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## GUIDANCE NOTE ON JOBS AND GROWTH ISSUES IN SURVEILLANCE AND PROGRAM WORK—SUPPLEMENT ON COUNTRY CASE STUDIES

Approved By  
**Olivier Blanchard,**  
**Carlo Cottarelli, and**  
**Siddharth Tiwari**

Prepared by a staff team supervised by Kalpana Kochhar (SPR), Prakash Loungani (RES), Ranil Salgado (SPR), and Ben Clements (FAD); coordinated by Hans Weisfeld (SPR); and comprising Ruo Chen and Monique Newiak (both SPR), with contributions from Wendell Daal, Floris Fleermuys, Rodrigo Garcia-Verdu, Javier Arze del Granado, and Kevin Wiseman (all AFR); Alexandros T. Mourmouras (APD); Faezeh Raei (EUR); Elva Bova (FAD); Antonio David (ICD); May Khamis, Amina Lahreche, and Harold Zavarce (all MCD); Raphael Espinoza and Davide Furceri (both RES); Carol Baker (STA); and Mercedes Garcia-Escribano, Fei Han, Herman Kamil, and Lawrence Norton (all WHD).

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## I. INTRODUCTION

**1. This supplement provides case studies of how countries around the world have addressed jobs and growth challenges, and how Fund staff have helped in this.** The studies are meant to provide cross country experience. They share a broad structure, organized around four questions:

- What was the initial situation regarding growth, employment, and income distribution?
- What policy measures were implemented to enhance growth and employment and to even out the distribution of income? Were potential complementarities or trade-offs between enhancing growth, employment, and income distribution considered?
- How did Fund staff help the authorities? For example, in which areas did staff help the authorities analyze issues, how did staff go about analyzing issues, and what were the main considerations that shaped staff's recommendations?
- What were the results of policy actions taken?

**2. The case studies attest to a wide range of jobs and growth challenges.** In advanced countries, improving the functioning of labor markets appears to be a key issue, including by addressing labor market duality (Spain) and strengthening incentives to take up work (Germany and Korea). In emerging market countries, reform of labor market policies is an issue as well (Mexico), but challenges also include improving the income distribution (Brazil and Namibia) and avoiding the middle income trap (Malaysia). In low-income countries (Haiti), an important goal is raising tax revenue to allow for greater public investment and social spending. Finally, making the best use of hydrocarbon revenue (Algeria, Bahrain, Republic of Congo, and more recently also Ghana) is a challenge that cuts across income groups.

**3. While a collection of case studies does not allow drawing firm conclusions on which policies work well, a few points are worth making:**

- The German and Mexican labor market reforms are seen as having helped, or as being likely to help, bring unemployment down and support growth. In contrast, the overall impact of the Spanish reforms appears less certain so far, given the presently high rate of unemployment in this country. While a number of reasons might explain this difference, and the longer-term effects of the Spanish reforms are not yet known, a contributing factor to this difference in outcomes so far likely is the fact that Germany and Mexico implemented reforms in a stable macroeconomic environment while Spain did so in very difficult circumstances. This demonstrates the desirability of implementing reforms in good times, and of providing as supportive an environment as possible within the limits of available policy space when reforms have to be started in less favorable times.

- The case study for Korea, presenting findings from preliminary staff research, suggests that female labor force participation in Korea could be raised by removing disincentives that arise from the tax treatment of second earners, increasing childcare benefits, and facilitating more part-time work opportunities. In this way, the gap between male and female participation could be lowered by about one third. The case study also estimates that policy actions aimed at enhancing skills, such as retraining programs, could lower skills mismatches and substantially raise youth employment.
- The case of Brazil suggests that in a context of stability-oriented macroeconomic policies, well-targeted social transfers can help support inclusion, and thus possibly growth and stability, at a limited budgetary cost. Further, Brazil's experience suggests that reforms aimed at lowering compliance costs, such as the introduction of a simplified taxation scheme for small businesses, can support labor market formalization.
- The case of Malaysia appears to suggest that policies aimed at broad economic inclusion can help development from low- to middle-income level, while transition to advanced country status requires, in addition, gains in education to meet the needs of today's knowledge and innovation-based industries. An upgrading of other elements, such as a strengthening of institutions, may also be needed.
- The case study for Bahrain appears to demonstrate that in countries with some hydrocarbon revenue and a large supply of low-cost foreign labor, a combination of education and training initiatives combined with limits on and taxation of foreign labor can contribute to raising the private sector employment of nationals. This said, avoiding a large public sector wage premium that undermines nationals' incentives to take up employment in the private sector, is also important.

## II. ALGERIA: STRUCTURAL REFORMS TO RAISE GROWTH AND EMPLOYMENT<sup>1</sup>

**4. The Algerian economy is heavily dependent on the hydrocarbon sector, which accounts for 98 percent of total exports and more than 65 percent of the budget resources.** The public sector dominates the economy and growth in the private—and more generally the nonhydrocarbon—sector is inhibited by regulatory constraints, an insufficiently developed financial sector, as well as limited openness to both trade and foreign investment.

**5. Over the recent past, staff's policy discussions with the authorities have borne increasingly on the issue of growth and employment in the country,** where unemployment has been declining fast but remains high in some segments of the population (such as the youth and women). Discussions were based both on original analytical work and on the use of the recently developed jobs and growth template.<sup>2</sup>

### Growth and labor market performance in Algeria

**6. Algeria's growth over the 2000s averaged 3.5 percent overall, reaching 6 percent in the nonhydrocarbon sector.** While this was a marked improvement compared to the previous decade, growth has remained below its long-term potential, which could be as high as 6 percent per year.<sup>3</sup> A cross-country analysis highlights that, over the last two decades, lackluster improvements in total factors productivity and insufficient physical capital accumulation have hampered Algeria's performance compared to other economies, while the country did relatively well with respect to human capital, notably thanks to the healthy growth of the labor force<sup>4</sup>.

**7. The unemployment rate improved markedly over the past decade, falling from a high of 29.5 percent in 2000 to 10 percent in 2011.** Supporting this improvement were (1) the rapid demographic transition that brought working-age population growth from 3.6 percent in 1990 down to 1.8 percent in 2011; (2) low, stable and somewhat declining participation rates; and (3) a rapid increase in employment concomitant to the acceleration of growth in the nonhydrocarbon sector, led by rising public sector investment.

**8. A recent wave of active labor market policies was launched in 2009, and was aimed notably at the youth.** These measures included tax exemptions for employment-creating small and medium enterprises; interest subsidies and guaranties for credit extended to young entrepreneurs; and subsidies to employers' social security contributions. The authorities also designed schemes to

<sup>1</sup> Prepared by Amina Lahreche (MCD).

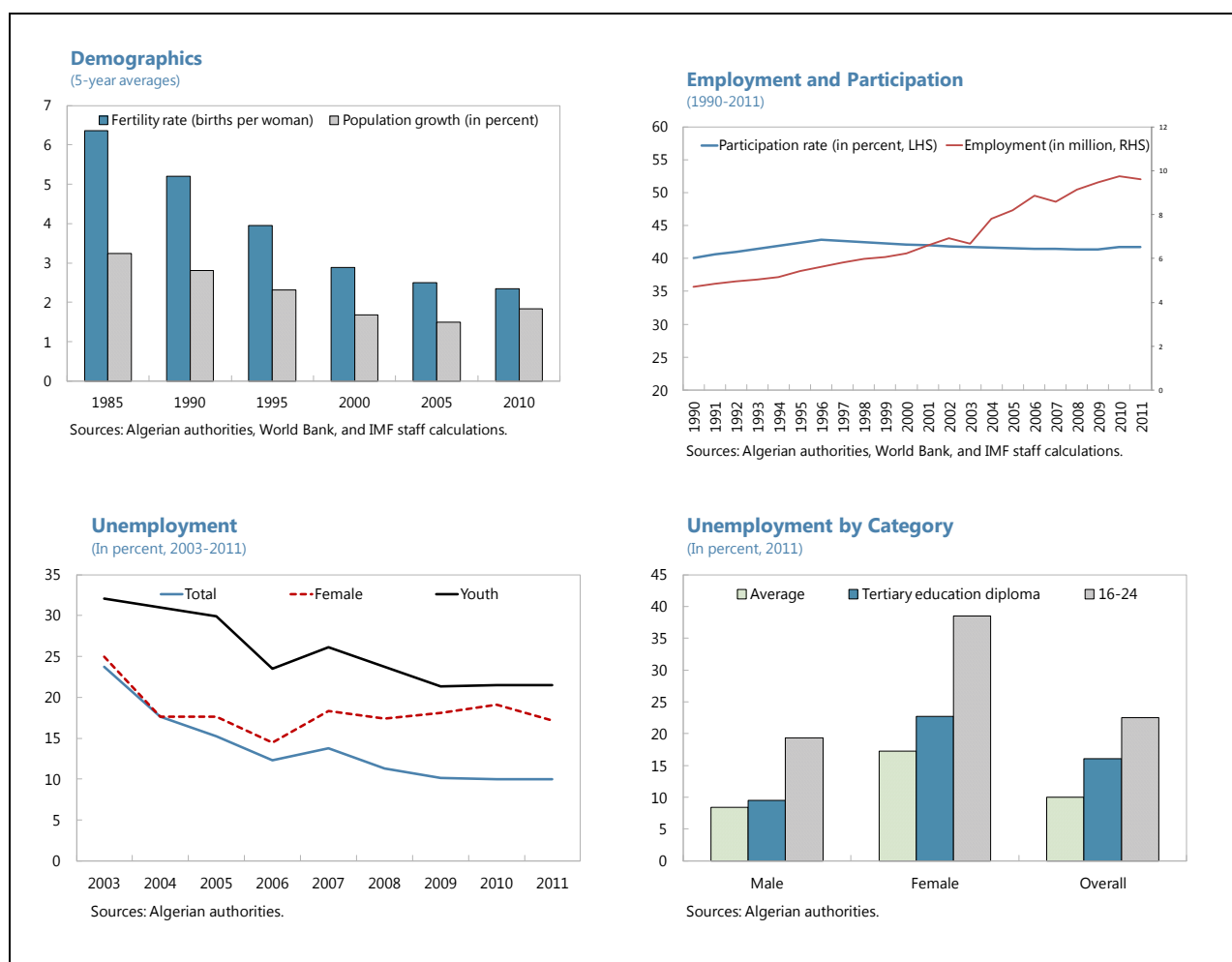
<sup>2</sup> See <http://www-intranet.imf.org/jobsandinclusivegrowthtoolkit/Pages/EmploymentTools.aspx>.

<sup>3</sup> See IMF Country Report No. 13/47 ([www.imf.org/external/pubs/ft/scr/2013/cr1347.pdf](http://www.imf.org/external/pubs/ft/scr/2013/cr1347.pdf)).

<sup>4</sup> See "Promoting Faster Growth in Algeria", in Algeria: Selected Issues Paper, IMF Country Report No. 13/48, February 2013.

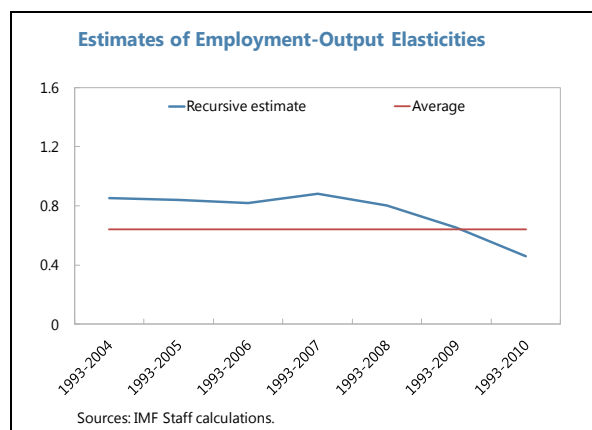
provide technical support to small entrepreneurs (such as market analysis or legal support), as well as training and skills development programs for employees. While the sustained impact of these measures is not yet clear – in part because they have been accompanied by temporary public sector hiring and preferences for domestic contractors in public procurement – it is likely that they have contributed to the recent decline in unemployment, especially for the highly educated, whose unemployment rate declined from 21.4 percent in 2010 to 16.1 percent in 2011.

**9. The overall improvement in labor market outcomes however masks unequal developments across various segments of the population:** in particular, while unemployment rates are relatively low for males above 25 years old, they are much higher for women, the youth and the highly educated.



## Assessing the elasticity of employment to growth

**10. Labor market performance is reflected in the elasticity of employment to growth.** An examination of Algerian data over time<sup>5</sup> suggests that, while the overall elasticity of employment to growth was on average close to 0.64 over 1993-2010, it was considerably lower for the youth and has been declining over the most recent years. Recent estimates, including more recent years (1990-2012), indicated that the overall elasticity of employment to growth remained close to 0.6 on average in Algeria, somewhat lower than the average of the 9 MCD countries for which estimates were significant.



**11. Scenarios developed for the 2012 Article IV<sup>6</sup> consultations using the “jobs and growth” template indicates that strong and sustained growth would be required to reduce the unemployment rate given the prevailing elasticity.** Harnessing the growth potential of Algeria would require broad and deep structural reforms; in addition, broad and deep structural reforms—including to the labor market—would be needed to increase the elasticity of employment to growth and make a significant difference to unemployment.

**12. Factors empirically known to affect the growth-employment elasticity include economic openness and export orientation, product market regulation and competitiveness, and the size of the public sector.** In addition, an efficient labor market plays a critical role. The synthetic index developed by the Fraser Institute of Economic Freedom suggests that Algeria has been lagging behind somewhat in this respect, and has not improved as much, compared to other countries.<sup>7</sup> Among the sources of “micro” rigidities is the duality of the labor market; in particular, the high level of protection of permanent, formal workers (mostly in the public sector) has contributed to the development of large informal economy with limited employment protection. “Macro” rigidities include a relatively large tax wedge on formal employment, the existence of a minimum wage that has been increasing faster than productivity, and relatively high public wages compared to private sector wages, which all may affect employment in the formal, non-public sector.

**13. An empirical analysis undertaken by the Algeria desk in 2011 suggests that an improvement in labor market policies, as measured by the Fraser Institute’s Economic Freedom of the World labor market flexibility index, helped lower unemployment in a sample**

<sup>5</sup> See “Unemployment and Labor Market Issues in Algeria”, in Algeria: Selected Issues Paper, IMF Country Report No. 12/22.

<sup>6</sup> See IMF Country Report No. 13/47, February 2013.

<sup>7</sup> Results using data from other sources, such as Aleksynska and Martin (2011), are similar.

