stolen so much that the nation's poor had been rendered poorer.[6] This blatant corruption was a major factor in the overthrow of the Marcoses shortly thereafter.

More recently, and more disturbing to me personally, is the experience of my own country, the United States. In the thirty-five years preceding the Great Recession of

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[6] *The New York Times* (26 March 2004: A6) published a list of 'embezzling leaders' compiled by Transparency International. Ferdinand Marcos was number two on the list, after Indonesia's Suharto. Marcos is estimated to have stolen US$5 billion to US$10 billion during his fourteen-year presidency.

2007-, real national income per capita grew by 113 per cent. Yet, the poverty rate, which had fallen from 25 per cent when it was first calculated in 1962 to 12 per cent by 1973, never fell lower. It exceeded 13 per cent in 2008 and is now above 15 per cent. Part of the reason for poverty not falling is that the labour market earnings of some important groups—for example, all men in the United States—are markedly lower than they were forty years ago. Household incomes are down too: 7 per cent lower now in real terms than they were in 1999 (US Census Bureau 2011).

In the 2012 presidential campaign in the United States, one side kept repeating, 'If you tax the job creators, they won't create as many jobs'. This is a half-truth. It is probably true that private businesses will create fewer jobs the more they are taxed. But it is also true that the tax proceeds can and would be used by government specifically to create more jobs by hiring additional teachers for the schools, additional construction workers to rebuild roads and bridges, and additional police and firefighters. Who said that the goal of public policy is to maximize *private sector* employment? Little is being done in the United States to focus the debate on raising *total* employment, especially those jobs that can be done by the poor.[7]

Economic growth *in general* can be stimulated. So too can *pro-poor* economic growth. The Commission on Growth and Development, headed by the Nobel Prize-winning economist Michael Spence, reported (2008, 2009) that the fastest growing developing economies in the world had a number of features in common:

- They made the most of opportunities in the world economy.
- They maintained macroeconomic stability.
- They achieved high rates of savings and investment.
- They relied on markets to allocate resources but also intervened to affect what people brought to markets.
- They had committed, credible, and capable governments.

The Commission also presented a long list of 'bad ideas'. Among the ones relevant to employment and the labour market are relying on the civil service as an employer of last resort (as opposed to rural employment schemes, which serve as a safety net), providing open-ended protection to specific sectors or jobs, paying civil servants less than they could earn elsewhere in the labour market, and abandoning an outward-looking market-driven growth strategy because of financial failures in the advanced countries.

In short, for economic growth to benefit the poor, mechanisms must be in place whereby growth reaches the poor. Donors can influence policy by credibly assessing whether such mechanisms—especially labour market mechanisms—are in fact in place and help strengthen them or put them in place if they are not.

3.2 International trade

It has long been known that export growth is positively associated with wage growth (World Bank 1995: 55). China, South Korea, Thailand, Indonesia, and Malaysia come

[7] See, however, Krueger (2012) and Stiglitz (2012).

out most positively on both dimensions. On the other side, we find Jordan, Ghana, and Nigeria doing badly on both accounts.

Openness to trade is often measured as the sum of exports and imports. Exporting is good for labour market outcomes. It is not clear, though, that importing is. Indeed, the case has been made that East Asian growth was brought about by *export* expansion, not *import* expansion (World Bank 1993).

Free trade is not necessarily fair and often is not. As countries consider whether to further open their economies to international trade, it is useful for country governments and donor agencies to think in terms of the effects on the poor. It is for reasons such as these that India and other countries have not allowed major retailers such as Wal-Mart to operate within their borders—small merchants with no alternative source of livelihood would get wiped out.

Freer trade is likely to result in labour market losses. This is because labour markets are segmented, and therefore those workers who lose relatively good jobs may never recover their current earnings levels. Not surprisingly, they will resist freer trade unless they are compensated. Analysts across the political spectrum concur that, for practical if not always ethical reasons, those affected adversely by international trade need to receive some form of compensation. *The Financial Times'* Martin Wolf put it well: 'It would be immoral for rich countries to deprive the poor of the world of so large an opportunity for betterment merely because they are unable to handle sensibly and justly the distribution of the internal costs of a change certain to be highly beneficial overall'.

Expanded trade adjustment assistance, extended unemployment insurance benefits, and wage insurance are among the policies that have been proposed in the rich countries. So too are the elimination of farm subsidies, which have an important bearing on poor countries. Alas, in the current political climate, none of this is likely to happen any time soon.