**of 140 countries over 1980-2008, and that the impact was higher in Algeria than in the average of the sample.** A dynamic estimate points to a lasting impact.<sup>8</sup> These results are likely to be significantly strengthened if efficiency-enhancing labor market reforms were complemented by structural measures to enhance trade openness, competitiveness, competition and private sector orientation.<sup>9</sup>

### **Policies to increase growth ...**

**14. Discussions with the authorities underscored the importance of supporting higher investment: directing public capital spending toward projects that generate high economic returns; and maintaining efforts to improve the quality of spending, while private sector participation could be better leveraged.** The environment for private investment needs to be improved, in particular by lowering the cost of doing business, improving tax administration, facilitating trade, and improving access to finance, notably for privately-owned SMEs.<sup>10</sup>

**15. Policies are also needed to support an efficient and knowledge-driven economy.** A larger openness to both trade and foreign direct investment would support a faster accumulation of knowledge. Policies to enable innovation and increase technological absorptive capacity together with investment in education, training, and health, would support knowledge absorption. Institutions are essential to the optimal allocation and efficiency of factors; in particular, government effectiveness, a business climate supportive of private-sector development, and a sound competitive environment should be encouraged.

### **... and employment**

**16. The empirical analysis suggests that reforms to improve labor market efficiency could have a valuable effect in reducing unemployment both in the short and in the medium term.** While measures to reduce micro and macro rigidities are important, they are also complex to implement and would take time given the structure of the bargaining system in Algeria (where the government, the private sector employers and the trade unions all are strong stakeholders). However, other less structural reforms can be implemented that require less consensus building. It would be particularly important to implement measures aimed at reducing search and hiring costs, such as the high payroll taxes,<sup>11</sup> in order to integrate women and young workers into the labor market.

<sup>8</sup> See "Unemployment and Labor Market Issues in Algeria", op. cit.

<sup>9</sup> See "Unemployment and Labor Market Issues in Algeria", in Algeria: Selected Issues Paper, IMF Country Report No. 12/22.

<sup>10</sup> For additional information, see IMF Country Report No. 13/47, February 2013.

<sup>11</sup> For additional information, see IMF Country Report No. 13/47, February 2013.



**17. The high level of unemployment among young graduates is also the result of skills mismatches.** On the one hand, the private sector has not been able to create sufficient demand for skilled workers; on the other, the distribution of Algerian students is highly unbalanced towards disciplines such as humanities, social sciences, law and education; this generates a shortage in the skills most needed by the private sector. In this context, active labor market policies should seek to improve the efficiency of the job matching process and to enhance the skills of the unemployed. Structural policies should aim at improving the employability of the labor force, for instance through “education for employment” policies.

**18. Finally, reforms aimed at improving the business climate and fostering product market competition are key to increase labor demand over the medium-term.** In particular, lower barriers to entry would curb market power and incumbents’ rents, tend to reduce wage claims, and contribute to closing the gap between productivity and real wages.

### III. BAHRAIN: LABOR MARKET REFORMS<sup>12</sup>

*Bahrain enacted a number of labor market initiatives during 2004–06 that contributed to lowering the unemployment rate and significantly slowing the growth of public-sector employment.*

#### Growth and employment

**19. Bahrain witnessed high growth rates throughout the past decade.** Non-oil economic activity grew at a fast pace during most of the 2000s; it slowed down at the end of the decade, mostly because of the onset of the global financial crisis in 2008 and domestic political turmoil in 2011. While real non-oil growth averaged 9.6 percent during 2000–07, average annual real non-oil growth during 2008–11 was at 4.6 percent, about 5 percentage points lower than the previous period.

**20. Bahrain has a segmented labor market.** At end-2012, Bahraini nationals constituted around 49 percent of the population, and accounted for 85 percent and 20 percent of employees in the public and private sectors, respectively. High public-sector wages and lower working hours attract Bahraini nationals to public-sector employment, and effectively set relatively high reservation wages for nationals in private-sector employment. Accordingly, about 40 percent of the Bahraini nationals labor force is employed by the public sector. Non-nationals are employed mostly by the private sector and are generally paid lower wages than nationals in similar positions. Despite the high growth rates witnessed in the 2000s and the absorption of nationals into the public sector, Bahrain experienced high unemployment rates among nationals; the rates reached a high of 16 percent in 2006. This was largely due to skill mismatches of Bahraini nationals and the availability of cheaper expatriate labor.

**21. Bahrain has limited fiscal resources.** Similar to other Gulf Cooperation Council (GCC) countries, Bahrain is largely dependent on oil for fiscal revenue. However, unlike its neighbors, Bahrain's oil reserves are small, which limits its ability to employ nationals in the public sector. Furthermore, the main long-term challenge for Bahrain is to continue to diversify its economy away from oil. To do so, it needs to upgrade its domestic labor force to work productively in the private sector and to innovate. In this context, Bahrain's labor reform program described below focuses on training and skill building of the Bahraini labor force.

#### Labor market reforms: initiatives and results

**22. The labor market reform initiative was launched in 2004 with the aim of improving job opportunities for nationals and facilitating the mobility of non-nationals.** Labor market reforms were spearheaded by the Economic Development Board (EDB) tasked with promoting Bahrain's Vision 2030. Reforms included the creation of the National Employment Project (a job-matching/placement program for unemployed nationals, which operated for 18 months), the Labor

<sup>12</sup> Prepared by May Khamis and Harold Zavarce (MCD).

Market Regulatory Authority (LMRA),<sup>13</sup> the Labor Fund (LF) “Tamkeen,” and the Unemployment Insurance Program.<sup>14</sup> The objectives of the reforms were to stimulate investment and technological change and to enhance education and training of the Bahraini labor force. Bahrain also requires a minimum “Bahrainization ratio,” under which the share of Bahraini nationals in the work force of various economic sectors must attain certain minima.

**23. The Labor Fund provides training programs and support to enterprises to foster private sector development and employment.** It administers training institutes for job seekers and employers, and supports small and medium-sized enterprises (SMEs) in their efforts to improve productivity, with, for instance, affordable loans to upgrade technology (by guaranteeing access to loans from commercial banks). Tamkeen also conducts industry and product exhibitions, and facilitates an easy flow of information and learning between firms and customers and between job seekers and employers.

**24. More recently, the Ministry of Labor instituted a multifaceted set of programs for training Bahraini nationals and supporting the private sector.** Programs include: (i) training new graduates in basic skills to prepare them for employment, subsidizing part of the private-sector wages paid to nationals in the initial stages of employment (BD 150–200 per month for two years), and (ii) cooperating with the private sector in setting up skill improvement programs and on-the-job training. Specialized courses (lectures and hands-on training) for technical professions such as law and engineering have been instituted. The national program for apprenticeship, modeled after Germany’s system, is being developed. New initiatives are also in preparation. These include: (i) the establishment of a skills assessment center that would provide skill certificates for both Bahraini and expatriate workers; (ii) a market intelligence unit, to be developed with the EDB to understand future market skill needs; and (iii) developing occupational standards (for 125 occupations) that will also help develop training standards and provide input for the skills assessment design and educational curriculum.

**25. Reforms also targeted increasing female labor force participation.** Two initiatives were created to provide incentives for enterprises to hire women nationals. The first is the provision of two non-national permits for each female national employee hired. The second is a job-sharing program that allows two female employees to work part-time by sharing one full-time position.

**26. Levies on non-nationals’ salaries finance the Labor Fund program fully.** During the period 2006–12, Tamkeen costs averaged about 0.6 percent of GDP. The unemployment insurance scheme is also fully funded from employers’ and employees’ contributions, and levies on non-nationals

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<sup>13</sup> The LMRA regulates labor markets, oversees licensing and non-national employment, and collects statistics and performs labor market research to inform policy discussions. In 2009, Bahrain became the first GCC country to end the sponsorship system for foreign workers, allowing workers to move jobs without the permission of their employer.

<sup>14</sup> Unemployment insurance provides income for the unemployed (for 12 months), and for new entrants to the labor market (for six months). All beneficiaries are required to join a training and placement program.

**27. Labor market reforms were successful in reducing unemployment and containing public-sector employment growth.** Bahrain succeeded in achieving a drastic reduction in unemployment in a short period of time; the unemployment rate fell from a high of 16 percent in 2006 to below 4 percent by end-2012. Furthermore, the rate of growth of nationals' public sector employment slowed from 5 percent during 2002–06 to 2 percent in 2007–12. The highest growth in nationals' private sector employment was in trade (which includes the hospitality sector), followed by finance. Furthermore, the number of women nationals in such sectors as retail has been on the rise in recent years.

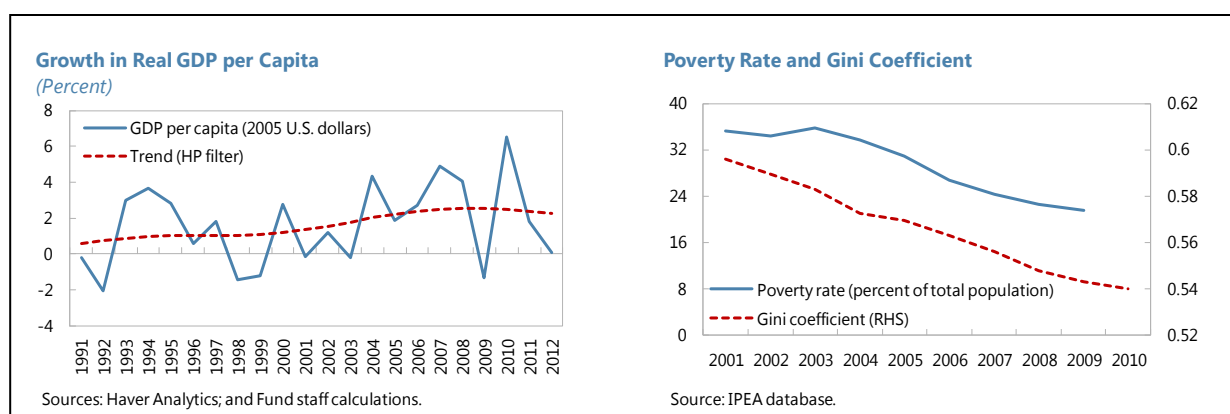
### **Fund involvement and recommendations**

**28. Staff has welcomed the above-noted reforms. Discussions with the authorities focused on minimizing potential distortions and fiscal cost.** Staff generally welcomed the emphasis placed on vocational training, the introduction of social insurance for SMEs, and consultation with unions and the business community in formulating labor policies. In the initial stages of the reforms, staff recommended that the unemployment insurance plan be fully funded to avoid drains on the budget. Staff also argued for using price-based interventions instead of sectoral quotas for Bahrainis, and cautioned against quickly increasing the cost of expatriate labor, so as to avoid adverse impacts on competitiveness. In recent years, staff has also been advising Bahrain (and GCC countries more generally) to avoid public sector wage premia. While agreeing in principle with staff on this issue, the authorities cite political pressures as reasons for public sector wage increases.

## IV. BRAZIL: GROWTH, EMPLOYMENT, AND INCOME INEQUALITY<sup>15</sup>

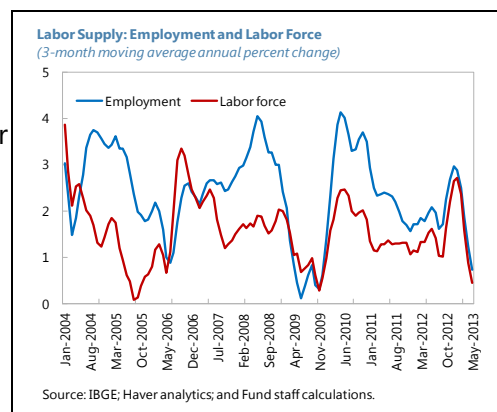
### 29. Brazil has witnessed a decade of robust growth and remarkable social transformation.

A strong policy framework (fiscal responsibility, inflation targeting and a flexible exchange rate) has contributed to macroeconomic stability and supported strong growth, together with a sustained improvement in the terms of trade. Brazil's annual growth averaged 3.6 percent during 2003-12, compared to 2.3 percent during 1995-2002, and GDP per capita has followed a strong upward trend. Meanwhile, Brazil has seen a substantial reduction in poverty and inequality and rising living standards of large segments of the population.<sup>16</sup> The poverty rate has declined from 35 percent in 2001 to 21 percent in 2009 and inequality, as measured by the Gini coefficient, declined too.<sup>17</sup>



### 30. The social transformation has been underpinned by significant improvements in the labor market, in turn facilitated by the prolonged macroeconomic stability.

- Employment has grown more strongly than the labor force resulting in a steady decline in the unemployment rate since 2009. The unemployment rate reached a record low of 5.5 percent by end-2012, down from 11.7 percent in 2002.

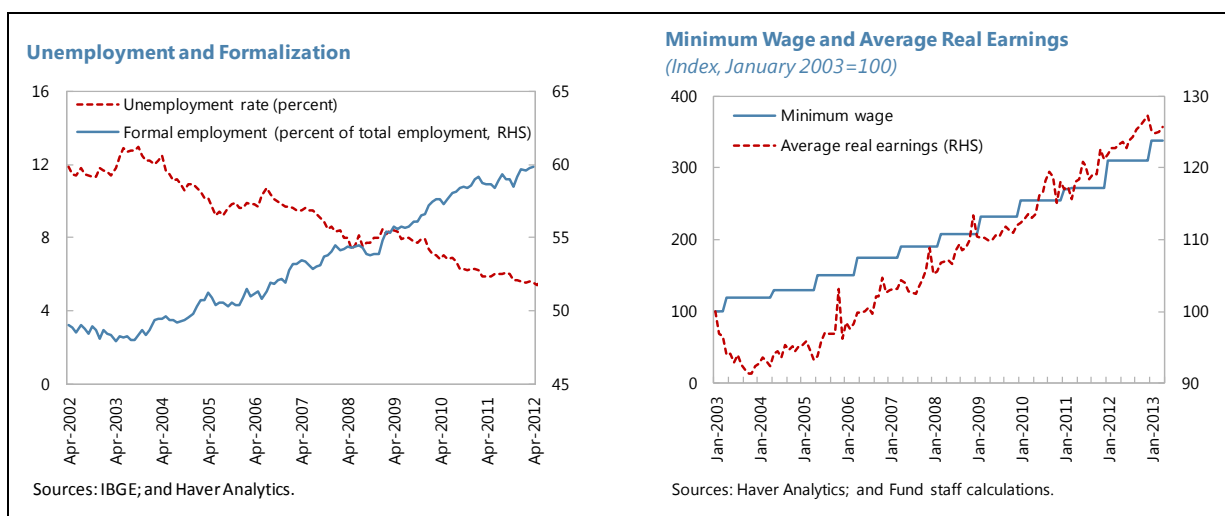


<sup>15</sup> Prepared by Mercedes Garcia-Escribano and Fei Han (WHD).

<sup>16</sup> According to *"Economic Mobility and the Rise of the Latin American and Caribbean Middle Class"*, the World Bank, Washington, D.C., 2013, Brazil's middle class represents 30 percent of total population, compared to 22 percent in 2002. Middle class is defined as people with per capita household income of 10 to 50 U.S. dollars per day in the report.

<sup>17</sup> Poverty rate is defined as the percentage of people in the total population with per capita household income below the poverty line. The poverty line considered here is twice the extreme poverty line, an estimate of the value of a basket of food with minimum calories needed to adequately meet a person, based on the recommendations of FAO and WHO.

- Labor market formalization has grown steadily. Formal jobs now account for 60 percent of employment, representing an increase of 10 percentage points since 2002. In addition to the strong economic growth, several regulatory changes have benefited this process, including the introduction of simplified taxation for small businesses, and measures for private pension funds to increase portability of benefits and lower the costs of participation for small enterprises.



- Real wages have risen, in particular in the service sector, reflecting buoyant domestic demand and sustained increases in the minimum wage.

**31. In addition to strong employment growth, social policies have contributed to the reduction of poverty and inequality.** Brazil has successfully expanded well-targeted social assistance programs. Federal spending on social assistance programs has almost doubled in percent of GDP over the last decade but at less than 1 percent of GDP it remains small relative to total spending.<sup>18</sup> The two main programs are transfers to low-income elderly and disabled adults (equivalent to the minimum wage), and the *Bolsa Família* program. The latter program features a direct cash transfer to poor households, with the benefit varying according to the household's level of per capita income and number of children, conditional on children's school attendance and participation in basic health care programs. This program, created in 2004, currently benefits almost 14 million households, at a budgetary cost of 0.4 percent of GDP, and is widely recognized as an effective policy in reducing poverty and inequality.<sup>19</sup>

**32. Brazil's greater inclusiveness supported sizable gains in private income and consumption and may thus have had a positive effect on growth and macroeconomic stability.** The gains in income and inclusion also went hand in hand with financial deepening, suggesting that there may also have been a helpful feedback relationship between inclusion and financial sector development.

<sup>18</sup> See Teresa Ter-Minassian, 2012, "Structural Reforms in Brazil: Progress and Unfinished Agenda", IADB Policy Brief No. IDB-PB-158, Inter-American Development Bank.

<sup>19</sup> A study by the UNDP's International Policy Centre for Inclusive Growth found that the *Bolsa Família* program explains about 20 percent of the drop in household income inequality since 2001.

## V. REPUBLIC OF CONGO: INCLUSIVE GROWTH<sup>20</sup>

*This note summarizes the approach taken by the Republic of Congo (Congo) team to integrate inclusive growth into the 2012 Article IV consultation discussions (SM/12/134).<sup>21</sup> In broad terms, given strong qualitative and quantitative indications that policies have not been inclusive, the team evaluated a series of quantifiable dimensions of inclusive growth (see table below) to gauge which areas warranted particular emphasis. Dimensions were limited to those which are directly or indirectly impacted by policy. In the case of Congo, all dimensions were lacking, leading to adoption of inclusive growth as the overarching theme of the discussions. Other country teams will likely find only a few dimensions which warrant in depth study and focus.*

Quantifiable Dimensions of Inclusive Growth	
Sustained growth	Post-conflict growth pattern
Broad-based growth	Oil versus non-oil activity
Informality	Production, employment
Employment	Un-, under-, and vulnerable employment
Business climate, governance	Ease of doing business
Access to financial services	(Underdeveloped) banking sector
Access to basic infrastructure	Post-conflict, stock of infrastructure
Social outcomes	Incidence of multidimensional poverty

### Quantitative assessment

**33. An initial back of the envelop calculation indicated that growth in the oil-rich country had not been inclusive**—indeed, despite oil revenues of \$20 billion over the decade ending 2011 and per capita GDP of about \$3,600, over half of the population of 4 million continued to live in poverty, with over 70 percent suffering from at least one-dimension of multidimensional poverty.

**34. The mission team then focused on using available quantitative indicators to make an initial assessment of the key dimensions holding back inclusiveness.** For sectors outside of the Fund’s core mandate, it was imperative to capitalize on the work of development partners. In addition to widely available indicators, such as national accounts statistics, the Doing Business

<sup>20</sup> Prepared by Carol Baker (STA) and Javier Arze del Granado (AFR).

<sup>21</sup> <http://www.imf.org/external/pubs/cat/longres.aspx?sk=40046.0>

Report (World Bank), banking sector data and the UN's Human Development Index, the team benefited from a 2009 Employment and Informal Sector Survey and a 2011 World Bank Employment and Growth study. For infrastructure, staff adapted academic work to construct in-house calculations of the road network<sup>22</sup>, while using World Bank MDG data points on electricity consumption.

**35. The results of the quantitative assessment were daunting, indicating that all dimensions of inclusion were lacking.** Notably, in addition to revealing low non-oil growth and sustained poverty, the analysis indicated that a large share of the population is excluded from participation in income earning economic activity; diversification is hindered by a difficult business climate; basic infrastructure (roads, energy, water) is severely lacking; and a labor skills mismatch—resulting from an inappropriately focused and low quality education system—leads to high un- and under-employment, especially among youth.

**36. Given the severity of the bottlenecks, the quantitative analysis alone could not answer the question which dimensions were holding back inclusion.** Coming to an overall assessment required using the team's judgment.

### Coming to an overall assessment

**37. After looking at the quantifiable indicators, and given knowledge acquired in the field, the team concluded that growth has not been inclusive, in large part because of interlinked bottlenecks which were present in all dimensions.** In order to foster inclusive growth, coordinated policy actions were required in areas under the Fund's core mandate (growth, taxation, budget allocation, public financial management, financial sector) as well as areas in which development partners generally take the lead (business climate, governance and transparency, employment policy, health and education policies, etc.).

### The approach to the 2012 Article IV consultation

**38. The approach was to focus the team's analytical work on areas under the Fund staff's core area of expertise, namely macroeconomic policy, and leverage work of development partners in other areas.**

**39. At the stage of the PCN:** the team was in a strong position to make recommendations in most dimensions by building on the analyses carried out and strong collaboration with development partners throughout the ECF program (2008–11). For example, (i) the authorities put an emphasis on inclusive growth in their new PRS (January 2012); (ii) donors had assisted the authorities to develop a financial sector strategy (2008) and an Action Plan to Improve the Business Climate (adopted February 2011); and (iii) the World Bank produced an Employment and Growth study (December 2011) which contains a matrix of recommendations to increase labor market participation and

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<sup>22</sup> Gwilliam, Keneth, et al. (2011). Africa's Transport Infrastructure: Mainstreaming Maintenance and Management. The World Bank, Washington D.C.



improve the labor market. Preliminary results were also available from the authorities' 2011 Household Survey.

**40. In the field:** the team actively sought out and collaborated closely with less traditional development partners, such as Unicef and the World Food Program (WFP) in areas related to social service provision and policies to strengthen the social safety net. This included inviting development partners to the technical meetings on relevant topics (with the approval of the authorities) and holding joint presentations on key topics, such as the benefits of a public expenditure tracking (PETS) diagnostic in improving health and education outcomes. The team worked closely with donors to define their work program for the coming year, requesting that key diagnostic studies in the social area be brought forward in support of strengthening expenditure quality. Subsequently, at joint meetings donors informed the government of their willingness to put PETS on the top of their agenda (Unicef and the World Bank) and identified sources of financing. The WFP informed the team of their work with Ministry for Social Affairs on an incipient and small "in kind" transfer program which is showing promising results, and the team expressed support for these efforts in technical as well as policy meetings. Finally, at the donor briefing, the team pressed for greater collaboration among donors to "speak with one voice" aimed at improving inclusive growth outcomes, *inter alia*, better governance/transparency of oil resources.

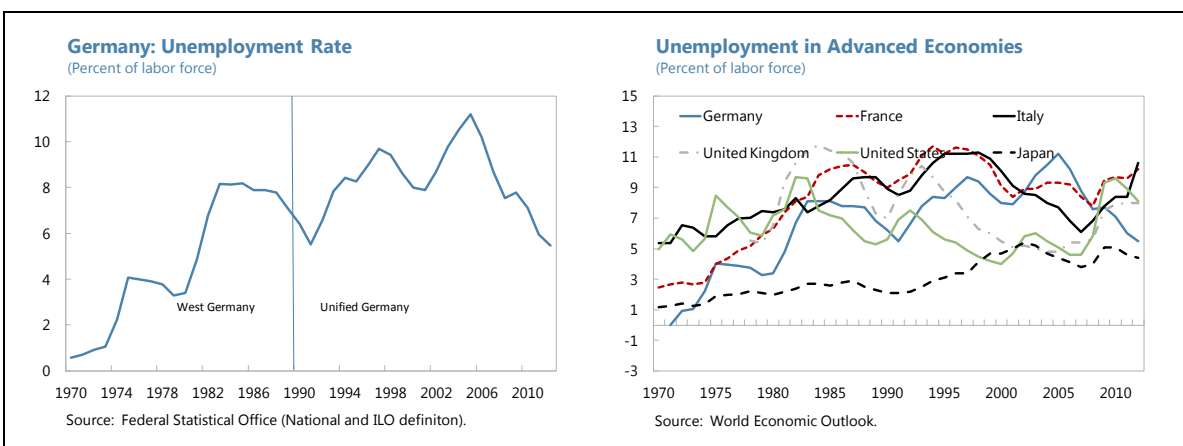
**41. In the staff report:** inclusive growth was made the overarching theme. The case was presented as "Congo at a crossroads", where growth has been strong but not inclusive.

- The team's own analysis focused on *our core areas of expertise*, namely aspects of fiscal policy which support raising inclusiveness. Topics included: (i) reducing expenditure volatility/procyclicality by introducing a fiscal rule for the spending-saving of oil receipts; (ii) expenditure allocation to investment and social areas; and (iii) raising the quality of spending, especially in investment (improvements in PFM) and social service provision (health and education). The team also weighed in on the authorities' growth model based on Special Economic Zones, noting that a first-best solution would be to improve the overall business climate for all firms (which includes a major overhaul of the unduly complex tax system) and avoid creating new distortions.
- On areas outside of our core expertise, the team produced short background notes summarizing the main issues outlined in the reports of development partners (i.e., the World Bank Employment and Growth study, 2011) and attached them to the staff report. The main message is that given the severity of the situation, a multi-pronged approach to job-rich growth is needed.

## VI. GERMANY: LABOR MARKET REFORMS<sup>23</sup>

After decades of rising unemployment, Germany undertook major reforms of its labor market institutions and unemployment benefits in early 2000s, forging an environment with higher incentives to supply labor and improved flexibility to create jobs. The reforms served Germany well during the crisis and are reflected in its low unemployment rates. The German labor market is currently strong. However, continued policy efforts are needed to improve upward mobility in some segments.

**42. The German labor market has gone through a salient transformation in the last decade**, from being called the “sick man of the Europe” in the late 90s to the “labor market miracle” during the Great Recession. Current low unemployment rates have not always been the case in Germany. In fact, from 1970 to 2005 there has been a secular increase in unemployment rates in Germany, only partially interrupted but not reversed by cyclical trends. The labor market was characterized by the prevalence of long-term unemployment and low job creation. The roots of the problem were interlinked. High reservation wages (due to high and long unemployment benefits) reduced incentives for labor supply and job search. On the other hand, high reservation wages combined with high firing costs and rigid wage determination mechanisms discouraged job creation.



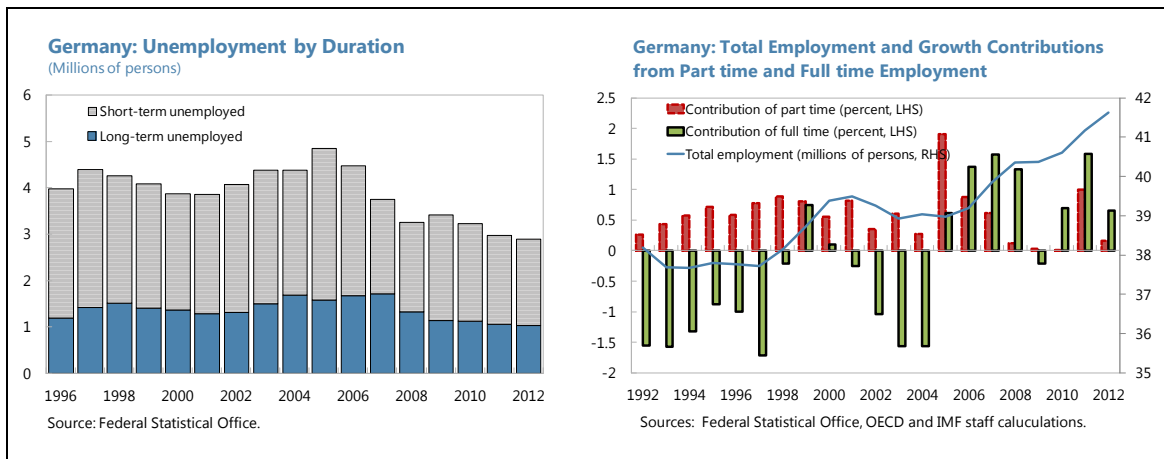
**43. High unemployment rates and pressures on the social security funds triggered a far-reaching labor market and social policy reform in early 2000s, called Hartz I-IV reforms.** Approved during 2002-03 but implemented gradually, these complementary reforms can be broadly grouped in three sets based on their goals. One set of reforms incentivized job creation by reducing firing costs: Hartz I significantly deregulated the temporary work sector, giving individual employers flexibility to vary employment through temp workers without incurring hiring or firing costs. In addition, Hartz II increased the threshold size for firms subject to layoff rules, from five to ten workers. Another set of reforms aimed at increasing incentives for labor supply and job search: Hartz IV considerably reduced the size and duration of unemployment benefits and made them conditional on tighter sets of rules for job search and acceptance. Moreover, Hartz II also introduced so-called mini-jobs, or part-time forms of employment involving monthly income of less than 400

<sup>23</sup> Prepared by Faezeh Raei (EUR).