3.3 Private sector

Aid may be considered for improving the investment climate and in other ways stimulating private sector development. In formulating policies with respect to the private sector, it is important to bear in mind what is motivating companies. I believe the message of basic microeconomics is right: that private companies are motivated by the drive for ever-higher profits. In the labour market, private companies will hire workers or not, pay them well or not, train them or not, or employ 'high road human resource practices' or not, depending on what is in their profit-maximizing interests to do. As former US Secretary of Labour Robert Reich (2007) has said, 'Don't believe for an instant that a company is going to sacrifice profits for the sake of social goals . . . It's not business' business'.

Some analysts think that what is good for businesses is bad for workers and vice versa. I disagree. I see ample win-win opportunities. Many aspects of private sector development may not only enable companies to earn higher profits but also enable workers to benefit from increased employment and/or higher wages. But mutual gains are no more automatic than zero sum actions are.

Take the example of Intel, which decided to build a US$300 million semiconductor assembly and test plant in Costa Rica rather than in Brazil, Chile, Indonesia, Mexico, the Philippines, or Thailand; 2,800 workers are now employed there. They also decided to build a number of major facilities in China rather than the United States. What questions does Intel ask when it makes locational decisions like these? Says its chairman, Craig Barrett, 'What inherent strength does the country bring to the table?'. Explaining why Intel did *not* build a plant in the United States, the company's CEO, Paul Otellini, explains: 'The things that are not conducive to investments [in the United States] are [corporate] taxes and capital equipment credits. . . If I build that factory in almost any other country in the world, where they have significant incentive programs, I could save US$1 billion. . . The cost of operating when you look at it after tax was substantially lower [in China] and you have local market access'. And why does Intel *not* build a plant in India? Says Barrett, 'You don't have infrastructure. Your electricity goes off four times a day' (Fields 2012: 127).

Intel does not need the workers of Costa Rica or China. However, the poor workers of Costa Rica and China desperately need the good jobs that Intel creates.

Private companies play an essential role in economic development as employers and taxpayers. Those governments, development institutions, non-governmental organizations, and ordinary citizens who are interested in helping the poor should explore ways of harnessing the energies of private companies toward mutually advantageous ends.

3.4 Generating more paid employment

If policy makers in a country and the aid organizations that assist them decide to give priority to expanding the number of jobs for the poor in paid employment, what types of action within the labour market should they consider undertaking? International experience suggests lessons regarding a number of possible policy measures.

First, *avoid prematurely high labour costs.* By 'prematurely high labour costs', I mean labour costs that are higher than they would have been if they had been set by supply and demand in the labour market. The great preponderance of evidence from all over the world shows a non-zero wage elasticity of demand for labour (Hamermesh 1993).[8] Therefore, higher wages and other benefits—whether brought about by minimum wages, trade unions, public sector pay policies, multinational corporations, or labour codes—are likely to reduce employment below what it otherwise would have been. On the other hand, the bulk of the evidence also shows that the wage elasticity of demand for labour is less than one (in absolute value), and therefore higher wages would result in higher total wages being paid to workers (Freeman 2010). There certainly are many development reasons that higher wages, more generous benefits, and greater labour market protections should be sought, but increasing wage and salaried employment is not one of them.

Second, *remove undue barriers to employment.* In many developing countries, employment protection laws are in place restricting dismissals of workers. While the

8 One notable exception is the study by Card and Krueger (1995) of fast-food workers in the United States.

workers covered by the legislation are in fact likely to enjoy more secure employment, there is also an unintended side effect: employers may be reluctant to hire workers in the first place, knowing that they cannot be dismissed in the event of a business downturn or unsatisfactory job performance. In India, where this phenomenon has been studied most carefully, stricter employment protection laws have been found to have resulted in lower employment and higher poverty (e.g., Besley and Burgess 2004). India's Prime Minister Manmohan Singh, himself a distinguished economist, has asked: 'Is it possible that our best intentions for labour are not actually met by laws that sound progressive on paper but end up hurting the very workers they are meant to protect?' (Srivastava 2011).