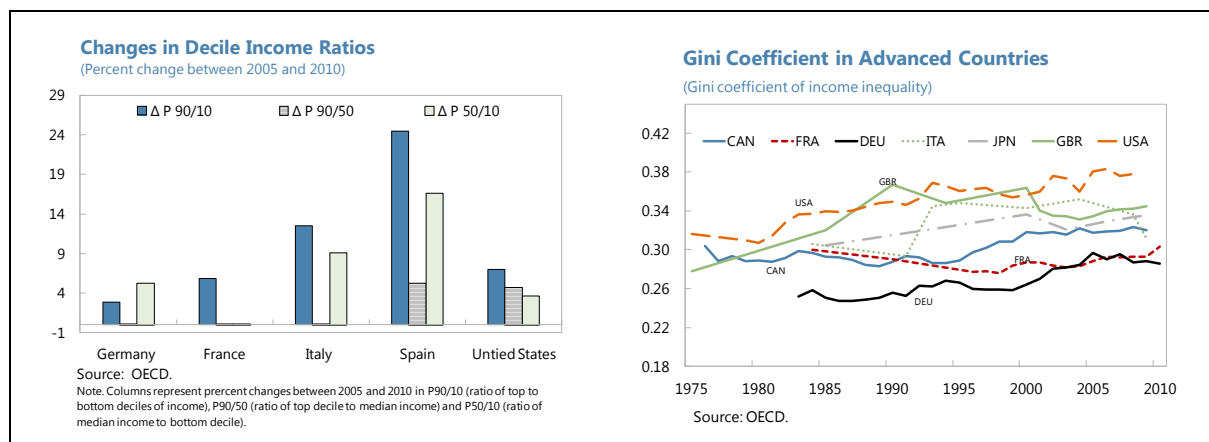
EUR monthly which were exempt from most social security taxes. A third set of reforms (Hartz III) restructured the Federal labor agency and sought to improve training and matching efficiency of job searchers. The Hartz reforms moved Germany closer to the Nordic system of “flexicurity” with medium to high level of employment protection, generous but conditional unemployment benefits, and strong active labor market policies facilitating labor reallocation (micro flexibility). However, compared to the Nordic model, the German model provides less protection and has more decentralized bargaining systems.

**44. Reforms of marginal jobs led to more flexibility in core jobs.** Reforms of the low-wage sector led to non-legislative changes in the core labor market (high-paid protected jobs) which was difficult to deregulate. Growth of temporary jobs gave rise to a second tier of employment in manufacturing and resulted in competition in the regular employment sector. The firms and unions started to increasingly introduce flexibility into collectively bargained work arrangements. One key change was the gradual adoption of worktime accounts, enabling reduction of working hours or pay in exchange for avoiding layoffs. This feature increased macro flexibility and served the German economy well during the crisis as firms reduced hours instead of dismissing workers. The macro flexibility provided through work-time accounts, was supplemented by enhancing the longstanding practice of short-time subsidies (kurzarbeit) during the crisis, which facilitated work-time reductions by partially compensating workers for part of their lost income.

**45. Reforms had a favorable impact on employment.** There is broad agreement that the Hartz reforms increased employment possibly with a lag, which continued to be seen through the recession. Long-term unemployment rate is now 40% lower than its pre-reform peak. The reforms are estimated to have reduced the equilibrium unemployment rates by about 1.2 percent. Although labor market gains continued regardless of the crisis, the positive reform outcome was also helped by favorable global macroeconomic environment in the pre-crisis boom.



**46. The impact of reforms on inequality is less clear.** An increased labor participation of low-skilled may be part of the observed increase in income inequality; however, it is difficult to disentangle this impact from the global rise in inequality. In addition, while initially the number of part-time jobs increased, it has stabilized since and employment growth of full time jobs have picked up, with a potential dampening impact on inequality



**47. The German labor market is working well but there is ample scope to improve the performance of some of its segments.** Training and activation policies need to be maintained to integrate the disadvantaged groups, the remaining long-term unemployed, and to help with the upward mobility of the temporary workers and the marginally employed. Part-timers face steep tax-wedges to increase hours worked, with the effect of making these jobs persistent rather than stepping stones to full-time employment. Removing fiscal disincentives and providing training can help mitigate risks of persistent marginal employment.

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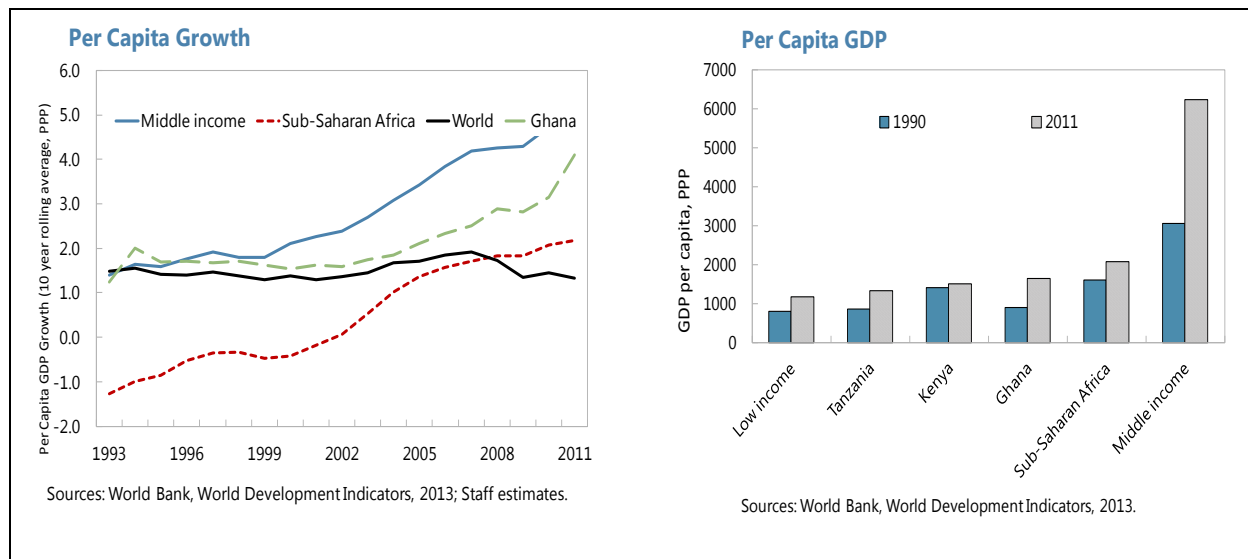
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## VII. GHANA: INCLUSIVE GROWTH SUCCESSES AND CHALLENGES<sup>24</sup>

Ghana has experienced strong and broadly inclusive growth over the last 20 years, defined as growth that raises the income of most or all in society, including the poorest groups. Significant progress in poverty reduction has been achieved as well as the establishment of a highly rated governance and business environment. Although poverty and social indicators have improved significantly, about a quarter of the population still lives below the poverty line. Demographic trends will require the creation of 6–7 million jobs in the next 20 years, more than half of the current labor force, to absorb new entrants into the labor market. Success will hinge on complementing growth from extractive industries with diversified, private sector-led growth in more labor-intensive sectors. Staff discussions with the authorities have focused on addressing Ghana’s main growth constraints, consistent with the government’s own growth and development agenda.

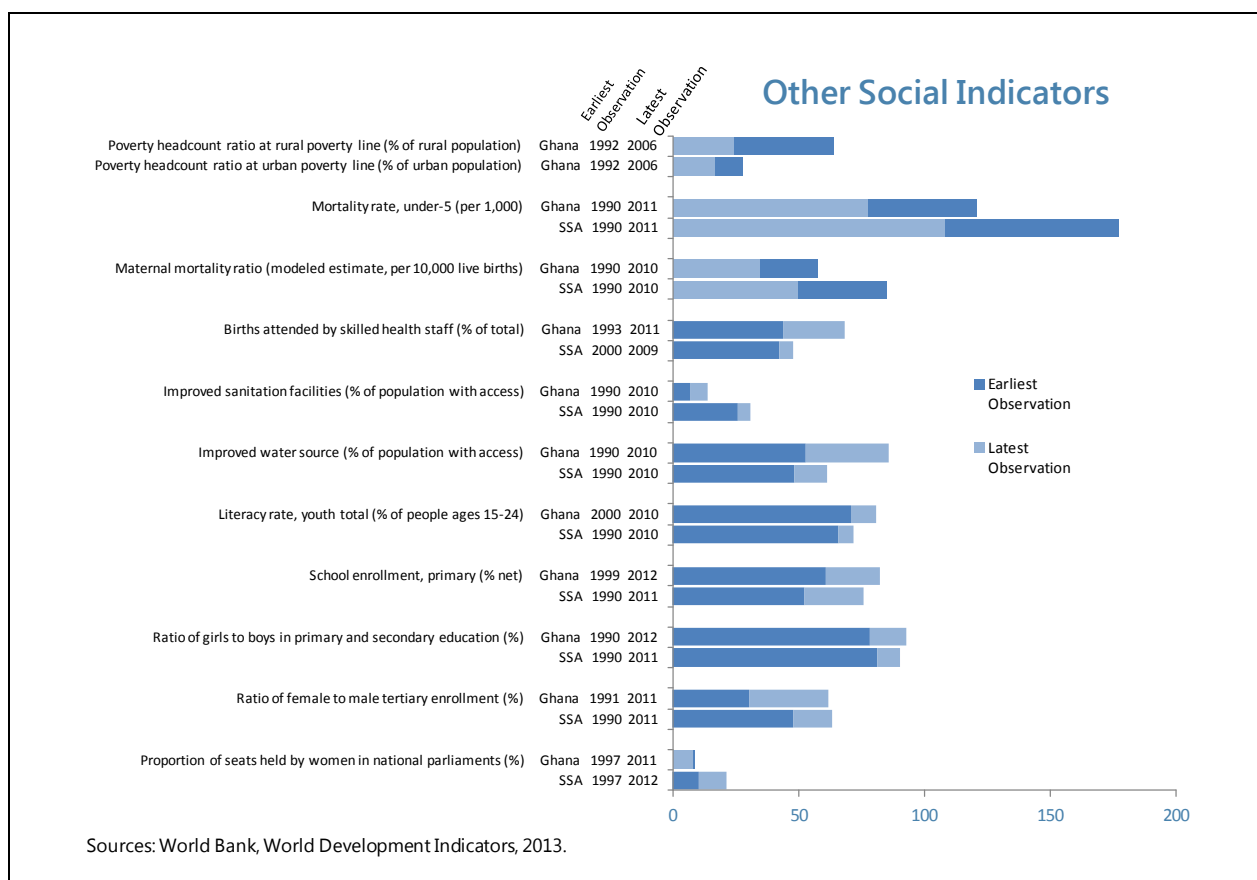
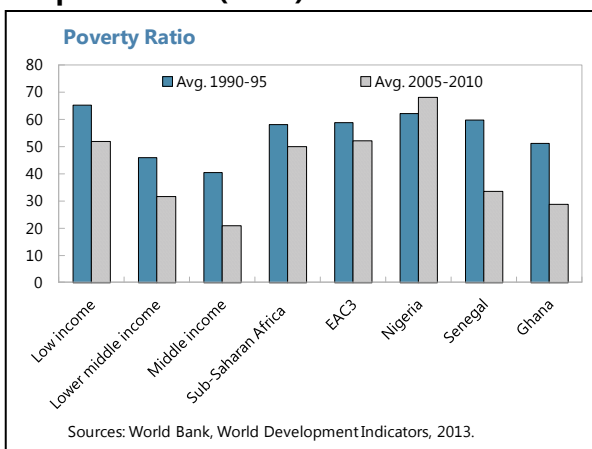
### Background

**48. Ghana has experienced strong per capita GDP growth over the last 20 years, consistently outperforming Sub-Saharan Africa and the world.** Growth has accelerated over the last 5 years, with strong performance in 2011, in particular, due to investment in oil extraction. This growth experience has recently vaulted the country into lower-middle income status.

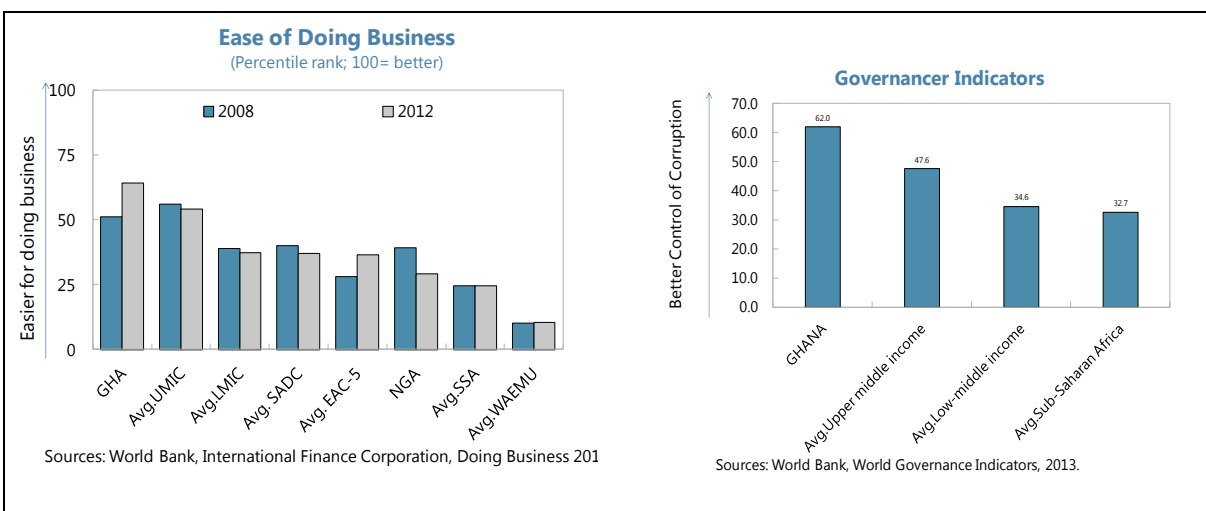


<sup>24</sup> Prepared by Wendell Daal and Kevin Wiseman (both AFR), based on Country Report No. 13/187 (Appendix II)

**49. Ghana has also made substantial progress reducing poverty, as reflected in the significant improvements in the Millennium Development Goal (MDG) measures.** The fraction of the population living on less than \$1.25 a day has declined significantly, outperforming regional peers. Ghana has also kept pace with, or outperformed, the Sub-Saharan African (SSA) average in a range of other development indicators. However, while Ghana has made progress in its urban/rural poverty divide from a very unequal starting point, it still had the largest urban/rural consumption divide of the 6 countries studied in the October 2011 Regional Economic Outlook (REO) for SSA.



**50. Ghana’s successes in growth, poverty reduction, and quality-of-life improvements have been underpinned by a high-quality governance environment.** Ghana has been highly rated in the World Bank’s World Governance Indicators since their first observation in 1996. Its ratings have continued to improve, accelerating past even the average Upper-Middle Income Country in the World Bank’s latest ease of doing business indicators.



## Authorities' growth and development agenda

**51. The government's own transformation agenda provided the context for the discussions with staff.** It pursues three broad objectives:

- Economic diversification. Leveraging oil and gas resources to create a robust job-creating manufacturing sector will require significant infrastructure investments and removal of the main bottlenecks to growth—inadequate and unreliable energy provision and lack of affordable private sector financing.
- Social inclusion. To make further advancements in poverty reduction, ensure that the benefits of growth are widely shared, and build a workforce ready to take on higher-skilled jobs, the government wants to further strengthen Ghana's social safety net and continue investments in utilities, health, and education, while improving the quality of social spending.
- Macroeconomic and debt sustainability. The public debt ratio has steadily risen since the country benefited from HIPC/MDRI debt relief, and the government realizes that fiscal consolidation is needed to reduce external vulnerabilities, lower inflation, and support of private investment.

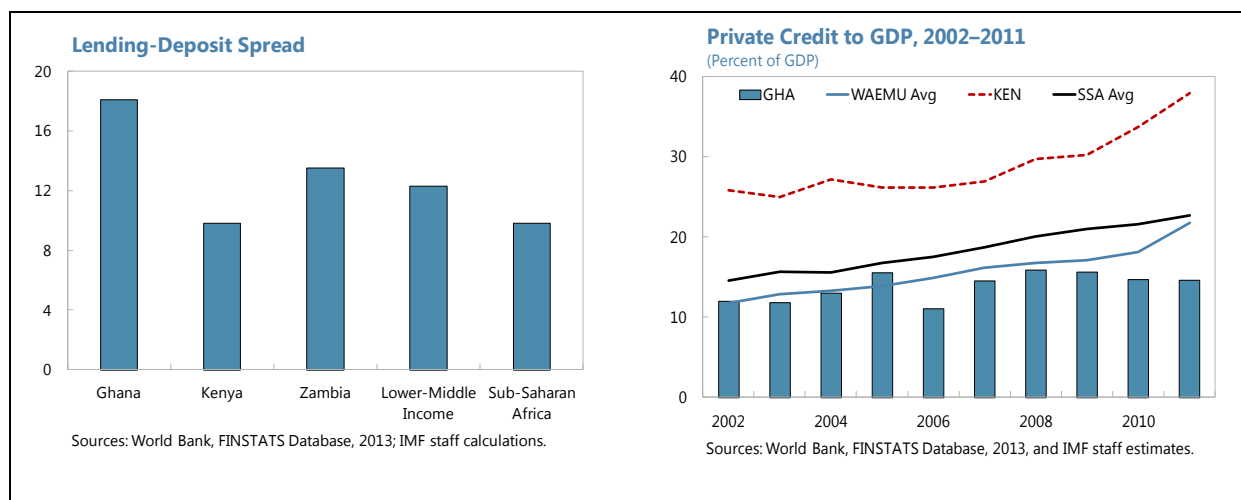
## Constraints to growth

**52. Access to affordable credit and reliable electricity provision are the principal constraints to private sector growth.** These constraints—identified in a recent study by the U.S. and Ghanaian governments based on firm-level surveys—present a particular burden for small and medium-sized enterprises and labor-intensive sectors, where growth is most inclusive.

**53. Despite the existence of a relatively well-developed banking system, access to affordable financing is a problem.** Ghana's banking system has more bank accounts and branches per capita than the regional average, and even though rural and community banks have become a key channel for financial inclusion, only about 30 percent of Ghanaian adults have an account at a

formal institution. A sizeable part of the population relies instead on the services of about 600 microfinance companies, as well as 3,000–5,000 individual *susu* collectors, traditional providers of informal banking services, that serve over half a million customers.

**54. For those parts of the population that have bank accounts, the high cost of borrowing is significantly constraining access to credit.** Double-digit real lending rates—kept up by large government financing needs—are crowding out the private sector; private credit is low relative to similar, and even less developed, markets. In contrast, the real return to savings is negative, leaving domestic savings ratios well below those of countries with less developed financial markets.



**55. Energy supply has been identified as another major constraint on growth.**

Entrepreneurs report that unreliable energy supply, the high cost of private generators, and the uncertain future of energy providers are major concerns in investment decisions. These concerns are most acute in sectors which contribute heavily to job growth—manufacturing and downstream agricultural transformation.

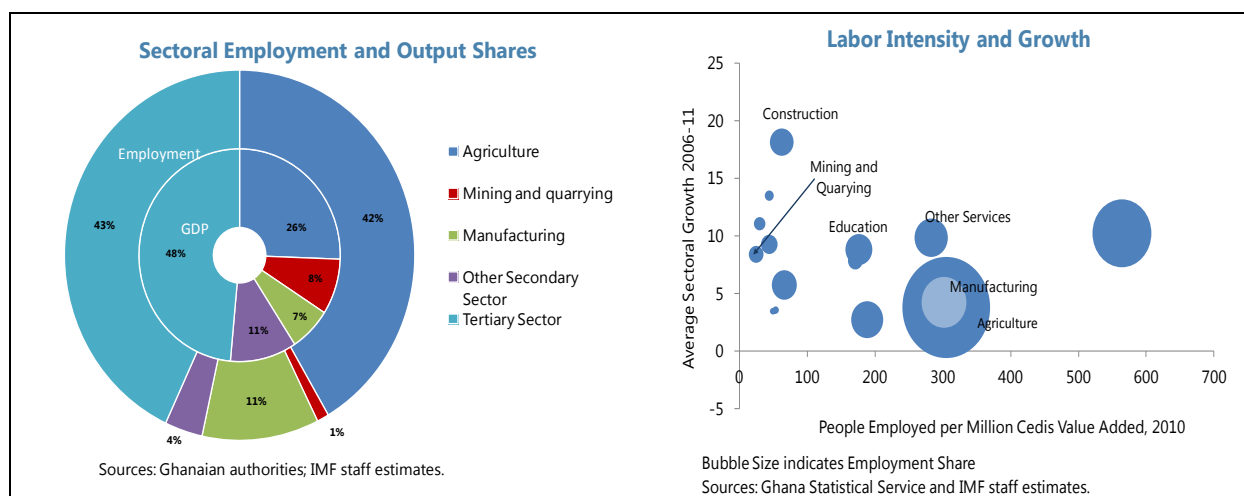
**56. The poor financial situation of energy providers is preventing necessary maintenance and additional investment.** Reluctance to raise electricity prices to cost-recovery levels, along with relatively high commercial and technical losses in the distribution network, has severely affected the financial viability of the state energy companies. The sector came recently under further strain from the rupture of the West African Gas Pipeline, increasing the share of petroleum-based production at double the marginal cost.

### Growing where the jobs are

**57. Ghana's economy will need to add 6-7 million jobs by 2030, according to population and economic activity rate projections.** Currently more than 80 percent of Ghana's jobs are in the informal sector, and it is unlikely that the formal economy will be able to generate enough stable salary work to absorb the influx of new workers. More than 40 percent of workers are in the agricultural sector which remains poorly paid and largely informal. Among the middle-income SSA



countries compared in the Fall 2012 REO, the agriculture share of GDP in Ghana was more than twice as high as in any other country and was declining at the second slowest rate. As discussed below, the sector has registered below-average growth over the past 5 years.



## Fund involvement and recommendations

**58. During the 2013 Article IV Consultation, discussions were guided by the government's own growth and development agenda.** The team focused on the main identified constraints to strong and inclusive growth, which were integrated into the consultation in several ways:

- Dedicated outreach event with members of local think tanks and CSOs. The team presented an assessment of Ghana's broadly inclusive growth over the past two decades and identified challenges going forward. A discussion followed with local experts assessing key bottlenecks and identifying solutions.
- Coverage of inclusive growth topics in meetings and mission outputs. The team pursued problems related to electricity provision, credit access, and interest rate spreads in a variety of meetings with the private sector, unions, and public sector entities. These topics were highlighted in policy discussions and woven into the team's press release and staff report.
- Enhanced financial sector surveillance. Ghana's participation in the LIC pilot provided an opportunity to elaborate in more detail on the linkages between financial sector development and inclusive growth.

**59. Conversations with business and union representatives, civil society organizations, and the authorities showed a broad consensus across key stakeholders:**

- Fiscal consolidation should be the government's immediate priority, with a realignment of spending away from wages and subsidies toward investment in infrastructure. Lower government borrowing will make private credit more affordable, while a return to cost-recovery electricity tariffs will help restore the financial viability of the state-owned energy companies as a prerequisite for stabilizing Ghana's energy supply. In addition to easing Ghana's main growth

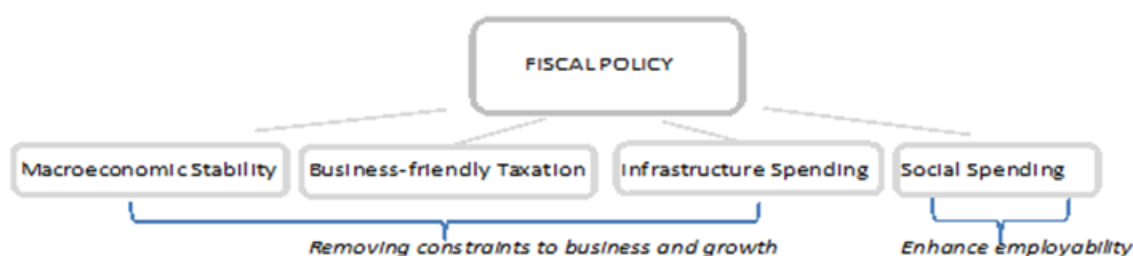
constraints, fiscal consolidation will also reduce external vulnerabilities arising from a high current account deficit and low foreign reserve cover. At the same time, there was a shared recognition that successful transformation requires administrative and institutional reforms to promote reliable policy implementation, higher efficiency of public infrastructure investment, and deeper financial intermediation.

- Looking forward, policies will have to focus on promoting growth in employment-producing sectors. Even though Ghana enjoys a natural comparative advantage in agriculture and should not pursue a manufacturing-led growth strategy at all costs, diversifying unskilled labor away from basic agriculture, while increasing agricultural productivity, would likely lead to higher growth with particular benefits for the most vulnerable within and outside the agricultural sector. At the same time, the extractive sector will continue to be an engine of growth over the next 10 years as petroleum production peaks and new natural gas fields are brought on stream. Prudent use of natural resource revenues for infrastructure and human capital investments will determine the extent to which Ghana's resource wealth will contribute positively to the welfare of the average Ghanaian.

## VIII. HAITI: STRUCTURAL FISCAL REFORMS TO STRENGTHEN GROWTH AND INCLUSION<sup>25</sup>

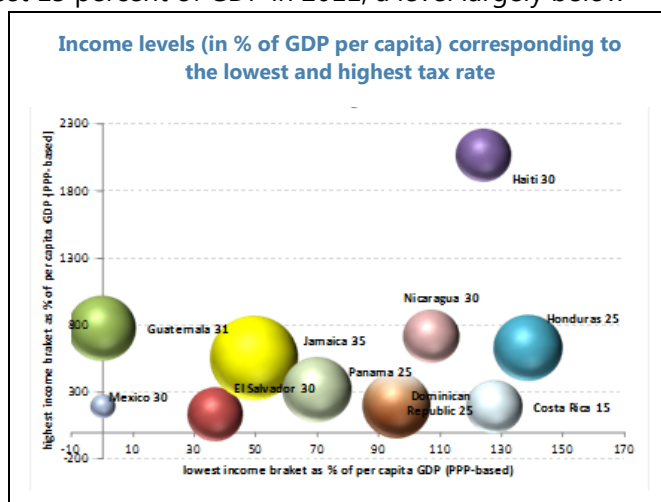
**60. Haiti is one of the poorest countries in the world.** GDP per capita in 2011 was about \$1000 USD on a PPP basis, which represents a decline of 25 percent from twenty years ago. Almost 80 percent of the population lives in extreme poverty, and inequality is very high, with a Gini coefficient based on market income of 59.2. Haiti's poverty is rooted in its difficult history, but also reflects periods of macroeconomic mismanagement, poor infrastructure, and an unfavorable business environment. Political instability, deep domestic institutional and structural weaknesses, and frequent natural disasters (including the massive 2010 earthquake) compound these challenges. Employment is low, concentrated in small business and in the informal sector.

**61. Fiscal policy can serve as an important tool for promoting strong and inclusive growth.** Fiscal policy can help create favorable conditions for growth through macroeconomic stability, and its revenue and spending components can be powerful tools to promote higher living standards. An appropriate taxation structure and well-functioning tax administration can enhance inclusive growth and investment by a) increasing revenue overall; b) promoting private sector development; and c) reducing income inequality. Higher revenue mobilization is a key prerequisite for raising spending in a sustainable manner and can thereby help reinforce growth and inclusion. In conjunction with structural reforms to improve the business environment, private sector development could be boosted through a business and growth friendly taxation with lower taxes on business and labor and higher taxes on property and consumption. A progressive taxation structure could help reduce or contain inequalities. Expenditure policies, meanwhile, can stimulate economic activity through the creation of infrastructure and can encourage the formation of human capital and the overall employability of the workforce through higher spending on health and education.



<sup>25</sup> Prepared by Elva Bova (FAD) and Lawrence Norton (WHD).

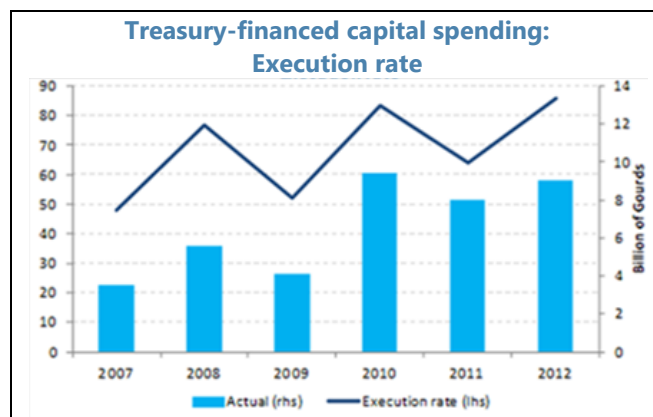
**62. Domestic revenue is low in Haiti, and the taxation structure hinders private sector development.** Domestic revenue stood at almost 13 percent of GDP in 2011, a level largely below that of countries with similar levels of GDP per capita. This reflects capacity constraints in the administration and collection process, a high level of tax expenditures, and a taxation structure that does not reflect the needs and compliance challenges of large, medium, and small taxpayers. Haiti relies heavily on indirect taxation, particularly customs duties and a turnover tax that is applied on all levels of the production chain, posing a significant burden on business. Haiti's taxation structure is therefore one constraint on Haiti's business environment (along with a cumbersome and uncertain regulatory and legal regime, low levels of access to finance, and infrastructure bottlenecks), and is not efficient in raising domestic revenue. Moreover, Haiti's highest income tax rate takes effect only at very high levels of income, resulting in only weak progressivity and perpetuating inequality.