Third, *increase employees' skills and productive abilities to the extent that skill deficiencies are causing job vacancies to go unfilled.* Note the qualifier: to the extent that skill deficiencies are causing job vacancies to go unfilled. Employers do not hire the unemployed and underemployed for many reasons. If education and skills are expanded and additional skilled people join others in holding out for 'suitable' jobs, additional education and training may make labour market conditions worse, as has happened in a number of African economies (Bennell 1996; Pritchett 2001).

But in other circumstances, where employers are posting vacancies which they cannot fill because suitably qualified workers cannot be found, a different question arises: what is the best way to increase productive skills and abilities? The World Bank (2007) has classified educational policies according to those judged successful, those judged promising but unproven, and those judged unlikely to be successful.

As for post-schooling training, a good example for other countries to learn from is Mexico's System of Training Workers (known by its Spanish acronym, SICAT). The in-service training component of SICAT provides for employers to offer training in skills they need such as air-conditioner repairing and lathe operating; these are not necessarily the skills that would have been chosen by ministry officials in Mexico City. SICAT graduates have been found to have done better in the labour market than comparable individuals who did not undergo such training (Calderón-Madrid and Trejo 2001).

Fourth, *create jobs for the poor.* Examples of such so-called 'workfare' programmes are Argentina's Programme for Heads of Households, Bangladesh's Food for Work Programme, and India's National Rural Employment Guarantee Act (NREGA). General lessons have been drawn on how to design workfare schemes (Ravallion 2009).

NREGA is the most ambitious workfare programme in the world for several reasons: because India is the world's second most populous country, because it is an employment *guarantee* scheme, and because the programme has now been expanded to serve the poor in *each* of India's 600 districts. NREGA has been reported to have had some noteworthy positive effects (including reduction in distress out-migration, improved food security, employment with dignity, greater economic empowerment of women workers, and sustainable asset creation) but also some major problems (fewer than one hundred days of work, non-payment of wages to persons who have performed work, and other 'operational deficiencies'). The government of India is well aware of these problems and is working actively to overcome them.

Fifth, one thing which I think in general should *not* be done is to improve labour market information systems such as online information centers, public employment services, job banks, and the like. Such services are well-suited for situations in which employers want workers, workers want jobs, but the employers and workers cannot find one another—what labour economists call 'frictional unemployment'. But in my experience, unemployment and underemployment in developing countries are rarely frictional. What developing countries have is deficient demand in the wage and salaried labour market. Labour market information systems address the wrong problem and so are not deserving of scarce development resources.

3.5 Increasing self-employment earnings

Finally, suppose that priority is given to increasing the self-employment earnings of the poor. What types of action might prove effective? International evidence indicates a number of interventions that have had positive effects in raising self-employment earnings.

First, *design products to help raise the productivity of the self-employed.* Organizations including International Development Enterprises, KickStart, Fuel from the Fields, One Laptop per Child, and D-Rev: Design for the Other 90 per cent have done this. A wide variety of highly affordable products have been developed. Among them: a WorldBike designed especially for transporting cargo; a mobile water purification tool called LifeStraws that enables people to suck water directly through a filter, thereby preventing water-borne diseases; a rolling water system called Q Drum that enables large quantities of water to be rolled from place to place rather than carried on one's head or back; and a pot-in-pot cooling system with wet sand inserted between the two layers, enabling tomatoes to last for twenty-one days rather than two or three (Cooper-Hewitt 2007; Polak 2008).

Second, *adopt a positive policy stance toward the self-employed and avoiding hassling them.* In the cities of most developing countries, street traders and vendors are ubiquitous, selling lottery tickets, chewing gum, individual cigarettes, and whatever else those with money in their pockets may want to buy. But this general pattern is *not* found in South Africa. In the major cities there, one sees very few such workers. The reason is that the city councils have budgeted substantial sums for employing and equipping metro police officers to stop 'illegal, unlicensed street trading'. What makes the street trading 'illegal' is that very few permits are issued, and therefore the vast majority of traders have to operate without them. This kind of official hostility is worse than needless; it is anti-development. If the city councils were to regard poverty reduction as a top priority, recognize that most of the poor people living in their jurisdictions have no choice but to earn their livelihoods from self-employment, and adopt a more positive or at least a less negative policy stance toward the self-employed, the urban poor would have a better chance of earning their way out of poverty. The informal economy should be nurtured, not repressed.