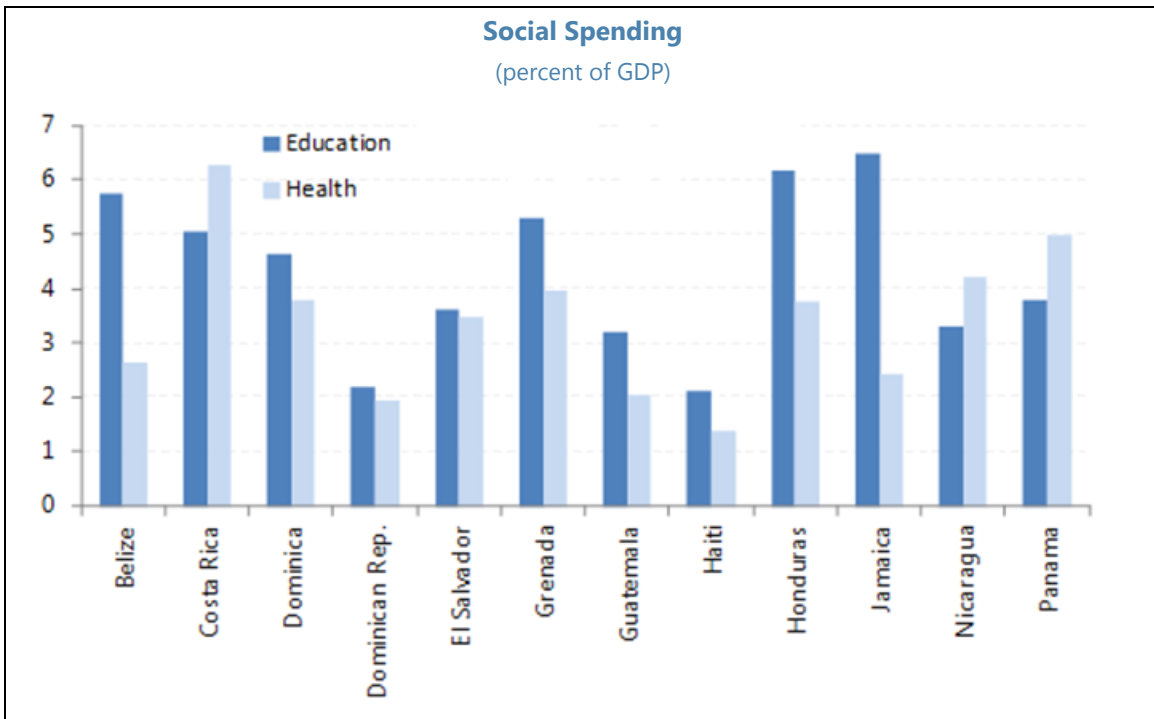
**63. Reforms to revenue collection could broaden the tax base while reducing compliance costs.** Haiti plans to replace the turnover tax with a traditional VAT, which could reduce incentives to operate in the informal sector while potentially raising revenue overall. The authorities plan to complete a study on the adoption of a VAT by December 2013, and are drafting a VAT law supported by IMF technical assistance. Reforms to the corporate tax structure could also be considered: for example, at present the tax on dividends must be added to the corporate income tax, and companies cannot deduct taxes on international income. Such reforms, as part of a broader effort to improve the business environment, could spur private sector development while raising revenue. A more progressive income tax system could also be considered.

**64. Improvements in the capacity to execute public spending programs would promote Haiti's long-term growth and development.**

Haiti has weak capacity for executing capital spending despite enormous infrastructure gaps. This reflects a fragmentation of the public investment program, cumbersome project execution, and weak information and control systems. Against this background, Haiti should pursue reforms to define clear responsibility among government institutions, enhance the control system, boost the work of the unit of project executions and promote a dynamic information system. Current



expenditures should also be reoriented more towards social spending, which are the lowest in the region.



## IX. KOREA: LABOR MARKET REFORMS<sup>26</sup>

### Situation regarding growth, income distribution and unemployment

**65. Korea's growth has gradually slowed since the mid 1990s, after an extended period of rapid growth.** As is often cited, it is one of the few countries that went from being a recipient of financial aid to a donor country and a member of the OECD in a short span of time, and is often hailed as a model for developing countries. However, Korean growth has decelerated in recent years. Actual real GDP growth has slowed from almost 10 percent during 1981-1990 to average around 3 percent during 2011-2012. This suggests that Korea's potential output has also trended down over time and, in the absence of sustained and comprehensive structural reforms, may continue to do so in the face of future demographic headwinds.

**66. At the same time, income inequality has worsened since the Asian crisis, albeit from low levels.** While the Gini coefficient of net disposable income has declined markedly from about 36 in 1980 to about 29 in 1998, it has been an upward trend increase since then reaching about 31 percent in 2010 (close to the OECD countries' average).<sup>27</sup> Though recent data indicate a reversal of this trend, owing largely to the government's social programs, it is not yet clear whether this amelioration of inequality will be sustained.

**67. Despite the deceleration in output growth, unemployment rates have steadily decreased over the last two decades.** The overall unemployment rate has declined from about 11 percent in 1998 to about 3.2 percent in 2012, while youth unemployment has decreased from about 12 percent to about 8 percent over the same period. While unemployment rates are currently among the lowest in the OECD countries, low female participation rates, decreasing youth employment rates, and low service sector productivity due to labor market segmentation are important labor market challenges, and factors contributing to lower potential growth and increasing income inequality. In this context, labor market reforms are critical for Korea.

### Focus of staff analysis

**68. For the forthcoming October Article IV, staff in collaboration with the authorities, will analyze two key labor market impediments and how they can be remedied: the low female labor participation rate and the degree of skill mismatch.** Specifically, these two issues will be analyzed as follows:

- Female labor force participation. First, the evolution of female labor force participation will be analyzed, also in comparison to the observed trends for male participation in Korea and for female participation in other OECD countries. Second, the analysis will assess the determinants of labor force participation in Korea compared to other OECD countries. Third, the results of the

<sup>26</sup> Prepared by Davide Furceri (RES).

<sup>27</sup> Data for income inequality are taken from the Standardized World Income Inequality Database (Solt, 2011).

empirical analysis will be used to quantify the effect of structural reforms in this area (such as child care benefits) on Korea's female labor force participation by simulating a convergence of policy settings towards those prevailing in benchmark OECD countries, identified as those with the lowest restrictions.

- Labor market mismatch and youth employment. First, the analysis will examine trends in youth employment and unemployment, including among young graduates. Second, a time-varying measure of mismatch will be constructed, and its evolution over time examined. Third, the analysis will assess how much of the evolution in youth unemployment and employment has been driven by skill mismatch between aggregate labor demand and supply.

### **Results of the analysis and policy recommendations.**

**69. Female labor force participation.** While much of the low participation rate in Korea compared to other OECD countries is explained by unobserved factors including differences in social preferences for participation, policies to remove labor market distortions can raise labor force participation rates. Specifically, preliminary findings suggest that the following policy actions could raise female participation rates in Korea: (i) making the tax treatment of second earners in a household compared with single earners more neutral; (ii) increasing childcare benefits; (iii) facilitating more part-time work opportunities. Simulations of comprehensive policy reforms in these areas suggest that they could lead to an increase in female participation rate of about 8 percentage points over the medium term, which would reduce by one third the gap between male and female participation rates.

**70. Labor market mismatch.** Preliminary findings suggest that: (i) skill mismatch had been decreasing until mid 2000, when it started stagnating and started to slightly increase; (ii) while there is a strong correlation between youth employment and the measure of labor market mismatch, youth and overall unemployment are not significantly correlated with labor market mismatch, suggesting that labor participation decisions are affected by changes in mismatch. The effect of mismatch on youth employment rate is economically important. Policy actions, including targeted educational policies and retraining programs, bringing skill mismatch back to the downward path before 2005 can increase youth employment rates by 0.6 percentage points per year, which would bring the youth employment rate back to the level before Asian crisis within 10 years.

## X. MALAYSIA: AVOIDING THE MIDDLE-INCOME TRAP<sup>28</sup>

**71. Background.** At the time of independence in 1957, the economy was commodities-based and ethnic Malay and other indigenous people (the bumiputera) were disadvantaged. Promoting shared prosperity was high on the nation's agenda. Malaysia's social contract aimed at enhancing the economic position of the bumiputera based on inclusive processes. Malaysia gradually expanded the range of commodities it produced and adopted rural development policies that increased land availability and agricultural extension. Manufacturing took off in the 1980s. Following the Asian financial crisis, sound macroeconomic management, a liberal trade regime, a reformed financial system, and emphasis on economic and government transformation and human resource development provide the institutional and policy framework needed to promote job creation and inclusive growth.

**72. Track record.** Malaysia's growth performance has been notable. Real GDP has expanded by over 6 percent per annum since 1961, resulting in a 25-fold increase in per capita income. Malaysia, a high middle income country now, aspires to reach advanced country status by 2020. Growth has been broad-based and transformative, involving economic diversification, export orientation and rapid urbanization. Trade amounts to over 130 percent of GDP and over 70 percent of Malaysians now live and work in urban areas. Modern sectors have absorbed large quantities of agricultural labor, helping to raise aggregate labor productivity.

**73. Social indicators.** Malaysia's rising per capita income has been accompanied by significant progress in indicators of well being. Poverty has been more than halved and child mortality and malaria have been reduced by more than two thirds. The headcount poverty rate (3.8 percent) compares favorably with regional peers and has been falling. Urban poverty in Malaysia is 1.9 percent (2009 figure), a fraction of rural poverty (8.4 percent). Income inequality is high compared to ASEAN-5 peers, rural-urban income disparities persist, and the median wage in agriculture is a third of that in manufacturing. Progress in gender equality lags behind and maternal mortality, while improved, remains high (29 percent per 100,000 births). Health and education attainment indicators have improved significantly but public health spending (2.2 percent of GDP) is relatively low.

**74. Jobs and employment.** The Malaysian economy supports about 11 million jobs and adds about 180,000 new jobs a year. Industrial employment peaked to a third of total in 1997 and now amounts to 28 percent (2010 figures). Services are now the single most important source of job growth. New jobs are increasingly high- and mid-skill, reflecting a general upgrading of skills in the economy. Labor force participation rate is 79 percent for men and 46 percent for women. Policies aim to raise the participation of women in the labor force—this could be an important source of employment growth in the future. Measured unemployment is low and fell from a peak of

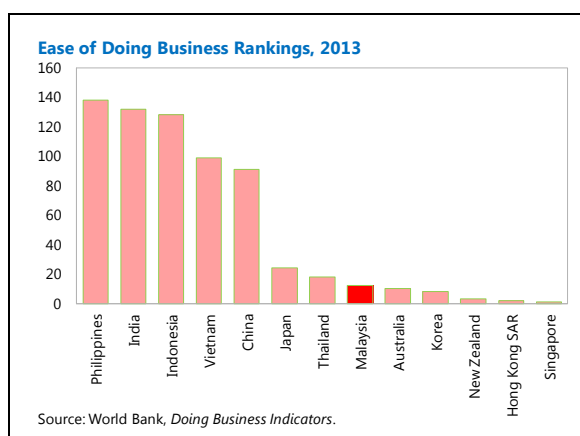
<sup>28</sup> Prepared by Alexandros T. Mourmouras (APD).



3.7 percent during the Global Financial Crisis to about 3 percent at present. Youth unemployment exceeds 11 percent however. About 1.1 million foreign workers (from Indonesia, Philippines and Bangladesh) have an important presence. They work in trade, manufacturing, agriculture and construction. Reducing dependence on foreign labor is a policy concern.

**75. Boosting growth.** A central objective of Malaysian policymakers is to avoid a middle income trap—the hypothesis that after reaching middle income levels a country’s growth rate may slow or even stagnate. In this regard, it is useful to ask what separates Malaysia from advanced countries like Korea. Differences in per capita income can be attributed to differences in endowments of human and physical capital, and total factor productivity (TFP): Korea’s output per capita is 2.6 times that of Malaysia while its capital-output ratio is 20 percent greater than Malaysia’s, and its human capital (proxied by school years per worker) is 13.95 (compared with 11.42 for Malaysia). Based on a growth accounting framework, differences in TFP are estimated to explain about half of the gap in output per worker in Korea and Malaysia; differences in education (human capital) explain about 30 percent, and differences in capital per worker explain the remaining 20 percent. The multiyear plans pursued by the Malaysian authorities aim to improve policies and institutions—the fundamental determinants of human and physical capital accumulation and of TFP growth—and avoid a middle income trap.

**76. Transforming the economy and government.** In response to the challenge, Malaysia is implementing a number of multi-year “transformation” programs to raise economic growth and strengthen its inclusiveness. These programs aim to improve public sector delivery, raise skills, support innovation, and turn Malaysia into a knowledge intensive economy. Concrete policy actions target strategic sectors (finance, infrastructure, oil and gas and other commodities). Priorities include enhanced competition, liberalization of services, divestment of public enterprises, and market prices for subsidized commodities. These efforts are helping to raise private investment, which had declined following the Asian crisis, and improving the business climate: Malaysia now ranks 12<sup>th</sup> in the World Bank’s 2013 Doing Business survey. All in all, Malaysia is on its way to realizing its objective of becoming a high income country by 2020.

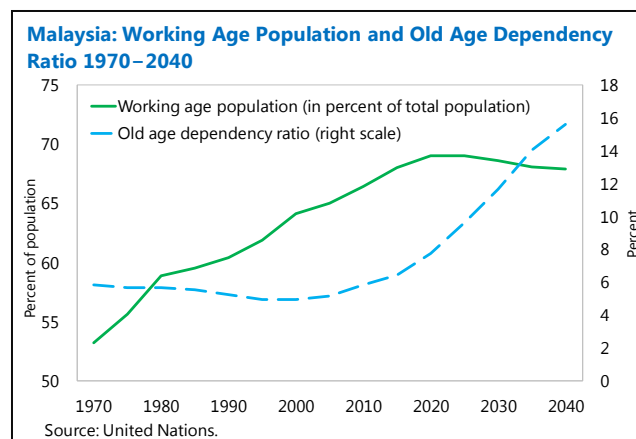


**77. Strengthening labor policies and institutions** in the face of heightened international demand (and competition) for talent and demographic change is another key policy objective:

- **Education.** Employment prospects, wages and living standards are closely related to the length and quality of schooling. Malaysia has made important progress in raising school enrollments: secondary net enrollment has risen sharply (to 68 percent in 2009 from 32.7 percent in 1970). Enrollment in tertiary education enjoyed a 10-fold increase since 1980 and the wage premium for university graduates exceeds 50 percent. These gains notwithstanding, Malaysia needs to

increase enrollments further in order to meet the skill requirements of an innovation-based economy and close the gap with OECD levels. Among the priorities are to improve educational attainment (what students actually know); expand access to tertiary education and the availability of financing among under-served groups; control quality in private universities; and retain Malaysia-grown talent at home (World Bank, 2012). The *Education Blueprint 2013-25* aims to transform the Ministry of Education and focus on results—putting Malaysian students at the top third of international assessments. The key in this area, as in all others, will be sustained implementation.

- Pensions. Malaysia's population of 29 million (mid-2012 estimate) has been growing at about 1.9 percent a year in the 2000s. Fertility has been falling and the share of working age population has been increasing, but the old age dependency ratio will start rising after 2020, which could pose challenges. Malaysia recently introduced a Private Retirement Scheme (PRS), which helps supplement the government-mandated Employees Provident Fund (EPF). The risk sharing characteristics of Malaysia's pension system could be improved by: (i) introducing a publicly funded, first pillar for noncontributors; and (ii) allow workers to receive their pensions as annuities, to help reduce longevity risk.
- Minimum wage. A minimum wage was introduced in 2013, aiming to boost wages of low-skilled workers and enhance productivity. Initial indications are that the impact on inflation and unemployment has been limited. The minimum wage should help the incomes of the poor and also provide incentives for businesses to shift to more capital-intensive technologies. Together with reforms to improve the business climate, it could lead to higher productivity. The minimum wage is set at a relatively high level, but flexibility in its implementation and the low share of labor costs in Malaysia could offset its impact on employment.
- Female labor force participation. At 46 percent, the participation of women in the labor force is low by regional standards. Raising it is quantitatively important for growth and also helps promote gender equity and intra-family income distribution. Malaysia plans to boost this rate to 55 percent by 2015. Legal reforms and incentives are in train to establish childcare facilities, employ and train women after career breaks, and promote flexible work arrangements.
- Strengthening social protection. Other dimensions of social protection need to be further developed. Labor redundancy costs are high (Malaysia is ranked 108<sup>th</sup> out of 144 countries in this area in the World Economic Forum's Global Competitiveness Report). Additional measures needed, such as introducing unemployment insurance; improving the targeting of cash transfers; and making them conditional on access to education and health care. Stronger social safety nets should also help reduce precautionary savings and narrow the current account.



**78. The future.** Turning Malaysia into a prosperous, inclusive nation will require continuous transformation of its economy and government to modernize institutions, infrastructure, and skills. The Malaysian authorities have identified a wide range of reforms to improve institutions, raise productivity, improve the effectiveness of education and enhance social insurance and protection. The minimum wage policy and the other reforms being debated, including unemployment insurance, should help to insure workers from risk. Challenges remain: public debt is relatively high, the budget needs to reduce its reliance on oil and gas revenue, and public spending must be better targeted and made more equitable, including by reforming fuel subsidies.

## XI. MEXICO: LABOR MARKET REFORMS<sup>29</sup>

**79. With macroeconomic and financial stability well entrenched, a key challenge for Mexico is to implement reforms to boost growth and employment generation.** Over the past two decades, Mexico has achieved low inflation and fiscal discipline, a stable financial system and deep integration to the rest of the world—underpinned by a strong rules-based policy framework. Despite these efforts, economic growth has been lackluster, trailing that of many other comparable emerging market economies.

**80. Labor market distortions have been identified as a key obstacle hampering economic growth (Chiquiar and Ramos-Francia, 2009).** Over the last four decades, labor regulations in Mexico (dating from 1970s) remained among the most rigid in the OECD and emerging markets. Labor laws considered employee-employer relationships as almost permanent, with little room for any but open-ended contracts. The legislation further constrained contracts by restricting part-time work and nonstandard work schedules, prohibiting hiring by the hour or on a trial basis. In addition, the working of labor courts did not favor the swift and predictable resolution of disputes, while setting high severance pay requirements, particularly for short-term workers (Arias et al., 2010). As a result, the high costs and constraints on hiring and firing reduced the total number of jobs in the formal sector, affected the composition of the labor force (youth and female unemployment being higher), and slowed productivity growth (firms adopt less technology or adopt it more slowly, cannot adapt to new environments, and invest less in training— especially small firms).<sup>30</sup> Overall, these distortions led to an inefficient allocation of labor, and the prevalence of low-productivity jobs in the large informal sector of the economy.<sup>31</sup>

**81. In late 2012, Congress approved a labor reform bill.**<sup>32</sup> The new legislation introduces new hiring modalities, streamlines dispute resolution, promotes incentives for productivity, regulates outsourcing practices and improves labor conditions. Specifically:

- To lower the costs of hiring workers and boost job creation in the formal sector, the law introduces new contractual modalities and flexible labor contracts. These include trial and initial training contracts, as well as temporary employment contracts for specific projects or seasonal activities (all these categories will accrue wages, social security and other benefits). The law also

<sup>29</sup> Prepared by Herman Kamil (WHD).

<sup>30</sup> World Bank (2012).

<sup>31</sup> About half of the Mexican labor force is employed in the unregulated informal sector, as workers or owners of predominantly small firms. As informal firms tend to stay small to avoid being noticed, their productivity is low because they do not reap the benefits of scale, they have limited or no access to credit, they are less likely to train their employees and to adopt new technologies, and they have limited access to government services (Loser, Fajgenbaum and Kohli, 2012).

<sup>32</sup> A political alliance between the major parties (the Pacto de Mexico) underpins an ambitious growth and productivity-enhancing agenda. These include reforms in labor markets (approved), education (approved), telecommunications (approved), and financial sector, public finances and energy reforms, to be considered later in 2013.

allows for hourly pay contracts (provided that the pay is not below the equivalent of the minimum wage) and establishes a new regulatory framework for outsourcing practices;

- To provide judicial certainty and reduce separation costs, the law streamlines the settlement of labor lawsuits and caps compensation for unjustified dismissals to one year of salary. These provisions would simplify the current dispute resolution process, which makes the process of layoff much more lengthy, costly, and uncertain (and can hold up severance pay for several years);<sup>33</sup>
- To improve labor organization within firms, productivity and labor skills will take precedence over seniority as the main criteria for promotion and filling vacancies, increasing incentives to invest in human capital.<sup>34</sup> The law recognizes training as the most important factor for increasing productivity and establishes a National Committee for Productivity, aimed at fostering labor quality and certification of labor skills.

**82. The new law enhances micro flexibility, increasing the ability of the economy to allow for the reallocation of workers to jobs needed to sustain productivity growth.** Contracting modalities that allow for probationary periods and training/skill development allow employees to gain necessary knowledge and employers to determine whether the workers can perform satisfactorily. This in turn increases labor mobility and workers' incentives to look for more productive jobs or train and acquire new skills in the formal sector. On the other hand, fewer frictions and greater certainty with regard to hiring and firing practices allows industries with cyclical demand to function more efficiently, enhancing the economy's ability to adjust to macroeconomic shocks. Overall, these effects would make the economy more efficient in the allocation of resources, helping increase total factor productivity and potential growth.<sup>35</sup>

**83. The new legislation expands worker's rights and social protection guarantees.** The law adopts the concept of "decent work", established by the International Labor Organization, which underscores the respect for the dignity of workers, and broadens the non-discrimination clause to include ethnic origin, nationality, disability, age, religion, immigration status, health status, sexual preference and marital status. The law also gives greater protection to vulnerable groups. For instance, it establishes that employers must provide adequate facilities for people with disabilities and formally bans child labor under 14 years of age.

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<sup>33</sup> If an employee challenged a dismissal, resolution of that dispute could take years. Meanwhile, the employer would be liable for continuously accumulating back pay and other fines until the case was resolved, even if the employee found a new job. These open-ended liabilities encouraged companies to operate in the informal economy, where workers could be hired and fired easily and were not entitled to benefits.

<sup>34</sup> Previously, seniority, not merit, was a major factor in promotions. Under the reform, employers will be able to use merit-based systems and offer productivity and performance bonuses. In promotions, companies may now consider a worker's skill and productivity before seniority.

<sup>35</sup> More flexible contracts could also motivate people previously not willing to work to find employment, and thus join the labor force.

**84. The labor reform aims for a more inclusive labor market, increasing youth and female labor force participation and gender equality in the workplace.**

The introduction of short-term and hourly contracts could have a positive impact on the quality of job creation— making it easier for young people (i.e., students) and women to find part-time jobs. The law also strengthens the protection of working women: it bans mandatory pregnancy tests and marital status questions that might discriminate against women in the hiring process, and explicitly forbids an employer from asking a woman to resign because she becomes pregnant. In addition, women will now have more flexibility in using their legally mandated six weeks of required annual leave before and after giving birth. Lastly, it imposes more severe penalties for bullying and sexual harassment.

**85. While it is premature to arrive at a firm estimate of the reform’s impact on growth, the central bank estimated that the labor reform could add about 0.2 percent per year to potential growth.**

Using a production function approach, Alcaraz et al (2013) estimated the impact of the labor reform mainly through its effects on formal job creation, the shift of employment from the informal to the formal sector, and an increase in labor productivity in the formal sector. According to the authors, the introduction of more flexible contracts is expected to lower youth unemployment and lead to an increase in formal employment, while the availability of hourly employment and wages will provide incentives for part-time salaried workers (typically in the informal sector) to shift to formal jobs. Also, the introduction of a cap on back wages would reduce costs associated with employment termination, implying a reduction of approximately 20 percent in hiring barriers in the formal sector. At the same time, training and trial contracts and the precedence of productivity over seniority are expected to increase formal workers’ productivity.

**86. While the Fund did not have a direct role in the 2012 labor market reforms, it had previously suggested that the authorities consider changes to labor market regulations.**

IMF (2010), for example, states that “...labor market reforms being discussed go in the right direction, but more action will be needed to increase flexibility”. IMF (2011) also notes that an expedition of reforms to enhance labor market efficiency would help create a more dynamic labor market, including among the young.

**87. An education reform program of Mexico’s public school system was signed into law in 2013, which could enhance inclusive growth.**

While enrollment has increased over the years, the quality of education remains below that of peers. Mexico ranks last in the Organization for Economic Cooperation and Development’s Program for International Student Assessment. A major cause of poor performance is that Mexico’s teaching profession is weak and poorly managed (Hanson, 2012). One of the key changes in the education reform is to create a professional system for evaluating, hiring, assigning and promoting teachers, while reducing labor unions’ interference on access to teaching positions. Enhancing the quality of education would, among other things, reduce the skills gap and help integrate more of the labor force into the formal sector.

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## XII. NAMIBIA: PROMOTING INCLUSIVE GROWTH AND EMPLOYMENT<sup>36</sup>

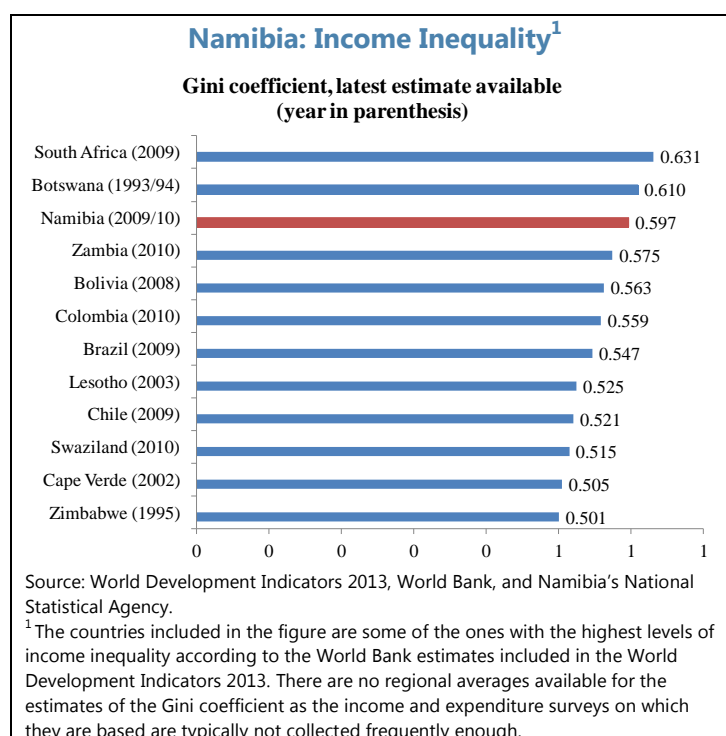
Despite the initial success after Independence in reducing inequality, Namibia remains among the countries with the highest levels of income inequality in the world. While growth over the last two decades has been inclusive, it has become less so over time. In order to increase the inclusiveness of growth, it is recommended that a thorough review of the targeting of public transfers and social programs is conducted to assess the extent to which they are reaching their intended beneficiaries. Given the importance of labor income as the main source of income for the great majority of Namibians, the issue of inclusive growth cannot be analyzed independently of the labor market, where high unemployment continues to be a major challenge.

### 88. Since Independence Namibia has managed to significantly reduce poverty and income inequality.

Nevertheless, despite the progress achieved, inequality in Namibia remains among the highest in the world, and the rate at which inequality has declined has slowed down: whereas the Gini coefficient declined from 0.70 in 1993/94 to 0.60 in 2003/04, it declined only marginally since 2003/04, to 0.59 in 2009/10.

### 89. Given that labor income is the main source of household income, the issue of income inequality is related to the other main challenge in Namibia, namely, the high and persistent unemployment rate.

According to the latest National Income and Expenditure Survey (NIES) corresponding to the years 2009/10, labor income constituted on average 72.3 percent of total income in Namibia, with 49.2 percent corresponding to wages and salaries and 23.1 percent to income from subsistence farming. According to the same survey, the unemployment rate remains high at 34 percent.



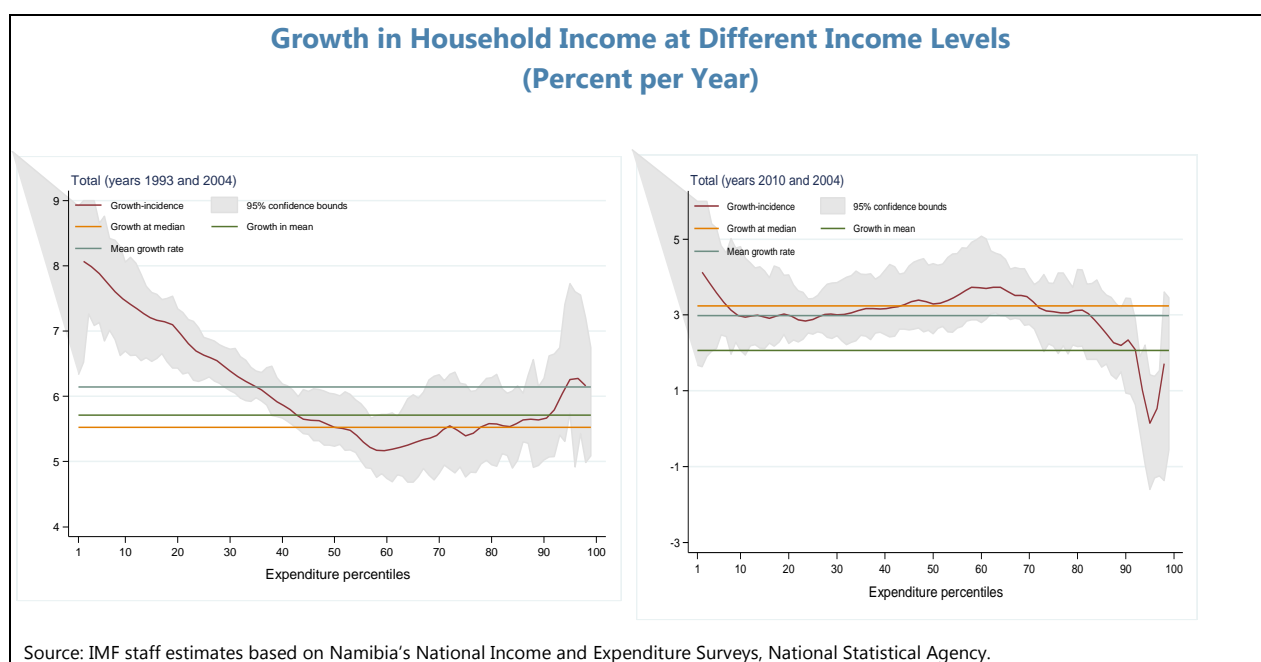
<sup>36</sup> This case study is a summary of "Promoting Inclusive Growth and Employment in Namibia," prepared by Rodrigo Garcia-Verdu (AFR), Antonio David (ICD) and Floris Fernanço Fleermuys (AFR), which appeared as Appendix V in the 2012 Staff Report of the Article IV Consultation for Namibia.