Third, *provide the poor in agriculture with more to work with.* Developing country farmers face many constraints including lack of land, water, other inputs, knowledge of best practice, access to product markets, protection against risk, and access to financial services. Land reform is, of course, one possible policy response. Others include: a system of rice intensification which enables more rice to be grown with fewer inputs;

investment in irrigation; agricultural extension; crop insurance; and credit to farmers (on which more below).

Particularly promising is the work of the Bill and Melinda Gates Foundation, which has highlighted agricultural development as one of its priority areas. When the Gates Foundation prioritizes something, not only does is make massive resources available but it also requires evidence on what works and what doesn't. With funding from the Gates Foundation, the International Food Policy Research Institute examined more than 250 possible interventions and concluded that twenty were 'proven successes'. They include the Green Revolution in Asia, improved maize in SSA, pearl millet and sorghum in arid lands, connecting the milk grid in India, and land tenure reform in Vietnam (Spielman and Pandya-Lorch 2009).

Fourth, *facilitate supplemental off-farm wage-employment and self-employment.* Even among farm households, it is the norm to have more than one activity (Banerjee and Duflo 2007). Off-farm rural activities can be stimulated by a variety of means, as the experience of Taiwan showed, in contrast to that of South Korea. Both economies grew rapidly, but Taiwan's path was much more egalitarian than that of South Korea.

Fifth, *make capital available to the poor at affordable rates.* The poor lack six kinds of capital: human capital, business capital, infrastructure, natural capital, public institutional capital, and knowledge capital (Sachs 2005). Consequently, the poor have only limited opportunities to raise the capital they need to be able to make profitable investments that might help lift them out of poverty. And indeed there are profitable investments to be undertaken: studies have calculated *monthly* rates of return of 15 per cent in Mexico and 5 per cent in Sri Lanka (McKenzie and Woodruff 2006; de Mel et al. 2008).

On the matter of affordability of capital, the interest rates charged to the poor are often exorbitant: 4.69 per cent *per day* in Chennai, India; 40 per cent *per month* in the Philippines; and 10 per cent *per month* in much of the rest of the developing world. But such high interest rates can be avoided. The Grameen Bank in Bangladesh charges its borrowers 12-17 per cent interest *per year* and enjoys a nearly 100 per cent repayment rate. In the Indian state of Andhra Pradesh, banks make loans to groups of women at 12 per cent *per year*, and if the group repays on time, the state pays 9 per cent, leaving the borrowers to pay just 3 per cent annually. Andhra Pradesh enjoys a repayment rate of almost 100 per cent as well. Microcredit programmes along such lines merit serious consideration in other places. Development banks and aid organizations could play an active role in funding them.

Sixth, *build skills and business know-how.* Among the many organizations involved in developing business know-how are: the ILO's Workers Activities Programme (ACTRAV); Coca-Cola Sabco; Goldman Sachs' '10,000 Women' initiative; India's Self-Employed Women's Association (SEWA); a government-operated training scheme for the self-employed in Côte d'Ivoire (PAFPA); and the Foundation for International Community Assistance in Peru.

And seventh, *stimulate microfranchising* (Fairbourne et al. 2007). Microfranchising brings together microfranchisors (entrepreneurs who wish to expand their businesses) and microfranchisees (people who seek to operate their own self-employment activities but may not have the business know-how). Examples of successful microfranchising are: the Grameen Bank's Village Phone programme and similar programmes operated by the Grameen Foundation in Rwanda and elsewhere; VisionSpring, which makes available low-cost eye exams and affordable reading glasses; and Honey Care Africa, which sets up beekeepers with hives, loans, training, extension services, and a guaranteed market for their honey at fair trade prices.

3.6 In conclusion

Many different possibilities for policy action have been raised in this section. How should policy makers and aid donors choose from among them? Section 4 addresses this question.

4 Choosing the most promising interventions

4.1 Introduction

We have considered broad groups of policies to raise the labour market earnings of the poor: policies which take place primarily outside the labour market but have an important bearing on the labour market, including growth, trade, and private sector policies; policies within the labour market to increase paid employment; and policies within the labour market to increase the returns to self-employment.

Assuming that *a* priority for economic development, though not necessarily *the* priority for economic development, is to improve labour market outcomes for the poor, how should country governments and aid organizations choose among policies aimed at this objective? Policy-makers face two broad policy decisions: choosing *among* broad policy areas and choosing *within* a broad policy area.