**90. Thus, one of the key challenges for the Namibian economy is how to sustain high growth while decreasing inequality and unemployment.** This case study summarizes part of the work that the IMF country team has done on the related issues of income inequality, unemployment, and inclusive growth. In particular, it focuses on the issue of the incidence of growth in Namibia and how inclusive has growth been over the past two decades, applying the methodology used in Chapter 2 of the African Department’s Fall 2011 SSA Regional Economic Outlook (REO). In particular, the growth incidence curves for real consumption per capita are estimated and compared for the sample periods 1993/94–2003/04 and 2003/04–2009/10.

**91. The results suggest that, compared to other sub-Saharan African countries analyzed in IMF (2011), Namibia has performed relatively well in terms of the inclusiveness of growth.**

Namibia, registered positive growth in real consumption per capita for all segments of the population over the eleven-year-period from 1993 to 2010. Growth was inclusive in both absolute and relative terms during the initial period (1993/04–2003/04), since households in the lower per capita income deciles registered higher growth rates than households in the middle and upper deciles. This is consistent with the significant decline in the Gini coefficient registered over this period. This positive outcome likely reflects the impact of post-independence social policies that targeted those segments of the population that had been excluded under the previous regime.



**92. Despite Namibia’s favorable inclusive growth pattern in the early stage following Independence, from 2003/04 to 2009/10 growth became much more neutral in terms of its incidence across per capita income deciles.** The growth incidence curve lost much of its slope during the second period, so even while growth benefited all households it did not benefit the poorest as much as in the earlier period. Thus, growth became less inclusive in a relative sense. This

is consistent with the fact that the Gini coefficient declined only marginally in Namibia.<sup>37</sup> The deceleration in the mean and median growth rates of real consumption per capita is noticeable in the graph, since in the second period the whole growth incidence curve shifted downwards.

**93. This change in the incidence of growth has possibly been the result of weaker targeting or leakage of social program, and of the expansion of expenditure not targeted to the poor, which have resulted in government expenditure become less progressive.** While testing this hypothesis requires using disaggregated data on income by source (labor earnings, rental income, pensions, social transfers, etc.), the fact that further reductions in inequality are proving more difficult should be a source of concern as the level of inequality in Namibia is still among the highest in the world.

**94. In order for Namibia to return to the inclusive growth pattern registered over the first decade after Independence, a rationalization and reallocation of government expenditures (including tax expenditures) should be undertaken to increase their progressiveness.** Namibia's public expenditures as a share of GDP are among the highest among upper-middle income countries. It is possible to reallocate public expenditures in a way that keeps total spending constant while increasing its progressiveness: based on a thorough analysis of the incidence of public expenditures, social programs and public transfers that do not reach or benefit their intended beneficiaries should be corrected or eliminated. Potential pockets of inefficiencies should also be identified and eliminated.

**95. The second crucial element for increasing the inclusiveness of growth in Namibia is improving the performance of the labor market.** As mentioned before, labor is the main source of income in Namibia, and unemployment has remained very high. On the determinants of unemployment in Namibia, the results of the recent work by Leigh and Flores (2012), shows that the high level of unemployment in the SACU region is attributable to structural rather than cyclical factors. In particular, their work shows that structural factors, including rapid wage growth above productivity increases, the existing skills mismatch, and the wage policies in the public sector can account for most of the high level of unemployment in the region. Namibia's Targeted Intervention Initiative for Employment and Economic Growth (TIPEEG) needs to be complemented with policies to address these structural factors.

**96. The policy dialogue with the Namibian authorities has focused on policies to reduce unemployment.** The IMF country team's analysis of the labor market in Namibia suggests that TIPEEG, a temporary workfare program, might have medium-term benefits by allowing youths to enter the labor force and gain valuable job experience. Nevertheless, the team advised that the program would need to have a skill development component to maximize its job creation potential on a sustainable basis.

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<sup>37</sup> It should be noticed, though, that the Gini coefficient corresponds to income, while the growth incidence curve corresponds to consumption per capita.

**97. A related area of the policy dialogue between the IMF team and the government of Namibia has been the government's wage and employment policies and their broader impact on the rest of the economy.** The public sector employs a significant share of the employed population (16 percent). Furthermore, government employees (including those working for state-owned enterprises) constitute about one out of every four salaried employees in Namibia. As a result of its size as an employer, the government's wage policies are likely to affect the functioning of the whole labor market. The IMF's country team advice to the government has been to take into account potential impacts of its wage and employment decisions on private sector job creation, and that public wage increases should be in line with sustainable increases in labor productivity.

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## XIII. SPAIN: LABOR MARKET REFORMS<sup>38</sup>

### Background

**98. After a brief stabilization in 2011, the Spanish economy fell back into recession in 2012 as the euro area debt crisis deepened in the south of Europe.** Pulled down by falling house prices, fiscal consolidation, banking sector stress and falling real household income, GDP contracted 1.4 percent in 2012, ending the year nearly 5 percentage points below peak.

**99. Unemployment rose to 25 percent in 2012, with youth unemployment reaching 50 percent.** The causes behind the increase in unemployment were: (i) the collapse of the construction sector; (ii) a lack of competitiveness, as wages in Spain had outpaced the rest of the euro area by around 15 percent since 2000; (iii) duality in the labor market, with very high external flexibility provided by temporary contracts; (iv) restrictions to firms' internal flexibility, fostered by an intermediate level of collective bargaining and the insider/outsider problem (since workers under permanent contracts were highly protected).

**100. The large increase in unemployment drove a surge in income inequality.** Spain was not able to afford a safety net wide enough to protect 6 million unemployed. By the end of 2012, only a quarter of the unemployed benefitted from regular unemployment insurance, whilst another quarter received more limited unemployment assistance. The remaining half of the unemployed population was not eligible for any unemployment benefits. As a result, the Gini coefficient increased by 6 percentage points between 2007 and 2010, one of the largest deteriorations in the OECD.<sup>39</sup> UNICEF (2012) estimated that 26 percent of children live in poverty in Spain, an increase by 10 percent from pre-crisis levels.<sup>40</sup>

### Policy measures

**101. Spain's ability to restore growth using macroeconomic management was constrained by its membership in the euro area and thus the absence of the monetary and exchange rate policy tool.** These constraints were worsened by the increase in financial fragmentation between periphery and core banking systems. Nevertheless, several steps were taken to limit the drag of the needed fiscal and external adjustments. Spain, in agreement with its European partners, slowed the pace of fiscal consolidation. The banking sector was restructured and recapitalized under an ESM-financed program. Spanish yields also benefitted from several ECB announcements intended to protect the euro.

<sup>38</sup> Prepared by Raphael Espinoza (RES)

<sup>39</sup> OECD Income Distribution Database ([www.oecd.org/social/income-distribution-database.htm](http://www.oecd.org/social/income-distribution-database.htm))

<sup>40</sup> UNICEF (2012), *La Infancia en España (2012-2013): El impacto de la crisis en los niños*.

**102. In 2012, the government embarked on an ambitious structural reform agenda.** A major labor market reform was enacted and retail hours were liberalized. Some measures to protect vulnerable households at risk of eviction were passed as well. Further reforms, yet to be implemented, have been announced to reduce the regulatory burden of trading within Spain and to liberalize professional services.

### **Labor market reform**

**103. The 2012 labor market reform was far-reaching, targeting the main weaknesses in the labor market:**

- (i) *Duality.* The difference in employment protection between workers under different types of contract was reduced. The renewal of temporary contracts was limited to 2 years maximum, and a new, more attractive, permanent contract was created for small firms.
- (ii) *Internal flexibility.* Priority was given to firm-level agreements over provincial or industry-wide collective agreements. The period during which expired collective agreements are automatically extended was limited to a maximum of one year. In addition, the use of opt-out clauses from collective agreements was clarified. The use of temporary dismissals and work hours reduction was facilitated.
- (iii) *Active Labor Market Policies.* Hiring subsidies were overhauled, with a reduction by half of the number of subsidized contracts. The replacement rate for unemployment benefits after 6 months was reduced by 10 percent.

### **Complementarities and trade-offs considered**

**104. The labor market reform was necessary to create a basis for growth in the medium term through a large internal devaluation.** But there were possible short term tradeoffs on growth, employment and income distribution in the event that the necessary wage flexibility would not be sufficiently forthcoming. In particular, some components of the reform (e.g., the reduction of dismissal costs) had the potential to accelerate job destruction during the crisis. The restriction to the use of temporary contracts may also slow down hiring when the economy recovers. Further, the reduction in unemployment benefits could exacerbate inequality.

**105. To mitigate the adverse effects on income distribution, the government implemented a modest extension of the unemployment assistance program.** Room for addressing adverse effects on growth was limited by tight constraints on fiscal policy and the absence of the monetary and exchange rate policy tool.

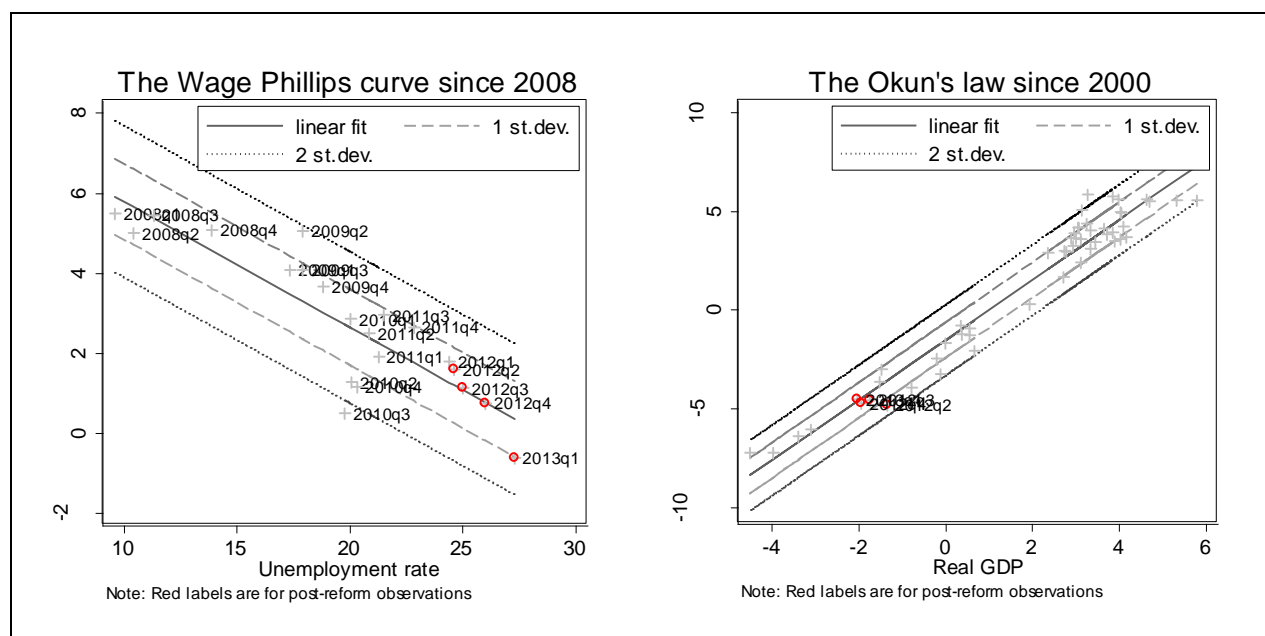
**Outcomes**

**106. The labor reform has had some positive effects.** Firms’ internal flexibility was improved and dismissal costs for workers under permanent contracts were reduced significantly. The priority given to firm level agreement and the reduced protection of workers under permanent contracts accelerated wage moderation.

**107. Thus, at the beginning of 2013, wage inflation in the private sector was negative for the first time in 2½ years.** Although not all of the extent of wage moderation can be attributed to the reform, an estimated wage Phillips curve suggests that some of the wage moderation could be explained by the labor market reform. The resulting improvement in competitiveness contributed to solid export growth. Nevertheless, wage moderation has not been commensurate to the internal devaluation required and to the need to reduce drastically unemployment.

**108. So far, the reform has also not measurably reduced duality.** The probability of finding a permanent job remains as low as before the reform, and the high probability of losing a job under a temporary contract remains unchanged. The new permanent contract for small firms has been used little.

**109. Meanwhile, the recession has deepened and GDP contracted by 2 percent in 2013-Q1.** Employment destruction accelerated; in fact, job destruction so far was no better than could have been predicted using a standard Okun’s Law. The unemployment rate reached 27.3 percent at the beginning of 2013.



## Fund involvement and recommendations

**110. The Fund, along with the ECB and the European Commission, emphasized the need to set up an independent evaluation of the reform.** The government decided to involve an international organization (such as the OECD) in its own assessment of the reform. Discussions with labor lawyers, Supreme Court judges, and think tanks also allowed the Fund to provide suggestions on how to clarify some elements of the reform and reduce legal uncertainty.

**111. The Fund also suggested additional measures to deepen the reform and minimize its adverse effects.** Fund advice was geared to the need to proceed with internal devaluation in the hopes of boosting employment immediately. In particular, the Fund recommended facilitating opt-outs from collective agreements and reducing labor costs (including taxes) on low-skilled workers. Aware of the potential adverse short-term effects of labor market reforms on growth, employment, and income distribution, the Fund argued that the fastest way to reap the benefits of the labor reform was to reach a tri-partite agreement based on commitments by employers to create jobs, in exchange for labor unions accepting further wage moderation.