Choosing *among* broad policy areas means deciding whether to allocate more development resources to one area (stimulating economic growth, for example) or to another (e.g., increasing paid employment). Similarly, choosing *within* a policy area means, for example, deciding to try to raise the returns to self-employment by increasing the availability of affordable microcredit or by investing in education and training. The do's and don'ts presented in this section are equally applicable to both.

Before suggesting how *to* choose, let me suggest some ways *not* to choose. Consider the choice between helping the poor where they are and helping the poor get out of where they are:

- Line of argument 1: We want to help the poor. The poor work mainly on family farms and in family businesses. Therefore, we should invest our development resources in improving incomes where the poor are, on family farms and in family businesses.

- Line of argument 2: We want to help the poor. The poor will remain poor as long as they remain in poor sectors. Family farms and family businesses pay poorly relative to wage employment, particularly when the wage employment is in enterprises registered with the government (what is sometimes called 'formal sector). Therefore, we should invest our development resources in creating new wage employment in registered enterprises so that the poor can move to the parts of the economy where earnings are higher.

- Line of argument 3: We want to help the poor. It is good to help the poor where they are, and it is also good to help the poor get out of where they are. Therefore, we should invest our development resources by using some to help the poor where they are and using the rest to help the poor get out of where they are.

I hope you noticed that these three lines of argument led to precisely contradictory conclusions. Yet many so-called 'policy implications' offered in the literature are just like this: because a certain policy action would produce benefits if undertaken, it should be done. The problem is that none of the preceding arguments recognizes that to use more of the available resources for one purpose implies having *less* available for another. Economists use the term 'opportunity cost' to recognize the budgetary tradeoffs—in this case, the cost of using resources to help the poor where they are is to *not* have those resources available to help the poor get out of where they are. To decide that something is good to do without also weighing the value of what is *not* getting done is not a good way to choose.

Let us turn our attention to how *to* choose.

4.2 A five-part policy evaluation framework

The following policy evaluation framework is one I have been using for a long time. I present it here for others who may also find it useful.

Policy instruments → Model → Outcomes →

Policy evaluation criteria → Policy evaluation judgment

The first step in the framework is to specify the action or alternative actions under consideration. These could be a law that might be passed, a regulation that might be imposed or removed, a tax, or a public expenditure.

The second step is to specify an analytical model. The best ones involve an interplay between theory and empirics, capturing the essential aspects of reality while leaving aside the less essential ones.

The third step is to use the model to predict the likely outcomes. In a labour market model, these outcomes might be changes in the number of workers in each type of job and the amounts they get paid.

The fourth step is to specify the policy evaluation criterion or criteria to be used. An example of a single policy evaluation criterion would be to analyze a proposed policy solely in terms of its effect on reducing poverty. Alternatively, an evaluation might be conducted in terms of multiple policy evaluation criteria such as increasing both employment and earnings. Some evaluators are comfortable using efficiency and equity as their criteria.

The fifth and final step is to evaluate the outcomes in terms of the policy evaluation criterion or criteria and reach a judgment about whether the proposed policy would have positive, negative, or ambiguous consequences.

In practice, these steps are better thought of as being developed simultaneously rather than sequentially, with considerable back and forth movement between them. Let us examine some of these steps in more detail.

4.3 Specifying the policy evaluation criteria

The best kind of policy analysis is one that starts with specifying an objective function: that which is to be maximized or minimized. The objective function sometimes has a single argument (e.g., minimize poverty as measured by the poverty headcount ratio) and sometimes multiple arguments (labour market well-being as a function of the number of jobs, how much workers earn in those jobs, the amount of social protection provided, and the honouring of core labour standards).[9] When the objective function has multiple components, *none of the components* is maximized; all components are *optimized* so that the *objective function* is maximized. Maximizing a multi-argument objective function therefore involves tradeoffs on the policy side. These policy tradeoffs are in addition to the budgetary tradeoffs described above, which always arise.

Many aid recommendations I have seen are made without any explicit policy evaluation criteria at all. It is stunning that those who do this are often surprised to be asked to make their policy evaluation criteria explicit.

Other aid recommendations are made on the basis of presumed goods—for example, it is presumably good to reduce a country's budget deficit, maintain a realistic exchange rate, or let supply and demand reign. Here too, it is worth asking those who make such recommendations what they think would be the effect on poverty of putting their recommendations into effect.

And still other policy recommendations are based on merit goods: education is socially meritorious, and therefore we should allocate more development resources to it. The problem with a merit goods argument is that many other things—health, housing, the arts, and many others—are also socially meritorious, which takes us right back to the point about budgetary tradeoffs: to use resources for one purpose means not to use them for another. What one gives up is as important to the decision as what one gets.

4.4 Specifying the model

Policy interventions need to be analyzed using a model. Supply and demand is a model. 'Firms maximize profits' is a model. 'The poor have many needs' is not a model; it is a fact.

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9 'Maximize the firm's profit' is a familiar example of a single-argument objective function. 'Maximize the individual's utility, where utility is a function of goods and leisure' is a familiar example of a multiple-argument objective function.

A good model involves the interplay of theory and data. It seems to me that the empirical reality of a developing country is that labour markets have multiple segments and multiple strata. By ‘multiple segments’, I mean that for workers of any given type, some jobs are better than others. And by ‘multiple strata’, I mean that workers differ in their type along some sort of hierarchy—for example, according to level of human capital or occupation.

A comprehensive labour market model would be one that recognizes multiple segments and multiple strata, models how each labour market segment and stratum works, and specifies how the various segments and strata link to one another via the migration of workers and the movement of firms.

Some features of a comprehensive labour market model are fairly generic. I would say that human capital plays an important role throughout the world in the sense that workers with more skills, often acquired through education and training, have the ability to perform certain jobs which those in the lower strata of the skills distribution lack. I would say too that a general feature of labour markets around the world is that they are segmented in the sense that (1) some jobs are better than others and (2) there are not enough of the good jobs for all who want them and are capable of performing them.

Beyond that, the right labour market model for a developing country might entail country-specific factors that vary from place to place. Examples are China’s household registration system (in Chinese, hukou) and the essential differentiation of India’s labour market between the peak and slack seasons in agriculture. It would be good to build such country-specific features into our analytical models.

Finally, I would mention features that seem *not* to be appropriate for conducting analysis in the developing country context.

One would be to assume that a country’s labour market is competitive. The problem with the competitive labour market model is that our textbooks teach us what a competitive labour market is, but real-world labour markets do not possess those characteristics.

Also problematical would be to conduct a policy analysis in terms of productivity. The problem with a labour market model based on productivity is that the word ‘productivity’ means different things to different analysts: among them, a worker’s physical output, value added per worker, total factor productivity, and many others. Unless the meaning of ‘productivity’ is defined in a particular context, the word means many things, and therefore nothing specific.

Many aid recommendations, including recommendations about employment and earnings in the developing world, suffer from one or another of these problems. I don’t know which is worse: to have an *inapplicable* underlying model or to have *no* underlying model. It would be good if analysts could try to avoid them both.

4.5 Using social benefit-cost analysis in formulating policy

A unified way of bringing together the foregoing considerations is to aim for as comprehensive a social benefit-cost analysis as time and knowledge permit. *Social* benefit-cost analysis entails looking at the *social benefits* (as versus the private benefits) and comparing them with the *social costs* (as versus the private costs). Let me illustrate.

The economics columnist for *The New Yorker*, James Surowiecki, has written, 'Just fourteen per cent of Americans, for instance, are running (or trying to run) their own business. That percentage is much higher in developing countries—in Peru, it's almost forty per cent. That's not because Peruvians are more entrepreneurial. It's because they don't have other options. What poor countries need most, then, is not more microbusinesses . . . To be sure, for some people the best route out of poverty will be a bank loan. But for most it's going to be something much simpler: a regular paycheck'. (Surowiecki 2008).

What Surowiecki leaves out is the fact that it is much more expensive to create a steady, regular paid job than it is to make a microloan to a microenterprise owner. Given the difference in costs, it is by no means clear that those who argue as Surowiecki does have necessarily reached the right conclusion (which does not imply that they have reached the wrong conclusion either).

Thinking in terms of social benefits and social costs could be done as follows. The easier question is to decide whether to do one single thing or not do it. In this case, we can ask three related questions:

1. What are the extra social benefits if the activity is undertaken?
2. What are the extra social costs of the activity?
3. How do the extra social benefits and extra social costs compare?

When more than one option is possible, similar questions can be asked:

1. What are the extra social benefits from each possible use of a development budget?

2. What are the extra social costs from each possible use?

3. For each possible use, how do the extra social benefits and extra social costs compare?

4. For which activity is the difference between benefits and costs the greatest?

(Note that I have used the word 'extra' rather than the word 'marginal', lest some readers understand 'marginal' in the sense of something that is unimportant. *Social* benefits and costs have been used throughout; many analysts neglect to distinguish social from private.)

The questions posed in the preceding paragraphs are not easy ones to answer. However, it is better to answer the right questions approximately than the wrong questions exactly.[10]

Finally, we may not have a good sense of the sizes of the social benefits and/or the social costs of various policy interventions, and so research may be needed in order to find out. Some researchers favour statistical and econometric approaches (Deaton 1997; Heckman 2001; Ravallion 2008), while others favour experimental approaches (Banerjee and Duflo 2011; Karlan and Appel 2011). No researcher today can afford to ignore either approach.

4.6 Practical questions to be asked

Imagine that you are a researcher or a country economist formulating a labour market policy proposal which you propose to take to a client country's government. Or imagine that you are a country government official formulating a policy proposal which you plan to take to a higher-level official in your organization. When you make such a proposal, it would be good to be prepared to answer the following three questions to the best of your ability:

- What specific labour market objective or objectives are you trying to achieve and by what welfare economic criterion or criteria will you decide if your objective(s) is/are being achieved?

- What theoretical labour market model are you using to analyze the effects of the proposed policy?

- What is the empirical evidence favouring one view of labour market functioning over another?

These three questions are the ideal. They define what we want to strive for. But let us not allow the best to be the enemy of the good. Professional economists and other social scientists can and should speak out even when we are not 95 per cent confident of our conclusions, because others are speaking out, and our hunches should be heard too.

5 Concluding thoughts

The three preceding sections defined the global poverty challenge and the world’s employment problem, presented policy options for improving employment outcomes, and suggested ways of choosing the most promising interventions. I have discussed issues relating to a number of major areas for policy intervention: stimulating growth, trade, and the private sector; generating more paid employment; and increasing the returns to self-employment. I have also emphasized that comprehensively-formulated labour market policies require explicit attention to the function being maximized or minimized, well-specified theoretical models, and appropriate empirical evidence. I would conclude with a few final observations.

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[10] A remark to insiders: think about the economist looking under the light post for his lost keys.

The first is to try to specify what constitutes a minimally acceptable foundation for a policy recommendation. To the extent that developing country governments and the donors that aid them are concerned about the economic well-being of the poor and in particular with their labour market earnings, three questions should be asked about proposed policies. First, is the contemplated action good for workers in general and for poor workers in particular? It is not enough just to ask whether the action in question would be good for the private sector. Second, how cost-effective is the proposed action? How do the direct benefits compare with the direct costs? And third, what about opportunity costs? Is the proposed policy not only *good* but is it *better* than some other policy? Time and resources may not permit these questions to be answered fully, but that is no excuse for ignoring them entirely.

The second is a question about how to think about targeting aid aimed at reducing poverty. The usual starting point is to think about aid to *poor countries.* However, more than 70 per cent of the absolutely poor people in the world live in *middle-income* countries, not *low-income* ones. This means that if the majority of the world's poor are not to be excluded from aid efforts, aid must be made available to the countries where the poor are and targeted on *poor people* in those countries. Lessons from the economics of targeting—fine targeting, categorical targeting, indicator targeting, and self-targeting—can help aid be more focused on helping the poor.

The third is where to seek applicable lessons. Most aid organizations are structured geographically: SSA, Latin America and the Caribbean, and so on. But many of the good ideas from international evidence come from countries that may not be nearby geographically but are near in terms of level of economic development. Nigeria may be able to draw relevant lessons from India's experience with its National Rural Employment Guarantee Act (both are lower-middle-income economies), and likewise Malaysia from Mexico's System of Training Workers (both are upper-middle-income countries).

Fourth, one particularly important gap in knowledge is how labour market conditions change within countries in the course of economic growth and non-growth. Are the optimists right that workers typically experience more and better job opportunities as economic growth takes place? Or are the pessimists right that most often those who enjoy economic and political power are able to work the system to their own advantage, thus causing poor workers to be left out or even immiserized? Maybe a future research study will enlighten us all on this vitally important question.

And finally, research is desperately needed on the question of how developing country labour markets actually work. As stressed above, sound labour market policies require sound labour market models. To be able to better design policy interventions, it is vital for policy makers and development organizations to be able to work with such models. It remains for more of them to be developed.

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